November 13, 2020

Canara Bank: Ratings reaffirmed for Tier II bonds and upgraded for Tier I bonds; Stable outlook assigned

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Basel III Tier II Bonds	7,900.00	7,900.00	[ICRA]AA+ (hyb) (Stable); reaffirmed, removed from Watch with Developing Implications and Stable outlook assigned
Basel III Additional Tier I Bonds	1,500.00	1,500.00	[ICRA]AA (hyb) (Stable); upgraded from [ICRA]AA- (hyb)&, removed from Watch with Developing Implications and Stable outlook assigned
Total	**9,400.00**	**9,400.00**	

**Instrument details are provided in Annexure-1*

Rationale

The rating upgrade for the Basel III Tier I bonds factors in Canara Bank's proposal to set off its accumulated losses against the share premium account. While the proposal is pending regulatory approval, ICRA notes that other public sector banks (PSBs) made similar adjustments recently and some of them have started receiving regulatory approval for the same. The proposed adjustments will significantly increase the bank's distributable reserves (DRs), which can be used to service the coupon on these bonds in a year of loss. As of April 1, 2020, the bank's DRs stood at ~1.5% of the risk-weighted assets (RWAs) and are likely to increase to 5.1%, thereby significantly augmenting its ability to service the coupon on its Tier I bonds.

The rating reaffirmation for the Basel III compliant Tier II bonds factors in Canara Bank's sovereign ownership and the demonstrated track record of the Government of India (GoI) by way of capital infusions into the bank. The continued capital support of the GoI over the past years has enabled the bank to accelerate its provisioning on stressed assets. As a result, the net non-performing assets (NNPAs) of the merged entity (Canara Bank merged with the erstwhile Syndicate Bank effective April 1, 2020) reduced to ~3.42% as on September 30, 2020 from ~5.42% as on September 30, 2019. With this, the solvency profile[1] improved to ~49% as on September 30, 2020 (68% as on September 30, 2019). The rating is also supported by Canara Bank's strong deposit franchise, resulting in a high share of retail deposits and a strong liquidity profile.

The above positives are, however, offset by the merged entity's weak capital position and the expected stress on the asset quality because of the high share of loans under moratorium. While the impact of the Covid-19 pandemic on the asset quality is still evolving, as on September 30, 2020, the bank had not received any repayment since March 2020 on its loans totalling ~4.5% of standard advances. The management has provided a guidance of loan slippages of ~2.0% of standard advances for FY2021 while ~2.0% of the standard loan book is expected to be restructured. This could lead to high credit provisioning over the next couple of years and modest profitability.

[1] *Solvency - Net stressed assets (including NNPAs, net non-performing investments and net security receipt) / Core equity capital*

With limited capital cushion over the regulatory core capital and likely stress on internal capital generation, the bank's Tier I capital requirements remain significant in relation to its market capitalisation. It has proposed an equity capital raise of Rs. 5,000 crore and the GoI has announced ~Rs. 20,000 crore for the recapitalisation of PSBs in FY2021 though the allocation of the same towards different banks is yet to be announced. The bank's ability to raise capital will remain critical for riding out the expected pressure on its asset quality while improving its solvency position and growth.

The Stable outlook factors in ICRA's expectation that the bank will continue to receive sufficient capital support from the GoI, given its increased importance in the Indian banking system. Upon its merger with the erstwhile Syndicate Bank (e-SB), effective April 1, 2020, Canara Bank is the fourth largest PSB in terms of advances and deposit base with a market share of ~6.4% in advances and ~6.7% in total deposits as on June 30, 2020 compared to ~4.5% and ~4.8%, respectively, prior to the merger.

Key rating drivers and their description

Credit strengths

Sovereign ownership with demonstrated capital support from GoI – The GoI held a 78.55% stake in the merged entity as on June 30, 2020 and infused equity capital of ~Rs. 21,449 crore (including e-SB) during FY2016-2020, which has supported the bank's capital profile even though it reported huge losses. The same has enabled the bank to improve its NNPA to less than 4% and maintain the regulatory capital ratios. The GoI has budgeted a capital infusion of Rs. 20,000 crore for PSBs in FY2021, and Canara Bank has proposed a capital raise of ~Rs. 8,000 crore (equity capital of up to Rs. 5,000 crore and debt capital of up to Rs. 3,000 crore). Given the expectations of weak profitability, the said capital raise will be important for the bank to improve its capital cushions over the regulatory levels as well as its solvency profile while achieving growth.

Well-developed deposit franchise – The merger has further strengthened the bank's network, which has become wider with ~10,500 branches and an improved presence in the southern states. Its current account and savings account (CASA) base stood at ~32% of the total deposits as on April 1, 2020, though this was below the PSB average of ~39%. Apart from the lower share of low-cost CASA deposits, the term deposit rate for Canara Bank as well as the amalgamated entity was higher than that of some large PSBs. Hence, the overall cost of interest-bearing funds for the bank on a merged basis was higher at ~5.34% compared to the PSBs' average of ~4.93% in FY2020. Canara Bank continues to offer a higher rate on its term deposits compared to some other PSBs as it has to compete with a few other South-based banks. Therefore, its overall cost of deposits may remain marginally higher than the PSBs' average. Nonetheless, given its widespread network, steady core deposit base and robust retail franchise, ICRA expects the merged entity to maintain its strong liability profile.

Improved systemic importance as fourth largest PSB and sixth largest bank in Indian banking system in terms of advances/deposit base – Prior to the merger, Canara Bank was the fourth largest PSB and seventh largest bank in the Indian banking system with an estimated market share of 4.5% and 4.8%, respectively, in advances and deposits. The merger, with effect from April 1, 2020, has created the fourth largest PSB and sixth largest bank in the Indian banking system with a share of 6.4% of net advances and 6.7% of total deposits as on April 1, 2020. Given the material increase in the bank's size following the merger, ICRA expects it to hold systemic importance in the Indian banking system. While the merged entity is currently not classified as a domestic systemically important bank (D-SIB), its classification in this category could pose additional capital requirements vis-à-vis the regulatory minimum levels.

Credit challenges

Asset quality uncertainty remains, given the still-evolving impact of Covid-19 – As the Covid-19 pandemic has led to stress on the debt-servicing ability of the borrowers, the bank had provided a moratorium to its borrowers during March-August 2020 as allowed by the regulator. At the end of the moratorium period, ~25% of its eligible advances were under moratorium (whereby the borrower had paid three or less instalments out of six instalments during the moratorium period). The collections subsequently improved in September 2020 and the non-paying customers (who have not paid any instalments since March 2020) reduced to ~4.5% of standard advances (or ~Rs. 27,000 crore). This included ~Rs. 6,826 crore (~1.1% of standard advances) as on September 30, 2020, which could have become an NPA had the asset classification not been frozen by the Hon'ble Supreme Court. The Reserve Bank of India (RBI) has also recently allowed banks to restructure loans, while maintaining the asset classification as 'standard', which could reduce the slippages in the near term but could lead to increased uncertainty on the asset quality profile over the medium term.

The impact of the pandemic on the asset quality is still evolving and the management has guided towards a gross fresh slippage rate of ~2.0% of standard advances in FY2021 (~Rs. 10,000 crore against which slippages in H1 FY2021 stood at Rs. 2,089 crore) from the loan pool of non-paying customers as on September 30, 2020. Further, ~2.0% of the standard loan book (~Rs. 12,000-13,000 crore) out of the non-paying borrowers is expected to be restructured. This, along with the existing stock of NNPAs (4.8% as on April 1, 2020 and 3.4% as on September 30, 2020), will lead to high credit provisioning over the next couple of years. The slippage rate provided by the management could increase in FY2021 and FY2022 if the collection efficiency and pace of economic recovery are not sustained in the coming quarters.

Despite the limited slippages in H1 FY2021, the bank's credit provisions remained high at 2.30% of advances largely driven by the provisioning on legacy NPAs. As a result, the provision cover on its stressed assets increased to 81.48% (including technical write-offs) as on September 30, 2020, and the solvency profile improved to ~49.4% of the core capital.

Profitability to remain under pressure over the next two fiscals – Given the marginally higher cost of deposits, the core operating profit of the merged entity is estimated to be relatively weaker in relation to the PSB average. On a merged basis, the operating profitability stood at ~1.12% of average total assets (ATA) in FY2020 (1.31% in FY2019) and was weaker than the PSBs' average of 1.47% in FY2020 (1.44% in FY2019). With elevated credit provisions, the bank reported huge losses on a merged basis during the last two years with an RoA of -0.57% in FY2020 (-0.23% in FY2019). The losses in FY2020, however, also resulted from the harmonisation of the asset quality and provisioning levels of the merging banks apart from various employee-related provisions.

The management has guided towards credit provisions of ~2.75% of advances in FY2021, which could exceed the bank's operating profit. Canara Bank's ability to accelerate provisions will be driven by its ability to raise capital. In the absence of a capital raise, the credit provisions could be lower and the NNPAs could be higher, thereby limiting an improvement in the solvency position. ICRA expects the overall profitability to remain modest with an RoA of less than 0.1% in the current fiscal.

Solvency could weaken unless supported by fresh capital raising – The bank's CET I capital and Tier I capital stood at 8.21% and 9.54%, respectively, as on September 30, 2020, reflecting weak capital cushions over the regulatory requirement of 8.0% and 9.5%, respectively, for April 1, 2021. Given the estimates of an RoA of less than 0.1%, ICRA expects that the bank will require equity capital of Rs. 5,000-7,000 crore to improve the cushion over the regulatory requirements as well as for growth, which the bank has guided towards growth of 6-8% in advances.

Canara Bank has proposed an equity capital raise of ~Rs. 5,000 crore, which could rise if the slippages and the restructuring exceed the guidance provided by the management. In the absence of a capital raise, the bank's ability to reduce its NNPAs will be constrained and its solvency position could weaken from the level of ~49% as on September 30, 2020.

Liquidity position: Strong

The merged entity continues to have a strong liquidity profile as depicted by the excess SLR of over 6% (above the regulatory requirement of 18% of net demand and time liabilities) as on September 30, 2020, driving a strong liquidity coverage ratio of 125.35% for Q2 FY2021 (daily average) against the minimum regulatory requirement of 100%. The bank had limited negative cumulative mismatches of ~0.9% of the total outflows in the up to 1-year maturity bucket, as per its structural liquidity statement (merged entity) for May 31, 2020. Supported by its sovereign ownership, healthy liabilities profile and excess SLR holdings, ICRA expects the bank to maintain a strong liquidity profile.

Rating sensitivities

Positive triggers – ICRA could assign a Positive outlook and/or upgrade the ratings if the merged entity is able to improve its solvency levels to less than 40% and maintain a capital cushion of ~1% over the regulatory capital ratios on a consistent basis.

Negative triggers – ICRA could assign a Negative outlook and/or downgrade the ratings if the merged entity's NNPAs are above 5% with a weak solvency profile of more than 60% on a sustained basis.

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 Bank's sovereign ownership and the demonstrated track record of capital infusions by the GoI. ICRA expects the GoI to support the bank with capital infusions, if required.
Consolidation/Standalone	To arrive at the ratings, ICRA has considered the standalone financials of Canara Bank post-merger with e-SB. Further, in line with ICRA's limited consolidation approach, the capital requirement of the Canara Bank Group's key subsidiaries/associates/joint ventures, going forward, has been factored in (including the entities taken over post-merger).

About the company

Canara Bank (merged with Syndicate Bank) is the fourth largest public sector bank and the sixth largest bank in the Indian banking system with the GoI owning a majority stake of 78.55% as on June 30, 2020. Headquartered in Bangalore, Canara Bank has a pan-India presence, directly through a network of 10,500 branches and 13,023 ATMs, nine subsidiaries, a joint venture and six associate companies.

Canara Bank reported a net profit of Rs. 851 crore in H1 FY2021 on a total asset base of Rs. 10.79 lakh crore as on September 30, 2020 against a net loss of Rs. 35 crore in H1 FY2020 on a total asset base of Rs. 10.14 lakh crore as on September 30, 2019. Its gross and net NPAs stood at 8.23% and 3.42%, respectively, as on September 30, 2020. The bank reported a Tier I capital ratio of 9.54% and CRAR of 12.77% as on September 30, 2020.

Key financial indicators - Standalone

(Rs. crore)	FY2019	FY2020	H1 FY2020^	H1 FY2021^
Net interest income	14,478	13,124	9,901	12,393
Profit before tax	-2,327	-1,756	206	1,083
Profit after tax	347	-2,236	-35	851
Net advances – Rs. lakh crore	4.28	4.32	6.38	6.16
Total assets* - Rs. lakh crore	6.88	7.18	10.14	10.79
% CET I	8.31%	9.39%	9.91%	8.21%
% Tier I	9.04%	10.12%	11.07%	9.54%
% CRAR	11.90%	13.65%	13.92%	12.77%
% Net interest margin / Average total assets	2.23%	1.87%	1.97%	2.34%
% Net profit / Average total assets	0.05%	-0.32%	-0.01%	0.16%
% Return on net worth	1.17%	-6.78%	-0.15%	3.88%
% Gross NPAs	8.83%	8.21%	9.60%	8.23%
% Net NPAs	5.37%	4.22%	5.42%	3.42%
% Provision coverage excl. technical write-offs	41.48%	50.73%	46.06%	60.58%
% Net NPA / Core equity	78.35%	53.87%	67.72%	49.41%

^ Unaudited merged financials for Canara Bank and e-SB
**Total assets and net worth exclude revaluation reserves*
Source: Canara Bank, ICRA's estimates
All calculations as per ICRA

Status of non-cooperation with previous CRA: Not applicable

Any other information: Not applicable

Rating history for past three years

Rating (FY2021)						Rating History for the Past 3 Years								
	Instrument	Type	Amount Rated	Amount Outstanding	Current Rating	FY2020				FY2019			FY2018	
					Nov-13-2020	Jan-31-2020	Sep-19-2019	Jul-11-2019	Apr-26-2019	Mar-29-2019	May-28-2018	May-11-2018	Mar-05-2018	Jul-31-2017
1	Basel III Tier II Bonds	LT	7,900.00	7,900.00	[ICRA]AA+ (hyb) (Stable)	[ICRA]AA+ (hyb)&	[ICRA]AA+ (hyb)&	[ICRA]AA+ (hyb) (Stable)	[ICRA]AA+ (hyb) (Stable)	[ICRA]AAA (hyb) (Negative)	[ICRA]AAA (hyb) (Negative)	[ICRA]AAA (hyb) (Negative)	[ICRA]AAA (hyb) (Negative)	[ICRA]AAA (hyb) (Negative)
2	Basel III Additional Tier I Bonds	LT	1,500.00	1,500.00	[ICRA]AA (hyb) (Stable)	[ICRA]AA- (hyb)&	[ICRA]AA- (hyb)&	[ICRA]AA- (hyb) (Stable)	[ICRA]AA- (hyb) (Stable)	[ICRA]AA (hyb) (Negative)	[ICRA]AA (hyb) (Negative)	[ICRA]AA (hyb) (Negative)	[ICRA]AA (hyb) (Negative)	[ICRA]AA (hyb) (Negative)
3	Certificates of Deposit	ST	-	-				[ICRA]A1+; withdrawn	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+
4	Basel II Lower Tier II Bonds	LT	-	-					[ICRA]AA+ (Stable); withdrawn	[ICRA]AAA (Negative)	[ICRA]AAA (Negative)	[ICRA]AAA (Negative)	[ICRA]AAA (Negative)	[ICRA]AAA (Negative)

Amount in Rs. crore; & - Rating Watch with Developing Implications

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	Instrument	Date of Issuance/ Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE476A08050	Basel III Tier II Bonds	Apr-27-16	8.40%	Apr-27-26	3,000.00	[ICRA]AA+(hyb)(Stable)
INE476A08043	Basel III Tier II Bonds	Jan-07-16	8.40%	Jan-07-26	900.00	[ICRA]AA+(hyb)(Stable)
INE476A09264	Basel III Tier II Bonds	Dec-31-15	8.40%	Dec-31-25	1,500.00	[ICRA]AA+(hyb)(Stable)
INE476A09256	Basel III Tier II Bonds	Mar-27-14	9.70%	Mar-27-24	1,000.00	[ICRA]AA+(hyb)(Stable)
INE476A09249	Basel III Tier II Bonds	Jan-03-14	9.73%	Jan-03-24	1,500.00	[ICRA]AA+(hyb)(Stable)
INE476A08035	Basel III Additional Tier I Bonds	Mar-05-15	9.55%	Perpetual^	1,500.00	[ICRA]AA(hyb)(Stable)

Source: Canara Bank
^ First call option due on March 03, 2025

Key features of the rated instruments

The rated Basel III compliant Tier I bonds (or Additional Tier I or AT-I bonds) 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 the coupon payments. The cancellation of discretionary payments shall not be an event of default.
- Coupons can be paid out of the current year's profits. However, if the current year's profit is not sufficient or if the payment of the coupon is likely to result in a loss, the coupon payment can be made through reserves and surpluses[2] created through the appropriation of profits (including statutory reserves). 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 RBI under the Basel III regulations.

These Tier I bonds are expected to absorb losses through the write-down mechanism at the objective prespecified trigger point fixed at the bank's (CET I) ratio as prescribed by the RBI – 5.5% till March 31, 2021, and thereafter 6.125% of the total RWAs of the bank or when the point of non-viability trigger (PONV) is breached in the RBI's opinion.

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 loss severity vis-à-vis conventional debt instruments. The rated Basel III Tier II bonds are expected to absorb losses once the PONV trigger is invoked.

Given the above distinguishing features of the Tier I bonds, ICRA has assigned a one notch lower rating on these than the rating on the Tier II instruments. The DRs, that can be used for servicing the coupon in a situation of inadequate profits or a loss during the year, stood low at 1.5% of RWAs as on April 1, 2020. However, the bank has proposed to set off its accumulated losses against the share premium, which is subject to regulatory approval. Following this, the DRs are expected to increase to 5.1% of RWAs. This will significantly improve the bank's ability to ride out the asset quality stress while maintaining its ability to service the coupon on its Tier I bonds.

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

Annexure 2: List of entities considered for limited consolidation analysis

S. No.	Name of the entity	Ownership	Consolidation Approach
1.	Canbank Financial Services Ltd.	100.00%	Limited Consolidation
2.	Canbank Venture Capital Fund Ltd.	100.00%	Limited Consolidation
3.	Canara Bank Securities Ltd.	100.00%	Limited Consolidation
4.	Canara Bank (Tanzania) Ltd.	100.00%	Limited Consolidation
5.	Canbank Factors Ltd.	70.00%	Limited Consolidation
6.	Canbank Computer Services Ltd.	69.14%	Limited Consolidation
7.	Canara Robeco AMC Ltd.	51.00%	Limited Consolidation
8.	Canara HSBC OBC Life Insurance Co.	51.00%	Limited Consolidation
9.	Commercial Indo Bank LLC., Moscow	40.00%	Limited Consolidation
10.	Kerala Gramin Bank	35.00%	Limited Consolidation
11.	Karnataka Gramin Bank	35.00%	Limited Consolidation
12.	Can Fin Homes	30.00%	Limited Consolidation
	Entities Taken Over Post Merger		
1.	Syndbank Services Ltd.	100.00%	Limited Consolidation
2.	Prathama Bank	35.00%	Limited Consolidation
3.	Karnataka Vikas Grameena Bank	35.00%	Limited Consolidation
4.	Andhra Pragathi Grameena Bank	35.00%	Limited Consolidation

Source: Canara Bank, e-SB, and ICRA research

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