January 31, 2020

Syndicate Bank: Rating remains on Watch with Developing Implications

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Basel III Compliant Tier II Bonds Programme	3,250.00	3,250.00	[ICRA]AA (hyb) &; Rating remains on Watch with Developing Implications
Total	**3,250.00**	**3,250.00**	

& Denotes under rating Watch with Developing Implications
**Instrument details are provided in Annexure-1*

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. The rated Tier II bonds under Basel III are expected to absorb losses once the point of non-viability (PONV) trigger is invoked.

Rationale

The rating considers the majority sovereign ownership of Syndicate Bank, its impending amalgamation with Canara Bank (rated [ICRA]AA+(hyb)& for Tier II bonds) and the expectation of continued capital support to the merged entity by the Government of India (GoI), if required. The rating remains supported by the pan-India presence of the bank, given its established retail franchise, with a strong presence in southern India. The majority GoI ownership and established retail franchise also aid the bank's strong liquidity profile with a comfortable liquidity coverage ratio (LCR). The rating further factors in the bank's adequate capitalisation profile with a modest capital cushion over the regulatory requirement.

However, the credit profile remains constrained by Syndicate's weak asset quality profile, with the fresh slippage rate remaining elevated in H1 FY2020 at 4.7% of standard advances (annualised), although this was lower than 5.9% in FY2019. While ICRA expects slippages in FY2020 to remain lower than FY2019 levels, the asset quality will remain weak and the credit provisions will continue to exceed the core operating profits, thereby remaining a drag on the bank's earnings profile. Syndicate has already reported a loss before tax of Rs. 842 crore in H1 FY2020 against a loss before tax of Rs. 3,415 crore in H1 FY2019. With sustained losses and high net NPAs (NNPAs), the bank's solvency profile remained weak with net NPA/core equity capital remaining weak at 85.92%, as on September 30, 2019, against 84.98% as on March 31, 2019. This was despite the bank raising sizeable equity capital of Rs. 4,463 crore (~2.4% of risk-weighted assets – RWAs) in FY2019. Going forward, given the impending merger with Canara Bank, the GoI has not announced any capital for Syndicate Bank under the scheme for the recapitalisation of public sector banks (PSBs) for FY2020. Hence, ICRA expects Syndicate's solvency to remain weak at 82-87% as of March 31, 2020, as a decline in the core equity capital (because of the expectation of loss-making operations in FY2020) is expected to negate the expected improvement in NNPAs.

The rating remains on Watch with Developing Implications because of the impending merger[1] of Syndicate Bank with Canara Bank. The earnings profile and the asset quality of the amalgamated entity (referred as Canara-M hereafter) is

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

expected to remain better than Syndicate Bank, even though the internal capital generation is likely to remain weak. The merged entity's low-cost current account and savings account (CASA) profile is expected to remain weak, given the low CASA share of both banks, which may translate into a higher cost of funds compared to peers and high reliance on bulk deposits for growth. Canara-M would have a large scale with a ~7.1% share in net advances and a ~7.2% share in total deposits of the Indian banking sector as on September 30, 2019 and the Reserve Bank of India (RBI) may classify Canara-M 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 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 and their description

Credit strengths

Sovereign ownership – Syndicate has a majority sovereign ownership with the GoI holding 78.48% as on September 30, 2019. The bank has received capital support from the GoI with infusions of Rs. 3,963 crore in FY2019, Rs. 2,839 crore in FY2018 and Rs. 776 crore in FY2017. As per ICRA's estimates, while Canara is well placed on its capital position, the merged entity will have a limited capital cushion over the regulatory levels as Syndicate is expected to continue posting losses in H2 FY2020. Hence, Canara-M 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 with strong presence in southern India supports steady deposits profile – As on March 31, 2019, the bank had an established retail franchise supported by a network of 4,031 branches and 4,509 ATMs, which aids a stable deposits profile. The bank's low-cost CASA deposits grew 6.5% YoY to Rs. 85,596 crore as on September 30, 2019 and accounted for 35.7% of the total deposit base, up from 33.4% as on September 30, 2018. Syndicate's widespread retail network also aids steady growth in retail term deposits (TD), which grew 6.6% YoY to Rs. 1,01,440 crore as on September 30, 2019. As the net credit growth remained modest at ~7% YoY as on September 30, 2019, the bank had limited need for bulk deposit mobilisation, which declined. With a lower bulk deposits base and steady growth in retail TDs, the share of retail TD (domestic) improved to 65.7% as on September 30, 2019 from 59.6% as on September 30, 2018. While the bank's core deposit base has grown steadily, its CASA share was lower than the average CASA share of PSBs of ~39% as on September 30, 2019.

Despite the improved share of low-cost CASA and retail TD, in addition to the lower deposit concentration, Syndicate's cost of interest-bearing funds inched up to 5.20% in H1 FY2020 from 5.12% in H1 FY2019, as the TD rates increased in FY2019, resulting in higher blended costs. The cost of funds remained higher than the PSB average of 5.16% in H1 FY2020.

In ICRA's view, the merged entity will be weak on CASA deposits, given the lower-than-average CASA share of the merging banks. As on September 30, 2019, the CASA share of the merged entity was ~31% of deposits, lower than the PSB average. This will translate into a higher cost of funds and will be a key driver of the merged entity's profitability.

Credit challenges

Fresh slippages moderate in H1 FY2020 but remain elevated – The bank's asset quality profile remains weak with the fresh slippage rate remaining elevated at 4.7% (annualised) in H1 FY2020, though lower than 5.9% in FY2019. This apart, cash recovery and upgradation have remained muted during this period because of the delay in recovery upon the resolution of a few large cases under the National Company Law Tribunal (NCLT). Thus, with sustained slippages and muted recoveries/upgradations and write-offs, the stock of gross NPAs (GNPAs) inched up to Rs. 25,382 crore (11.45%) as on September 30, 2019 from Rs. 24,680 crore (11.37%) as on March 31, 2019.

Although the bank received capital support from the GoI in FY2019, given the weak capital profile, it had limited headroom for upfronting provisions on its stock of GNPAs. Hence, the NNPAs declined marginally to Rs. 12,481 crore (5.98%) as on September 30, 2019 from Rs. 12,628 crore (6.16%) as on March 31, 2019. The provision coverage ratio (PCR), including technical write-offs (TWO), stood at 68.6% and was much lower than the PSBs' average of 77.3% as on September 30, 2019. For the merged entity, the GNPA and NNPAs are estimated at 9.6% and 5.4%, respectively, with an estimated PCR (including TWO) of 69.6% as on September 30, 2019.

As on September 30, 2019, the bank's SMA[2] 1 and 2 book outstanding stood at ~1% and ~3% of standard advances, respectively. Given the sizeable SMA book and the presence of certain vulnerable accounts in the SMA book which have a higher likelihood of slipping into NPA, the slippages will remain elevated for Syndicate Bank in H2 FY2020. In November 2019, the bank also reported divergences in GNPAs and NNPAs, which will have to be accounted for in H2 FY2020 results and may, therefore, remain a drag on the asset quality and credit provisions. Going forward, with a slippage rate of 4-5% (overall for FY2020) and a provision cover of 65-66% (excluding write-offs) for FY2020, ICRA expects the NNPAs to fall below 5% by March 31, 2020 with limited Tier I capital cushion. However, a lower PCR may drive higher NNPAs and capital cushions.

Losses to continue in FY2020 – Syndicate's earnings profile remains weak with the bank reporting a loss before tax of Rs. 842 crore in H1 FY2020 compared with a loss before tax of Rs. 3,415 crore in H1 FY2019, which can be attributed to the asset quality challenges resulting in sustained elevated credit costs.

Syndicate Bank's net interest income (NII) increased 15% YoY to Rs. 3,531 crore in H1 FY2020 from Rs. 3,078 crore in H1 FY2019, supported by growth in net credit (~7% YoY) and reduced slippages during the period, resulting in lower income reversals. Thus, the net interest margin (NIM) as a percentage of average total assets (ATA) improved to 2.27% in H1 FY2020 from 1.95% in H1 FY2019. The non-interest income also increased 24% YoY to Rs. 999 crore in H1 FY2020, supported by stable income from the sale of priority sector lending certificates (PSLCs) and improved recovery from written-off accounts. Supported by good NII growth and higher NII, the bank's core operating profit (excluding treasury gains) increased 39% YoY to Rs. 1,483 crore in H1 FY2020 (0.95% of ATA), despite a modest increase in employee and overhead expenses. While the operating profit increased, the bank's operating expenses remained higher than the sector average, which impacted its operating profitability vis-à-vis the PSB average. Despite the growth in core operating profits, elevated credit costs at 1.76% of ATA in H1 FY2020 against 2.15% in H1 FY2019 impacted Syndicate's net profitability. The net loss reported by the bank during this period was, however, somewhat cushioned by improved treasury gains, given the favourable yields trend during this period. Syndicate's income from trading profits stood at Rs. 283 crore (0.18% of ATA) in H1 FY2020 against Rs. 63 crore (0.04% of ATA) in H1 FY2019. ICRA expects the credit provisions for Syndicate to remain at 1.5-1.7% of ATA in FY2020, thereby translating into losses with a negative RoA of

[2] *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)*

0.5-0.6% for FY2020. 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.

Modest capitalisation profile and weak solvency – Despite the ongoing losses, Syndicate Bank's capitalisation profile remained modest, supported by a capital infusion in FY2019 and Rs. 660-crore core equity capital raised via the employee share purchase scheme (ESPS) in Q1 FY2020. The CET I, Tier I and CRAR were 8.96%, 10.95% and 13.78%, respectively, as on September 30, 2019, above the minimum regulatory requirement[3]. However, despite the modest capital profile, the elevated NNPAs translated into a weak solvency profile as indicated by the net NPA/core equity capital of 85.92% as on September 30, 2019 compared to 84.98% as on March 31, 2019.

While the NNPAs are expected to reduce further by March 2020, the core equity capital would be negatively impacted, given the expectation of losses for the bank. As a result, Syndicate Bank's solvency profile is expected to remain weak with net NPA/core equity of ~82-87% by March 2020. For the merged entity also, the solvency profile is expected to remain weak at ~60% as of March 31, 2020 (~68% as on September 30, 2019). ICRA also expects the Tier I capital cushion to remain limited for the merged entity. To maintain a 50-bps cushion over the regulatory levels, the merged entity may need to raise Rs. 800-3,100-crore Tier I capital. ICRA expects capital raising, if any, to be done at the anchor bank level with support from the GoI, if required. However, the inability to raise the requisite capital at the merged entity level may keep the credit growth or provision coverage below the ICRA-assumed levels. The extent of capital cushion and the solvency levels will remain key rating drivers for the merged entity.

Liquidity position – Strong

Supported by its established retail franchise in South India, which has aided its core deposit base, Syndicate's LCR remained above the regulatory requirement at 143.18% (daily average for the quarter) as on September 30, 2019. The structural liquidity statement (SLS) indicates moderation in the cumulative mismatch with a negative cumulative mismatch of ~6.7% (as a percentage of total outflows) in the up to 1-year bucket, as per the SLS as on June 30, 2019, against ~7.9% as on December 31, 2018. This was supported by elongation in the tenure of deposits as the bank's reliance on bulk TDs reduced. ICRA expects Syndicate to maintain strong liquidity, given its steady core deposit base and sovereign ownership. The bank can also avail liquidity support from the RBI (through reverse repo against excess SLR investments and the marginal standing facility) in case of urgent liquidity needs. As per ICRA's estimates, as on September 30, 2019, the bank was holding excess SLR investments of ~4.7% of total deposits.

Rating sensitivities

Given the impending merger, the rating sensitivities for Syndicate will be driven by that of the financial profile of the merged entity. The rating sensitivities for the merged entity (currently Canara Bank) are provided below.

Positive triggers – ICRA could assign a Positive outlook and/or upgrade the rating if the merged entity is able to reduce and maintain its NNPAs below 4% while improving its solvency (NNPA/core equity) to <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 exceed 5% with a weak solvency profile of NNPA/CET of >60% on a sustained basis.

[3] *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 capital conservation buffer (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 rating factors in Syndicate's sovereign ownership and the demonstrated track record of capital infusion by the GoI
Consolidation/Standalone	To arrive at the rating, ICRA has considered the standalone financials of Syndicate Bank and the merged financials of Canara and Syndicate

About the company

Manipal (Karnataka)-based Syndicate Bank is a PSB that was established in 1925. The GoI held 78.48% in the bank as of September 30, 2019. The bank's net worth (excluding revaluation reserves) stood at Rs. 14,339 crore as on September 30, 2019.

For H1 FY2020, the bank reported a loss after tax of Rs. 729 crore on a total asset base (excluding revaluation reserves) of Rs. 3.14 lakh crore as on September 30, 2019 compared to a loss after tax of Rs. 2,824 crore in H1 FY2019 on a total asset base (excluding revaluation reserves) of Rs. 3.08 lakh crore as on September 30, 2018. Syndicate's gross and net NPAs stood at 11.45% and 5.98%, respectively, as on September 30, 2019. The bank reported a Tier I capital ratio of 10.95% and CRAR of 13.78% as on September 30, 2019.

Key financial indicators (audited) – Syndicate Bank

	FY2018	FY2019	H1 FY2019	H1 FY2020
Net interest income	6,552	6,649	3,078	3,531
Profit before tax	-4,379	-3,103	-3,415	-842
Profit after tax	-3,213	-2,588	-2,824	-729
Net advances	210,684	2,05,044	1,95,179	2,08,716
Total assets	3,22,427	3,09,581	3,08,283	3,13,552
% CET I	7.56%	9.31%	6.04%	8.96%
% Tier I	9.41%	11.36%	8.07%	10.95%
% CRAR	12.24%	14.23%	10.95%	13.78%
% Net interest margin	2.11%	2.10%	1.95%	2.27%
% PAT / ATA	-1.04%	-0.82%	-1.79%	-0.47%
% Return on net worth	-24.74%	-18.00%	-47.09%	-9.82%
% Gross NPAs	11.54%	11.37%	12.98%	11.45%
% Net NPAs	6.28%	6.16%	6.83%	5.98%
% Provision coverage excl. technical write-offs	48.60%	48.83%	50.90%	50.83%
% Net NPA/ CET	95.64%	84.98%	131.44%	85.92%

Note: Amount in Rs. crore; Net worth and total assets exclude revaluation reserves
Source: Syndicate, ICRA research
All calculations are as per ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years – Syndicate Bank

Instrument	Type	Amount Rated	Amount O/S	Rating (FY2020) Current Rating 31-Jan-2020	Earlier Rating 19-Sep-2019	Rating History for the Past 3 Years FY2019 16-Aug-2018	FY2019 28-May-2018	FY2018 17-Aug-2017	FY2017 28-Jun-2016
Tier II Bonds – Basel III	LT	3,250.00	2,900.00 ^	[ICRA]AA (hyb) &; Reaffirmed and Remains on Watch with Developing Implications	[ICRA]AA (hyb) &	[ICRA]AA (hyb) (Negative)	[ICRA]AA+ (hyb) (Negative)	[ICRA] AA+ (hyb) (Negative)	[ICRA] AA+ (hyb) (Negative)

^ Rs. 350 crore yet to be placed
& 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 – Syndicate Bank

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE667A08013	Tier II Bonds - Basel III	02-Dec-2014	8.95%	02-Dec-2024	750.00	[ICRA]AA (hyb) &
INE667A08021	Tier II Bonds - Basel III	23-Mar-2015	8.75%	23-Mar-2025	400.00	[ICRA]AA (hyb) &
INE667A08039	Tier II Bonds - Basel III	28-Sep-2015	8.58%	28-Sep-2025	1,000.00	[ICRA]AA (hyb) &
INE667A08047	Tier II Bonds - Basel III	18-Dec-2015	8.62%	18-Dec-2025	750.00	[ICRA]AA (hyb) &
-	Tier II Bonds - Basel III	-	-	-	350.00#	[ICRA]AA (hyb) &

 # Yet to be issued

& Rating Watch with Developing Implications

Source: Syndicate

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About ICRA Limited:

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