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## **Rating Rationale for Canara Bank's Innovative Perpetual Debt Instrument Issue of INR 300 Crore or INR 3 billion**

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**IPDI Issue Rating: BWR AAA**

**Outlook: Stable**

Brickwork Ratings has assigned BWR AAA (Pronounced BWR Triple A) for Canara Bank's proposed Innovative Perpetual Debt Instrument (IPDI) issue of Rs 300 crore. Brickwork ratings 'BWR AAA' stands for an instrument that is considered to offer the BEST credit quality in terms of timely serving of debt obligations. Earlier (July 2009), Brickwork had rated Canara Bank's IPDI Issue of Rs 550 Crore. The current issue is an enhancement of the earlier issue. This addition in the Bank's tier I bonds issue will not affect the ratings, since the Bank has remained well within its borrowing capacity and has continued to perform well. The increase in the tier I capital would support the Bank's quest to sustain its growth momentum. The rating, inter alia, factors improving operating profits, comfortable capital adequacy, diversified credit deployment, and the Government of India's equity stake.

The impact of the economic slowdown in the domestic market and the financial crises in the international markets was relatively very low on the Indian Banking sector. After stronger than expected financial results in the financial year ending 2009, the Indian Banking sector has shown resilience to global economic slow down and expected to continue its growth. Canara Bank is one of the largest public sector banks with reported total assets of Rs 217,477 crore as on 31<sup>st</sup> March 2009. The bank has steadily grown its asset base over the years, aided by robust growth in deposits and advances.

The bank's cost of deposits reached 6.87% during FY 09 as against 6.80% in the previous year. Bank's cost of deposits slightly impacted the overall cost of funds, which has increased from 6.24% in FY08 to 6.32% in FY09. However, the bank's return on funds has increased from 8.31% in FY 08 to 8.73% in FY 09 and yield on advances from 10.22% to 10.79%. Further, the bank's NIM increased by 36 bps to reach a level of 2.78% in FY 09. This is slightly lower than its peer's average of 2.92%. Brickwork expects that the bank will continue to focus on retail deposits growth by leveraging its CBS platform.

Brickwork calculates *Leverage* that assesses Canara Bank's capital adequacy with reference to both on and off balance sheet exposures. The bank has shown a better leverage of 21.41 compared to its peers' of 21.91.

**Table I: Canara Bank Performance Indicators**

<b>Criteria (Rs Crore)</b>	<b>FY 09</b>	<b>FY 08</b>
<b>Total Assets</b>	219,646	180,529
<b>Deposits</b>	186,893	154,072
<b>Advances</b>	138,219	107,238
<b>Income</b>		
<b>Net Interest Income</b>	4,718	3,538
<b>Non-Interest Income</b>	2,311	2,213
<b>Profit</b>		
<b>Operating Profit</b>	3,964	2,956
<b>Net Profit</b>	2,072	1,565
<b>Non-Performing Assets</b>		
<b>Gross NPAs</b>	1.56%	1.18%
<b>Net NPAs</b>	1.09%	0.84%
<b>CRAR</b>	14.10%	13.25%
<b>Tier I</b>	8.01%	7.01%
<b>ROAA</b>	1.06%	0.92%
<b>Cost to Income Ratio</b>	43.61%	48.54%

The bank's total deposits stood at Rs 186,893 crore as on 31<sup>st</sup> March 2009, a growth of 21%, compared to Rs 154,072 crore a year ago. In line with public sector banks in India, the bank is also predominately funded through term deposits. As on 31<sup>st</sup> March 2009, the core deposits of Canara Bank grew by 38% to reach a level of Rs. 150,127 crore from the previous level of Rs. 108,936 crore. The bank's savings deposits have increased to Rs. 41,811 crore in FY 09 as compared to Rs. 35,267 crore in FY 08 with a growth rate of 19%. The bank's composition of low-cost deposits in aggregate domestic deposits stood at 30.7%, which is however 170 bps lower than the previous year figure of 32.4%.

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The bank's net advances grew by 29% to reach Rs 138,291 crore as compared to Rs. 107,238 crore in the previous year. The advances have grown robustly and the bank's term loans component at 49.04% in FY 09, is 170 bps lower than the previous year figure of 51.74%. During the year, the bank has implemented a Special Package with reduced interest rates to help Micro, Small and Medium Enterprises (MSMEs) to access easy credit. As a result, the bank's credit to MSME grew by a healthy 28% to reach Rs.23, 823 crore in FY 09. The bank's education loan increased to Rs.2,301 crore as on 31<sup>st</sup> March 2009, which has recorded a growth of 33% Y.O.Y basis, covering more than 1.46 lakhs students.

The bank has been very consistent in generating profit over the years. During FY 09, the bank posted impressive top line and bottom line figures. Canara Bank is one of the highly profitable public sector banks in India, with a total income of Rs. 19,430 crore in FY 09 and with a growth rate of 18.38% as against Rs. 164.14 crore in FY 08. This reflects the excellent growth in fund based income and its focus on healthy earning assets, which contributed to the improvement in the profitability.

During FY 09, the operating profit of the bank increased to Rs 3,964 crore from Rs 2, 959 crore, registering a robust increase of 33.94%. The bank's net profit also increased from Rs. 1,565 crore to Rs 2,072 crore during FY 09, with an impressive growth of 32.49%. The bank's profitability is largely driven by the lean operating structure, healthy earning assets and growth in non-interest income. As on 31<sup>st</sup> March 2009, the bank's interest income on advances, contributed to 65.9% of the total income which is on expected line.

During FY 09, the bank's total interest income grew to Rs 17,119 crore as against Rs 14,200 crore for the same period a year ago with a growth rate of 20.55%. Further, the bank's interest income to total income stood at 86.52% in FY 09 as compared to 85.91% in FY 08. On the other hand, the bank's non-interest income recorded a marginal improvement, and has grown only by 4.44% during FY 09.

**Table II: Canara Bank's Financials**

<b>Financials (Rs Crore)</b>	<b>2008-09</b>	<b>2007-08</b>
Interest Income	17,119	14,200
Interest Expenses	12,401	10,662
<b>Net Interest Income</b>	<b>4,718</b>	<b>3,538</b>
Fees & Commission	813	723
Trading Revenue	675	435
Other Income	823	1,055
<b>Operating Income</b>	<b>7,029</b>	<b>5,751</b>
Employee Expenses	1877	1,661
Other Operating Expenses	1188	1,130
<b>Operating Profits</b>	<b>3,964</b>	<b>2,959</b>
Provisions & Contingencies	1892	1394
<b>Profit Before Tax</b>	<b>2,072</b>	<b>1,565</b>

The bank's gross NPAs level increased during FY 09 to stand at Rs. 2,168 crore as against Rs. 1,273 crore in FY 08. The bank's gross NPAs increased from 1.18% in FY 08 to 1.56% in FY 09, which has further increased to 1.74% in Q1 FY 10. The net NPAs have shown a similar trend, and have increased from 0.84% in FY08 to 1.09% in FY09. This has further increased to 1.29% in Q1 FY 10. However the bank's performance under settlements and recovery was quite noteworthy as it has recovered Rs.1, 289 crore in FY 09 as against Rs 1,030 crore in FY 08.

The bank has an internal capital adequacy assessment policy to comprehensively evaluate capital adequacy requirements. As a result, the bank has identified its capital requirements in Q3 FY 09 and started building up Tier II capital by issuing Rs 325 crore bonds in Q4 FY 09 to augment its capital funds. As on 31<sup>st</sup> March 2009, the bank has reported a total capital adequacy ratio and Tier I capital at 14.01% and 8.01% respectively.

The bank's return on average assets has increased from 0.92% in FY 08 to 1.06% in FY 09 on account of good profits. Similarly, the bank has shown improvement in cost to income ratio during the year, which has come down to 43.61% in FY 09 from 48.54% in FY 08.

**Table III: Canara Bank Vs Peers**

<b>Key Ratios (FY 09)</b>	<b>Canara</b>	<b>Peers</b>
<b>Capital Adequacy</b>		
CRAR (Basel II)	14.10%	13.60%
Tier I (Basel II)	8.01%	8.38%
Leverage	21.41	21.91
<b>Asset Quality (As % of Advances)</b>		
Gross NPAs	1.56%	1.82%
Net NPAs	1.09%	0.60%
<b>Earnings</b>		
NIM	2.78%	2.92%
Non-Interest Income (Rs crore)	2,311	2,005
ROA	1.06%	1.13%
Cost to Income Ratio	43.61%	44.03%
<b>Liquidity</b>		
CASA	30.05%	33.05%
Credit Deposit Ratio	73.96%	72.84%
<b>Operating Ratios</b>		
Cost of Deposits	6.87%	6.35%
Cost of Funds	6.32%	5.97%
Return on Funds	8.73%	9.19%

BWR has made a study of the performance of Canara Bank vis-à-vis its peers in certain key parameters as given in the table above. BWR rating methodology has defined peer banks as those with closely similar size/operation as the Canara Bank.

Canara Bank's capital adequacy has been improving over the years. During FY 09, the bank's capital adequacy ratio under Basel II stood at 14.10%, which is 50 bps higher than its peers' average of 13.60%. However, the bank's Tier I capital stood at 8.01%, which is significantly (37 bps) lower than its peers' average of 8.38%. The bank's proposed IPDI issue of Rs 300 crore would improve the capital adequacy further.

The bank's asset quality has deteriorated during the financial year 2009. The bank's gross and net NPAs have increased to 1.56% and 1.09% during the year. In spite of the increase in non-performing assets, the bank's gross NPAs were 26 bps lower than its

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peers' average of 1.82%. However, the bank's net NPAs were significantly higher than its peers' average.

The bank has recorded a net interest margin of 2.78% during the year, which is slightly (14 bps) lower than its peers' average. On the other hand, the bank's non-interest income is significantly higher than its peers. In spite of healthy profits reported during the year, the bank's return on assets was still lower than its peers.

The bank's CASA deposits stood at 30.05% in FY 09, which is 300 bps lower than its peer banks' average. However, the bank's credit deposits ratio was higher than its peers.

### Shortcomings:

In the analysis of the Canara Bank's performance for FY 2009, a few shortcomings as under have been noticed.

- a) The share of CASA deposits has slipped from 32.39% as of 31<sup>st</sup> March 2008 to about 30.05% by the year ending March 2009.
- b) Consequently the cost of deposits has increased from 6.80% in FY08 to 6.87% in FY09.
- c) The bank has restructured nearly 72,184 accounts, which is 1.49% of its loan outstanding during FY09. Asset quality could get affected slightly in the coming year, which is evident in its Q1 FY 10 (gross NPAs increased to 1.74%).

### Mitigants:

The bank has taken conscious decision to improve its performance during the year to overcome the aforesaid deficiencies. It has introduced several new schemes for mobilizing low cost CASA deposits. Further, the bank intends to open 200 branches during the current financial year, which would help the bank to generate more low cost deposits. It is also encashing upon its technology initiative, to provide a wide range of value added services to its ever expanding clientele base. The Bank has in place appropriate risk management practices and is taking suitable steps for reducing the NPAs and improves asset quality. Overall the bank is taking necessary steps for overcoming the deficiencies.

### Bank Profile:

Incorporated in 1906, Canara Bank is one of the oldest public sector banks in India. The bank is from Dakshina Kannada district of Karnataka, the home of several outstanding banks in the country. The bank has always been in the forefront to improve its productivity and efficiency. Over the years the bank has been transforming itself from core banking activities to value added solutions.

During FY 09, with 55 new branches, the bank's delivery channel consists of 2733 branches, 2019 ATMs and 150 e-kiosks for Railway Ticket Booking. The bank has by-and-large spread its distribution channels evenly across four regions, namely metro, urban, semi-urban and rural. The Government of India (GoI) is a major shareholder of Canara Bank with a stake of 73.17%.

### Shareholding Pattern (As on 31<sup>st</sup> March 2009)

Shareholders	Stake
Government of India	73.17%
Financial Institutions	5.78%
Foreign	14.04%
Retail	7.01%

### Industry Snapshot:

Over the years, the Indian banking sector has benefited from a stable macro economic environment with unparalleled systemic support from the Indian government. The financial year 2009 witnessed deterioration in the global financial condition, which tightened the liquidity position and affected the credit off-take. Nevertheless, the Indian banking sector has skillfully tided over the crises, with ample support and measures to stimulate the economy from the government and RBI.

As scheduled, these banks have successfully implemented the Basel II norms during financial year 2009 in spite of financial crises in the domestic market. The public sector banks especially have shown a positive growth on account of proactive measures taken by the government during the year.

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## Rating Outlook:

Brickwork Ratings (BWR) issue rating is based on CAMEL-TP framework, which is used to assess the bank's financial fundamentals and risk exposures. The rating assigned to Canara Bank is specific to the proposed innovative perpetual debt issue of Rs 300 crore. The rating factors Canara Bank's ownership structure, (majority stake held by Government of India), optimum cost structure, higher profitability, diversified income stream, comfortable capital adequacy and CASA deposits.

Continuing financial crises in the international markets and the consequent impact on the domestic markets, though on a relatively much smaller scale, have reduced the appetite for credit off take. It may put some pressure on banks in maintaining asset quality and their margins in the near term Brickwork expects that the bank's healthy capital adequacy, sound fundamentals, efficient risk management system, and low operating expenses would enable the bank to tide over the current situation and maintain its growth. As such, Brickwork has assigned 'Stable' outlook for the bank's issue.

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