

Canara Bank

March 29, 2019

Summary of rating action

Instrument*	Previous Rated Amount(Rs. crore)	Current Rated Amount(Rs. crore)	Rating Action
Additional Tier-I Bonds Programme – Basel III	1,500	1,500	[ICRA]AA (hyb) (negative); outstanding
Tier-II Bonds Programme – Basel III	7,900	7,900	[ICRA]AAA (hyb) (negative); outstanding
Lower Tier-II Bonds Programme	325	325	[ICRA]AAA (negative); outstanding
Certificates of Deposit Programme	20,000 [^]	30,000 [^]	[ICRA]A1+; Assigned/outstanding
Total	29,725	39,725	

* Instrument details are provided in Annexure-1

[^] Amount outstanding, as on March 25, 2019, was Rs. 12,100 crore

ICRA has reaffirmed the short-term rating of [ICRA]A1+ (pronounced ICRA A one plus) for the certificates of deposit (CD) programme of Canara Bank, for an enhanced amount of Rs. 30,000 crore (previously Rs. 20,000 crore). ICRA has ratings outstanding of [ICRA]AAA(hyb) (pronounced ICRA triple A hybrid) on the Rs. 7,900-crore Basel III compliant tier-II bonds programme, [ICRA]AA (hyb) (pronounced ICRA double A hybrid) on the Rs. 1,500-crore¹ Basel III compliant additional tier-I (AT-I) bonds programme and [ICRA]AAA (pronounced ICRA triple A) on the Rs. 325-crore lower tier-II bond programme of Canara Bank². The outlook on the long-term ratings is Negative.

The rating for the Basel III compliant tier-I bonds (AT-I bonds) is two notches below the Basel III compliant tier-II bonds of the bank, as these instruments have the following loss-absorption features that make them riskier:

- Coupon payments are non-cumulative and discretionary, and the bank has full discretion, at all times, to cancel coupon payments. Cancellation of discretionary payments shall not be an event of default.
- Coupons can be paid out of current year profits. However, if the current year profit is not sufficient or if the payment of the coupon is likely to result in a loss, the payment can be made through reserves and surpluses³ created through the appropriation of profits (including statutory reserves). As per ICRA's estimates, these reserves and surpluses stood at 4.16% of the risk-weighted assets (RWAs) as on December 31, 2018. However, the coupon payment is subject to the bank meeting the minimum regulatory requirements for CET I, Tier I and total capital ratios (including capital conservation buffer, CCB) at all times, as prescribed by the Reserve Bank of India (RBI) under Basel III regulations.

These tier-I bonds are expected to absorb losses through the write-down mechanism at the objective pre-specified trigger point fixed at the bank's CET I ratio as prescribed by the RBI – 5.5% till March 2019, and thereafter 6.125% of the total RWAs of the bank or when the point of non-viability (PoNV) trigger is breached, in the RBI's opinion.

¹ 100 lakh = 1 crore = 10 million

² For complete rating scale and definitions, please refer to ICRA's website (www.icra.in) or other ICRA rating publications

³ Calculated as per the amendment in the Basel III capital regulations for AT-I bonds by the RBI, vide its circular dated February 2, 2017; as per the amended definition, distributable reserves include all reserves created through appropriations from the profit and loss account

The letters 'hyb', in parenthesis, suffixed to a rating symbol stand for hybrid, indicating that the rated instrument is a hybrid subordinated instrument with equity-like loss-absorption features. Such features may translate into higher levels of rating transition and loss severity vis-à-vis conventional debt instruments.

Rationale

The rating reaffirmation on the short-term borrowing programme of the bank factors in its comfortable liquidity profile with positive cumulative mismatches in the up to 1-year buckets, as per the structural liquidity statement (SLS) as on February 28, 2019. Supported by its established retail liability franchise and therefore, stable core deposits, Canara's liquidity coverage ratio (LCR) remained adequate at 106.93% (average for the quarter) as on December 31, 2018, above the regulatory requirement of 90%⁴. The ratings remain supported by the bank's sovereign ownership (the Government of India (GoI) had a shareholding of 70.62% in Canara as on February 15, 2019) and its established franchise with a strong presence in the southern states. ICRA also takes note of the steady growth in the bank's advances, primarily on account of healthy growth in retail credit coupled with good growth in the agriculture and MSME segments. Continued focus on credit growth via these segments has helped the bank conserve capital, as reflected by the decline in the RWAs/advances ratio to 87.39% as on December 31, 2018 from 91.27% as on December 31, 2017.

The Negative outlook on the long-term ratings reflects the weak asset quality resulting in a weak solvency and earnings profile. This, in turn, has led to a reduction in the capital cushions in the absence of any significant capital raising and/or capital infusion by the GoI in the current financial year. Though the pressure on the bank's asset quality, in terms of fresh slippages, is expected to reduce in FY2020, the low provision cover on the existing stock of stressed assets is expected to keep credit costs high at 1.3-1.5% of ATA in FY2020. This will translate into a weak earnings profile. With increasing regulatory capital levels in FY2020 and weak internal capital generation, the bank will require both regulatory as well as growth capital, in our view. ICRA estimates Canara's overall Tier I capital requirement at Rs. 6,000-Rs. 7,500 crore (30-40% of the current market capitalisation) in FY2020, for growth as well as for maintaining a cushion over the regulatory capital requirements.

Outlook: Negative

The Negative outlook reflects the bank's large capital requirement so that it can maintain comfortable capital cushions and improve its solvency levels. The outlook will be revised to Stable at the current rating level if the bank is able to raise the required capital to improve the capital cushions and the provision cover and solvency levels. The management had guided towards capital raisings and divestments in FY2019, which have not yet materialised. As a result, there has not been a significant improvement in the solvency profile and the capital cushions remain weak. This remains a credit negative for the bank.

Key rating drivers

Credit strengths

Sovereign ownership with demonstrated capital support from GoI – Canara has a majority sovereign ownership with the GoI's shareholding at 70.62% as on February 15, 2019. The stake declined from 72.55% as on March 31, 2018 as the bank issued shares to employees under the employee share purchase scheme (ESPS) and did not receive any capital infusion from the GoI in FY2019. The GoI has demonstrated capital support to the bank in the past, as reflected by the total capital infusion of Rs. 1,695 crore during FY2016 and FY2017 and an additional infusion of Rs. 4,865 crore in FY2018

⁴ Regulatory LCR requirement has increased to 100% from January 01, 2019

as a part of its public sector bank (PSB) recapitalisation programme. Despite the large budgeted capital infusion of Rs. 1.06 lakh crore in various PSBs in FY2019, Canara Bank has not received any capital from the GoI in the current fiscal. This, along with the lack of other capital raisings, has weakened the bank's capital cushions compared to the previous year. As per ICRA's estimates, the bank's capital requirement for FY2020 remains high and it will remain dependent on the GoI to meet a part of its capital requirement to maintain comfortable capital cushions over the regulatory levels. Continued GoI support/ability to raise capital from alternate sources to maintain capital cushions above the regulatory levels will remain a key rating driver, going forward.

Established franchise with widespread branch network in South India – As on December 31, 2018, Canara Bank was the fourth-largest PSB and seventh-largest bank in the Indian banking system (in terms of asset base), aided by its established retail franchise and strong presence in South India. It has a widespread network of 6,307 branches as on December 31, 2018, with ~45% branches located in the five southern states. Supported by an established branch network, the bank's low-cost current account and savings account (CASA) deposits increased by 10.6% to Rs. 1,74,391 crore as on December 31, 2018 from Rs. 1,57,586 crore as on December 31, 2017 and was better than the PSBs' average CASA growth of 6.7% YoY. However, with higher growth in total deposits (14.2% YoY), primarily on account of the growth in larger-ticket term deposits (TDs), the bank's CASA share in total deposits declined to 32.23% as on December 31, 2018 and remained below the PSB average of ~38.6%. While the management has guided towards increasing the CASA share to ~37% by March 31, 2020, the same will depend on the credit growth pursued by the bank, as the need for pursuing high deposit growth will increase the bank's reliance on bulk deposits, thereby reducing the share of CASA deposits. With lower CASA share and strong growth in large-ticket TDs, the bank's average cost of interest-bearing funds stood at 5.50% in Q3 FY2019 compared to 5.27% in Q3 FY2018 and remained above the PSB average of 5.19% and 5.09%, respectively. It remains competitive in relation to the overall banking sector average of 5.29% for Q3 FY2019 and 5.05% for Q3 FY2018.

Steady credit growth aided by strong growth in retail book – Canara Bank's net advances grew by 11.82% YoY to Rs. 4,17,227 crore as on December 31, 2018 from Rs. 3,73,123 crore as on December 31, 2017 compared to the banking sector average of 8.42%. This was aided by strong growth in the bank's retail advances, which increased by 24.76% YoY, with the agriculture and MSME segments also reporting good growth of 11.20% and 11.47%, respectively. Growth in these segments align with the bank's focus on capital optimised growth. This is reflected in the reduced RWA/advances ratio of 87.39% as on December 31, 2018 against 91.27% as on December 31, 2017. The management has guided towards continued focus on growth in the retail, agriculture and MSME (RAM) segments and seeks to increase the share of RAM in total credit to 60% by March 31, 2020 from 52% as on December 31, 2018.

Credit challenges

Solvency remains weak due to low provisioning cover on NPAs; incremental stress expected to reduce going forward – Canara Bank's asset quality remains weak with an elevated annualised slippage rate of 4.8% of standard advances in 9M FY2019. This, however, remained below the fresh slippage rate of 7.7% for FY2018. Gross slippages, after moderating in H1 FY2019, increased in Q3 FY2019 as certain large infrastructure exposures slipped into the non-performing asset (NPA) category. Despite elevated slippages, gross NPA (GNPA) declined to Rs. 44,621 crore (10.25%) as on December 31, 2018 from Rs. 47,468 crore (11.84%) as on March 31, 2018, supported by improved recoveries and upgradations of Rs. 8,509 crore (Rs. 3,184 crore in FY2018) and sizeable write-offs of Rs. 7,349 crore (Rs. 8,310 crore in FY2018) in 9M FY2019. Canara's provision coverage ratio (PCR)⁵ stood at 40.41% as on December 31, 2018 against 39.87% as on March 31, 2018 and was much lower than the PSB average of 55.98% as on December 31, 2018. Accordingly, the net NPA (NNPA) declined but remained high at Rs. 26,591 crore (6.37%) as on December 31, 2018 against Rs. 28,542 crore (7.48%) as on March 31, 2018. With elevated GNPA and a low provision cover, the solvency level, as reflected by Net NPA/Net worth, remained weak at 88.4% as on December 31, 2018 (98.2% as on March 31, 2018).

⁵ PCR is calculated excluding technical write-offs (TWOs)

As guided by the management, the SMA-2⁶ advances stood at Rs. 3,491 crore (0.9% of standard advances) against ~Rs. 5,000 crore as on September 30, 2018 (reduction majorly on account of slippages in Q3 FY2019) while the SMA-1 book stood at Rs. 8,294 crore (~2.1% of standard advances). This represents a potential source of slippages during the next few quarters.

With continued provisioning and net reduction in GNPA's, we expect the NNPA's to decline further to 6.1% by March 31, 2019 (assuming PCR to improve to 43.5%) even though the solvency level should remain weak at ~86% as on March 31, 2019. For FY2020, we expect a gross slippage rate of 2-3% of standard advances though the provisioning levels, NNPA's and solvency level will be driven by the extent of capital raised by the bank. Based on our estimates of capital raised, we expect the provision cover to increase to 63-64%, leading to a decline in NNPA to 3.7-3.9% with solvency of 54-59%, which will still remain weak.

Weak profitability profile with the same expected to remain weak in FY2020 as well – Canara's profitability remains weak with the bank reporting a net profit of Rs. 899 crore (0.19% of ATA) in 9M FY2019 against a net profit of Rs. 638 crore (0.14% of ATA) in 9M FY2018 and a net loss of Rs. 4,222 crore (-0.71% of ATA) in FY2018. The profitability remains constrained by the elevated GNPA levels, which lead to high credit costs. Credit provisions, as a percentage of ATA, increased to 1.59% in 9M FY2019 from 1.34% in 9M FY2018.

While the net profitability remained weak, operating profitability registered strong growth, with operating profits⁷ increasing by 26% to Rs. 7,457 crore in 9M FY2019, aided by sizeable recoveries in NPA accounts. The improvement was also supported by strong growth in net interest income (NII) due to healthy growth in standard advances and an increased lending rate, which offset interest reversals on account of higher slippages during this period. The NII stood at 10,978 crore in 9M FY2019, up 20% YoY from Rs. 9,176 crore in 9M FY2018. As a result, net interest margins (NIMs⁸) improved to 2.29% in 9M FY2019 from 2.09% in 9M FY2018.

Though the bank reported net profits in 9M FY2019, its profitability remains susceptible to incremental credit costs considering the low provision cover (40.41% as on December 31, 2018) on its gross NPA. While factoring in the low provision cover and assuming an increased provision cover of 63-64% by March 31, 2020, ICRA expects credit provisions for the bank in the range of 1.3-1.5% of ATA in FY2020. This will lead to weak profitability with expected RoA of ~0.1% of ATA. Further, given the weak internal accruals, Canara's ability to pursue credit growth may be curtailed if it is unable to raise fresh capital as regulatory capital levels will increase in FY2020. This may restrict growth in its operating profits next year.

Sizeable capital requirement in FY2020 to maintain healthy capital cushions in relation to rating category – The bank's capital ratios remain adequate in relation to the regulatory capital requirements⁹. However, in the absence of capital infusion by the GoI or capital raising as expected earlier, the capital cushions have been declining. Canara's capital ratios, i.e., CRAR, Tier I and CET I stood at 12.21%, 9.54% and 8.81%, respectively, as on December 31, 2018, declining from 13.22%, 10.30% and 9.51%, respectively, as on March 31, 2018. The bank raised Rs. 557 crore in January 2019 by issuing shares to its employees under the ESPS. Further, it has the board's approval to raise Rs. 6,000 crore of capital via a

⁶SMA stands for special mention account and is bucketed into three categories - SMA0 (overdue by 1-30 days), SMA1 (overdue by 31-60 days) and SMA2 (overdue by 61-90 days)

⁷Operating profit excludes trading profits

⁸NIM = NII/ATA

⁹Minimum regulatory CRAR, Tier I and CET I as on March 31, 2019 is 10.875%, 8.87% and 7.375%, respectively (including CCB of 1.875%). From March 31, 2020, the CCB requirement would increase to 2.5%

qualified institutional placement (QIP) of equity shares in addition to raising Rs. 3,000 crore via AT-I bonds. However, these have not materialised so far.

With expectations of weak internal accruals, continued credit growth and limited capital infusion, Canara's capital cushion is expected to decline in the near term though it will remain above the regulatory requirements (including CCBs) for March 31, 2019. However, ICRA expects Canara to require regulatory as well as growth capital in FY2020, given the increasing regulatory requirements for March 2020 and weak internal accruals in FY2020. With 5-7% growth in RWA and a provision cover of 63-64%, ICRA estimates Canara's overall Tier I capital requirement at Rs. 6,000-Rs. 7,500 crore (30-40% of the current market capitalisation) in FY2020, so that it can maintain a capital cushion of ~100 bps over the regulatory Tier I requirements. If the bank pursues higher credit growth, its capital requirement would increase. To raise capital, the bank had earlier stated its plans to monetise its non-core assets, especially Can Fin Homes (Canara has a 30% stake), which has not materialised yet. ICRA expects the capital mobilised through divestments to meet only a part of the estimated capital requirement and the bank will need to raise capital from the market or depend on the GoI for the requisite capital. In a scenario where it is unable to raise the required amount, the bank may conserve capital by keeping the provision cover below the ICRA-assumed level stated earlier and by curtailing growth.

Canara can meet a part of its Tier I capital requirements through the issuance of AT-I bonds. It had Rs. 2,500 crore (0.73% of RWA) of AT-I bonds outstanding as on December 31, 2018. The bank's ability to service these bonds remains contingent on its meeting the regulatory capital requirements and reporting profits (including retained earnings). Canara's distributable reserves (DR), as a percentage of RWA, have been declining because of the losses reported in FY2018 and an increase in RWA. DR/RWA stood at 4.16% as on December 31, 2018 compared to 5.24% as on December 31, 2017. Assuming expectations of weak internal accruals in FY2020 and continued RWA growth, ICRA expects DR/RWA to decline further to 3.8-4.0% by March 31, 2020.

Liquidity position

As per its SLS dated February 28, 2019, the bank's liquidity profile was comfortable with positive cumulative mismatches in the up to 1-year buckets. Supported by its established retail franchise and, therefore, stable core deposits, Canara's LCR remained adequate at 106.93% (average for the quarter) as on December 31, 2018, above the regulatory requirement of 90%. Moreover, as on December 31, 2018, the bank was holding excess SLR of Rs. 19,455 crore (~3.4% of total deposits), which adds to the liquidity comfort. ICRA draws further comfort from the liquidity support available to the bank from the RBI (through reverse repo against excess SLR investments and the marginal standing facility scheme), which can be availed in case of urgent liquidity needs.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA Rating Methodology for Banks
	Impact of Parent or Group Support on an Issuer's Credit Rating
Parent/Group Support	The ratings factor in Canara's sovereign ownership and the demonstrated track record of capital infusion by the GoI. ICRA expects the GoI to support Canara with capital support, if required
Consolidation/Standalone	To arrive at the ratings, ICRA has considered the standalone financials of Canara

About the company

Canara is a large nationalised bank with the GoI owning a majority stake of 70.62% as on February 15, 2019. Headquartered in Bangalore, Canara has a pan-India presence, directly through a network of 6,307 branches and seven subsidiaries, an associate company and a joint venture. The Group provides a wide range of financial offerings including asset management, online trading, factoring and housing finance. As on December 31, 2018, the bank had 8.59 crore clientele accounts.

The bank reported a net profit of Rs. 899 crore in 9M FY2019 on a total asset base of Rs. 6.65 lakh crore as on December 31, 2018 against a net profit of Rs. 638 crore in 9M FY2018 on a total asset base of Rs. 5.94 lakh crore as on December 31, 2017. Canara's gross and net NPAs stood at 10.25% and 6.37%, respectively, as on December 31, 2018. The bank reported a Tier I capital ratio of 9.54% and CRAR of 12.21% as on December 31, 2018.

Key financial indicators - Standalone (audited)

	FY2017	FY2018	9M FY2018	9M FY2019
Net Interest Income	9,872	12,163	9,176	10,978
Profit before Tax	1,642	(6,561)	750	223
Profit after Tax	1,122	(4,222)	638	899
Net Advances	3,42,009	3,81,703	3,73,123	4,17,227
Total Assets	5,78,146	6,10,361	5,94,453	6,65,689
% CET 1	8.92%	9.51%	8.75%	8.81%
% Tier 1	9.77%	10.30%	9.57%	9.54%
% CRAR	12.86%	13.22%	12.48%	12.21%
% Net Interest Margin / Average Total Assets	1.75%	2.05%	2.09%	2.29%
% Net Profit / Average Total Assets	0.20%	-0.71%	0.14%	0.19%
% Return on Net Worth	3.96%	-14.52%	2.97%	4.05%
% Gross NPAs	9.65%	11.84%	10.38%	10.25%
% Net NPAs	6.33%	7.48%	6.93%	6.37%
% Provision Coverage (excl. technical write-offs)	36.70%	39.87%	37.25%	40.41%
% Net NPA / Net Worth	76.46%	98.15%	87.38%	88.36%

Total assets and net worth exclude revaluation reserves

Note: Amounts in Rs. crore

Source: Canara Bank, ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years

Instrument	Type	Current Rating (FY2019)				Chronology of Rating History for the Past 3 Years			
		Amount rated (Rs. crore)	Amount Outstanding (Rs. crore)	Mar-19	May-18	FY2018 Mar-18	FY2017 Dec-16	FY2016 Feb-16	Apr-15
Tier-II Bonds – Basel III	LT	7,900	7,900	[ICRA]AAA (hyb) (negative)	[ICRA]AAA (hyb) (negative)	[ICRA]AAA (hyb) (negative)	[ICRA]AAA (hyb) (negative)	[ICRA]AAA (hyb) (negative)	[ICRA]AAA (hyb) (Stable)
Lower Tier- II Bonds	LT	325	325	[ICRA]AAA (negative)	[ICRA]AAA (negative)	[ICRA]AAA (negative)	[ICRA]AAA (negative)	[ICRA]AAA (negative)	[ICRA]AAA (Stable)
Additional Tier-I Bonds	LT	1,500	1,500	[ICRA]AA (hyb) (negative)	[ICRA]AA (hyb) (negative)	[ICRA]AA (hyb) (negative)	[ICRA]AA (hyb) (negative)	[ICRA]AA (hyb) (negative)	[ICRA]AA (hyb) (Stable)
Certificates of Deposit	ST	30,000	12,100	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+

Complexity level of the rated instrument

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1: Instrument details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE476A08050	Tier-II Bonds - Basel III	27-Apr-16	8.40%	27-Apr-26	3,000	[ICRA]AAA (hyb) (negative)
INE476A08043	Tier-II Bonds - Basel III	7-Jan-16	8.40%	7-Jan-26	900	[ICRA]AAA (hyb) (negative)
NE476A09264	Tier-II Bonds - Basel III	31-Dec-15	8.40%	31-Dec-25	1,500	[ICRA]AAA (hyb) (negative)
INE476A09256	Tier-II Bonds - Basel III	27-Mar-14	9.70%	27-Mar-24	1,000	[ICRA]AAA (hyb) (negative)
INE476A09249	Tier-II Bonds - Basel III	3-Jan-14	9.73%	3-Jan-24	1,500	[ICRA]AAA (hyb) (negative)
INE476A09199	Lower Tier-II Bonds	16-Jan-09	8.08%	16-Jan-19	325	[ICRA]AAA (negative)
INE476A08035	Additional Tier-I Bonds	5-Mar-15	9.55%	Perpetual	1,500	[ICRA]AA (hyb) (negative)
-	Certificates of Deposit	-	-	7-365 days	30,000	[ICRA]A1+

Source: Canara Bank

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