January 31, 2020

Canara Bank: Ratings remain on Watch with Developing Implications

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)&; Remains on Watch with Developing Implications
Tier-II Bonds Programme – Basel III	7,900	7,900	[ICRA]AA+ (hyb)&; Remains on Watch with Developing Implications
Total	**9,400**	**9,400**	

& Rating Watch with Developing Implications
** Instrument details are provided in Annexure-1*

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 Canara Bank, as these instruments have the following loss-absorption features that make them riskier:

- The 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.
- The 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 payment can be made through reserves and surpluses[1] created through the appropriation of profits (including statutory reserves). As per ICRA's estimates, these reserves and surpluses stood at 4.8% of the risk-weighted assets (RWAs) as on December 31, 2019 (4.6% as on March 31, 2019). 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 2020, 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.

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 ratings consider the majority sovereign ownership of Canara, its impending merger with Syndicate Bank (rated [ICRA]AA (hyb)&) and the expectation of continued capital support to the merged entity by the Government of India (GoI), if required. The ratings further take into consideration Canara's established retail franchise (with a strong presence in the southern states), which aids a stable core deposits[2] base. Moreover, given the sovereign ownership and stable deposits base, the bank's liquidity profile remains strong. ICRA also takes note of the bank's improved capital cushions upon sizeable capital infusion by the GoI in the current fiscal. However, despite the capital infusion, the solvency profile remains weak in relation to the rating category, given the high stock of net non-performing assets (NNPAs), even though

[1] *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*

[2] *Core deposits constitute of current account and savings account (CASA) deposits and retail term deposits (TD)*

the reported capital ratios have improved. The ratings remain constrained by the bank's weak asset quality profile with high fresh slippages in 9M FY2020, elevated credit provisions and the consequently weak earnings profile, even though these were better than FY2019 and are likely to improve further in FY2021.

The ratings remain on Watch with Developing Implications because of the impending merger[3] of Canara with Syndicate. The asset quality, earnings profile and capital position of the amalgamated entity are expected to remain weaker than Canara because of the weaker profile of Syndicate. The merged entity's low-cost CASA deposit profile is expected to remain weak, given the low CASA share of both banks. This may translate into a higher cost of funds compared to peers and high reliance on bulk deposits for growth. Canara (merged) would have a large scale with a ~7.1% share in net advances and a ~7.2% share in the total deposits of the Indian banking sector as on September 30, 2019 and the RBI may classify the merged entity as a systemically important bank, which will increase its regulatory capital requirements. Based on the merged financials of the banks, the NNPAs for the combined entity stood at 5.42% and solvency (net NPA/core equity) at 68% as of September 30, 2019. The combined entity reported a net loss of Rs. 35 crore (return on assets (RoA) of -0.01%) in H1 FY2020.

In ICRA's view, for a 6-8% growth in RWAs and a 50-bps cushion over the regulatory capital requirements, the merged entity will need Rs. 800-3,100 crore of Tier I capital as its internal accruals are expected to remain weak with negative RoA of 0.1-0.2% in FY2020. If the merged entity maintains lower capital cushions or witnesses lower growth, the capital requirements may decline. The boards of both banks have accorded in-principle approval to the merger, which will be effective from April 1, 2020. ICRA will take appropriate rating action as and when more clarity emerges on the capital position and solvency profile of the merged entity.

Key rating drivers

Credit strengths

Sovereign ownership – The GoI accounts for a majority ownership in Canara with its equity stake increasing to 78.52% as on December 31, 2019 from 70.62% as on March 31, 2019, following a capital infusion of Rs. 6,571 crore in September 2019. The bank has received the requisite capital support from the GoI in the past as well, with a total capital infusion of Rs. 1,695 crore in FY2016 and FY2017 and Rs. 4,865 crore in FY2018, as a part of its public sector bank (PSB) recapitalisation programme. As per ICRA's estimates, while Canara is well placed on its capital position, the merged entity will have limited capital cushion over the regulatory levels, given the expectation of continued losses of Syndicate and no capital allocation to Syndicate in FY2020. Hence, the merged entity will need growth capital in FY2021. ICRA expects the Tier I capital requirements for the merged entity to be Rs. 800-3,100 crore, for 6-8% growth in RWAs and a 50-bps cushion over the regulatory requirements.

Established retail franchise and deposits base driven by strong presence in southern India – Canara has an established retail franchise, demonstrated by its widespread network of 6,328 branches and 8,873 ATMs as on December 31, 2019, with >40% branches located in the five southern states. This aids steady growth in the bank's low-cost CASA deposits, which grew at a modest ~5% YoY to Rs. 1.83 lakh crore as on December 31, 2019 from Rs. 1.74 lakh crore as on December 31, 2018. However, with higher growth in domestic deposits (~9% YoY as on December 31, 2019), the bank's share of CASA in domestic deposits declined to 30.93% as on December 31, 2019 from 32.23% as on December 31, 2018 and remains below the PSB average. The higher growth in domestic deposits was driven by the growth in retail TD, which increased 13% YoY, resulting in the share of retail TD improving to 57% as on December 31, 2019 from 55% as on December 31, 2018. Given the weak CASA share and the traditionally higher reliance on bulk TD, the bank's deposit base

[3] *The boards of both Canara and Syndicate have accorded in-principle approval to the merger*

remains concentrated, with the top 20 depositors accounting for 16.10% of the total deposits as on March 31, 2019 compared to 15.52% as on March 31, 2018 (14.45% as on March 31, 2017). In line with the declining interest rate environment, Canara has taken a cut of ~60bps for its 1-year deposit rates from April 2019. Hence, the cost of interest-bearing funds has started to decline and stood at 5.44% in Q3 FY2020 compared to 5.72% in Q2 FY2020. This is expected to decline further in FY2021 as the deposit rate cuts have continued in Q3 FY2020.

On a merged basis, the CASA deposits are estimated at 31% as on September 30, 2019, given the lower-than-average CASA share of the merging banks. This will translate into a higher cost of funds and will be a key factor for the merged entity's profitability.

Credit challenges

Fresh slippages remain high in 9M FY2020; low provision cover results in NNPAs remaining high – While the bank's fresh slippage rate continued to decline in 9M FY2019, it remained high. Canara reported fresh slippages of Rs. 11,094 crore in 9M FY2020 (annualised fresh slippage rate of 3.7% of standard advances) against a fresh slippage rate of 4.3% in FY2019. Despite the high slippages, the gross NPAs (GNPAs) declined to Rs. 36,645 crore (8.36%) as on December 31, 2019 from Rs. 39,224 crore (8.83%) as on March 31, 2019 and Rs. 44,621 crore (10.25%) as on December 31, 2018. The decline was on account of stable recoveries in 9M FY2020, driven by the recovery upon resolution of a large ticket National Company Law Tribunal (NCLT) exposure and modest write-offs. The provision coverage ratio (PCR), excluding technical write-offs (TWO), remained stable at 41.77% as on December 31, 2019 compared to 41.48% as on March 31, 2019 and 40.41% as on December 31, 2018. The bank's NNPA declined to Rs. 21,338 crore (5.05%) as on December 31, 2019 from Rs. 22,955 crore (5.37%) as on March 31, 2019 and Rs. 26,591 crore (6.37%) as on December 31, 2018 though it remained higher than the peers and PSBs' average. The PCR, including TWO, stood at 71.0% as on December 31, 2019 and was lower than the PSBs' average of 77.3% as on September 30, 2019. For the merged entity, the GNPAs and NNPAs were estimated at 9.6% and 5.4%, respectively, with an estimated PCR (including TWO) of 69.6% as on September 30, 2019.

As on December 31, 2019, the bank's SMA[4] 1 and 2 book (above Rs. 5 crore) declined to Rs. 7,933 crore (2.0% of standard advances) from Rs. 11,526 crore (2.8%) as on September 30, 2019, as certain vulnerable accounts in the SMA 2 book slipped in Q3 FY2020. These represent potential sources of slippages, going forward. Looking ahead, with a slippage rate of 3.5-4.0% (overall for FY2020) and a PCR of 60-62% (excluding TWO) by March 31, 2020, ICRA expects the NNPAs to be ~4% by March 31, 2020 and the solvency to improve to ~50% with a Tier I capital cushion of 0.6-1.0%. However, a lower PCR may drive higher NNPAs and capital cushions.

Profitability expected to remain weak in FY2020, given the levels of NNPAs – After reporting a sizeable loss before tax in FY2018 and FY2019, Canara reported net profits in 9M FY2020. However, the profitability remains weak with the bank reporting a net profit of Rs. 1,024 crore (RoA of 0.20%) in 9M FY2020 (Rs. 899 crore (0.19%) in 9M FY2019).

In 9M FY2020, the net interest income (NII) declined by 11% YoY to Rs. 9,805 crore, due to muted growth in standard advances, decline in the lending rate, higher cost of funds and income reversal because of sustained slippages. This, apart from a decline in the credit-to-deposit ratio, resulted in a decline in the net interest margin (NIMs) to 1.87% in 9M FY2020 from 2.29% in 9M FY2019. Given the lower NII, the operating profits also declined by 10% YoY to Rs. 6,744 crore (1.28% of ATA) in 9M FY2020 from Rs. 7,457 crore (1.56%) in 9M FY2019. Despite the high slippages, the credit costs remained lower at 1.1% of ATA in 9M FY2020 compared to 1.6% in 9M FY2019 as Canara has maintained a stable provision cover. Thus, despite the lower operating profits, the net profitability was supported by lower credit costs and

[4] *SMA 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)*

higher contribution from treasury, given the favourable yields. The trading profits increased to Rs. 575 crore (0.11% of ATA) in 9M FY2020 from Rs. 160 crore (0.03%) in 9M FY2019.

Though Canara reported net profits in 9M FY2020, its profitability remains susceptible to incremental credit costs considering the low provision cover (41.77% as on December 31, 2019) on its GNPAs. ICRA expects the credit provisions for Canara to remain high at 1.3-1.5% of ATA in FY2020, thereby translating into a weak RoA of ~0.1% for FY2020 (assuming an increased provision cover of 60-62% by March 31, 2020). For the merged entity, ICRA expects the provisioning to remain high at ~1.4-1.5% of ATA, which will result in negative RoA of ~0.1-0.2% in FY2020.

Improved capital cushions supported by capital infusion by GoI; however, solvency remains weak – Supported by a capital infusion of Rs. 6,571 crore by the GoI in the current fiscal, Canara's capitalisation indicators improved with CET I, Tier I and CRAR of 10.29%, 11.05% and 13.86%, respectively, as on December 31, 2019 compared to 8.31%, 9.04% and 11.90%, respectively, as on March 31, 2019. This was above the minimum regulatory requirement[5]. The increase in core equity, upon the capital infusion, also supported an improvement in Canara's solvency profile to 58% as on December 31, 2019 from 78% as on March 31, 2019, though it remains weak in relation to the rating category of the bank.

While ICRA expects Canara's solvency to improve further to ~50% by March 31, 2020, the merged entity's solvency profile is expected to remain weaker at ~60% as of March 31, 2020 (~68% as on September 30, 2019) because of Syndicate's weaker solvency profile (85.9% as on September 30, 2019). ICRA also expects the Tier I capital cushion to remain limited for the merged entity, which may need to raise Rs. 800-3,100-crore Tier I capital to maintain a 50-bps cushion over the regulatory levels.

Canara can meet a part of the Tier I capital requirements (at the merged entity level) through the issuance of AT-I bonds, which stood at Rs. 2,500 crore (0.76%) of RWAs) as on December 31, 2018. Canara's distributable reserves (DRs), as a percentage of RWAs, have improved in 9M FY2020 because of reported profit. The DR/RWA ratio stood at 4.8% as on December 31, 2019 compared to 4.6% as on March 31, 2019.

Liquidity position: Strong

The bank, as on September 30, 2019, had a positive cumulative mismatch in the less-than-1-year bucket, as per its structural liquidity statement (SLS). Canara's liquidity coverage ratio (LCR) remained adequate at 118.82% (average for the quarter) as on September 30, 2019, above the regulatory requirement of 100%. 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. Also, given the steady core deposits base of CASA and retail deposits, ICRA expects the bank's liquidity profile to remain strong.

Rating sensitivities

Positive triggers – ICRA could assign a Positive outlook and/or upgrade the ratings if the merged entity is able to reduce and maintain its NNPAs below 4%, while improving the solvency (Net NPA/Core Equity) with less than 40% and maintaining 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 weak solvency profile (Net NPA/Core Equity) of more than 60% on a sustained basis.

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[5] *Minimum regulatory CET I, Tier I and CRAR stood at 7.375%, 8.875% and 10.875%, respectively, as on March 31, 2019. With the CCB increasing to 2.50% from 1.875% effective March 31, 2020, the regulatory CET I, Tier I and CRAR requirements will be 8.0%, 9.5% and 11.5%, respectively, as on March 31, 2020*

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 provide Canara with capital support, if required
Consolidation/Standalone	To arrive at the ratings, ICRA has considered the standalone financials of Canara Bank and the merged financials of both Canara and Syndicate

About the company

Canara is a large nationalised bank with the GoI owning a majority stake of 78.52% as on December 31, 2019. Headquartered in Bangalore, Canara has a pan-India presence, directly through a network of 6,328 branches and 8,873 ATMs, seven subsidiaries, an associate company and a joint venture. As on December 31, 2018, the bank had 9.13-crore clientele accounts.

Canara reported a net profit of Rs. 1,024 crore in 9M FY2020 on a total asset base of Rs. 7.11 lakh crore as on December 31, 2019 against 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. Canara's gross and net NPAs stood at 8.36% and 5.05%, respectively, as on December 31, 2019. The bank reported a Tier I capital ratio of 11.05% and CRAR of 13.86% as on December 31, 2019.

Key financial indicators – Standalone (audited)

	FY2018	FY2019	9M FY2019	9M FY2020
Net Interest Income	12,163	14,478	10,978	9,805
Profit before Tax	(6,561)	(2,327)	223	1,579
Profit after Tax	(4,222)	347	899	1,024
Net Advances	3,81,703	4,27,727	4,17,227	4,22,608
Total Assets	6,10,361	6,88,319	6,65,689	7,11,355
% CET I	9.51%	8.31%	8.81%	10.29%
% Tier I	10.30%	9.04%	9.54%	11.05%
% CRAR	13.22%	11.90%	12.21%	13.86%
% Net Interest Margin / Average Total Assets	2.05%	2.23%	2.29%	1.87%
% Net Profit / Average Total Assets	-0.71%	0.05%	0.19%	0.20%
% Return on Net Worth	-14.52%	1.18%	4.05%	4.07%
% Gross NPAs	11.84%	8.83%	10.25%	8.36%
% Net NPAs	7.48%	5.37%	6.37%	5.05%
% Provision Coverage (excl. technical write-offs)	39.87%	41.48%	40.41%	41.77%
% Net NPA / Net Worth	85.3%	78.3%	88.36%	57.17%

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	Amount Rated	Amount O/S	Rating (FY2020) Current Rating Jan-31-2020	Earlier Rating Sep-19-2019	11-Jul-2019	26-Apr-2019	Rating History for the Past 3 Years FY2019 29-Mar-2019	28-May-2018	11-May-2018	FY2018 05-Mar-2018	31-Jul-2017	FY2017 28-Dec-2016	01-Apr-2016
1	Tier-II Bonds – Basel III	LT	7,900	7,900	[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)	[ICRA]AAA (hyb) (negative)	[ICRA]AAA (hyb) (negative)
2	Additional Tier-I Bonds	LT	1,500	1,500	[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)	[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+	[ICRA]A1+	[ICRA]A1+
4	Lower Tier-II Bonds	LT	-	-	-	-		[ICRA]AA+ (Stable); Withdrawn	[ICRA]AAA (negative)	[ICRA]AAA (negative)	[ICRA]AAA (negative)	[ICRA]AAA (negative)	[ICRA]AAA (negative)	[ICRA]AAA (negative)	[ICRA]AAA (negative)

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

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 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]AA+ (hyb) &
INE476A08043	Tier-II Bonds - Basel III	7-Jan-16	8.40%	7-Jan-26	900	[ICRA]AA+ (hyb) &
NE476A09264	Tier-II Bonds - Basel III	31-Dec-15	8.40%	31-Dec-25	1,500	[ICRA]AA+ (hyb) &
INE476A09256	Tier-II Bonds - Basel III	27-Mar-14	9.70%	27-Mar-24	1,000	[ICRA]AA+ (hyb) &
INE476A09249	Tier-II Bonds - Basel III	3-Jan-14	9.73%	3-Jan-24	1,500	[ICRA]AA+ (hyb) &
INE476A08035	Additional Tier-I Bonds	5-Mar-15	9.55%	Perpetual	1,500	[ICRA]AA- (hyb) &

& – Rating Watch with Developing Implications

Source: Canara

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About ICRA Limited:

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