MD and CEO's Message

A ROBUST FOUNDATION

> There is a push from the regulator towards financial inclusion and they insist on high asset quality at the same time. It is more possible to address this paradox today than before because India has created a unique digital infrastructure, including credit bureaus, biometrics, e-KYC...

V Vaidyanathan
Managing Director & CEO

Dear Shareholders,

It's a great pleasure writing to all of you on the occasion of IDFC FIRST Bank's Annual Report for the year 2022-23.

First, a few words in the context we operate in. India is well placed with moderate inflation and strong GDP growth. India is powering up today with a few key pillars including acceptance of entrepreneurship as a key driver of progress, accelerated pace of capital expenditure, providing social benefits to the bottom of economic pyramid, building digital ecosystems, increased financialization, liberalisation, reforms like GST, and timely shift towards a "green" economy.

If India stays on such course of reforms, and continues investing in physical, digital, and social infrastructure, we will all see the miracle of India almost reaching developed country status within our lifetimes, exceeding per capita income of $15,000 by 2050.

In the medium term, with the economy projected to touch $7 trillion economy by 2030, a significant shift is underway – millions of people are advancing from lower to mid-income tiers and from middle to upper class. Rising disposable incomes empower citizens to aspire for and afford enhanced quality of life. A recent UN report notes that India lifted 415 million from poverty in 15 years. The next 10 years will be better, and that's how the power of compounding works. The basket of goods and services consumed will change dramatically, and the economic progress will offer immense opportunities in Banking and Financial services.

The RBI is ever watchful, and forward-looking at the same time. They are sensitive toward the lower sections of society and hence a push from the regulator towards financial inclusion but they insist on high asset quality at the same time. It is more possible to address this paradox today than before because India has created a unique digital infrastructure, including credit bureaus, biometrics, e-KYC, e-agreement, e-verification, and e-cash flow assessment, where we get more precise, digitised information and trackability of transactions and cash flows.

Coming to our Bank, I'm happy to share that the bank has come through its unique birth pangs of a DFI (Development Financial Institution) converting to a universal Bank and has emerged very strong. In the private sector, after ICICI Bank in 2002, we are the only other institution which has successfully managed such a transition, which was done under the leadership of my former boss, the legendary Mr. K V Kamath.

To give you confidence about the trajectory for our Bank, please look at the transformation our bank has gone through. Under the visionary leadership of our former MD and CEO, Dr. Rajiv Lall, IDFC acquired a universal Bank license, which is an extraordinary lifetime achievement few can parallel, a lifetime contribution to our Bank, and to our country. The Bank at that time itself proactively started the movement towards retail and scouted for a retail franchise, which is how the merger with Capital First happened. DFIs, by nature, have large exposures, institutional borrowings, and institutional lending. Because of our DFI background, our Bank had several unique challenges at inception.

As of December 31, 2018 because we were a newly created Bank, we had a low CASA base with CASA ratio at 8.68%. Because of our DFI background, we had low core operating Profits, at only 0.32% of assets in H1 FY 19, leaving little cushion for credit costs or PAT. Most of our liabilities (91.96% or ₹ 1,18,981 crores) out of total deposits & borrowings of ₹ 1,29,381 crores were institutional. Only 8.04% were retail. To add, the Bank had rather large exposures in infrastructure and corporate Loans which went into rough weather because of the changing economic winds. We booked losses of about ₹ 2,000 crores on these accounts and stopped accrual on the charged-off accounts which reduced our operating profits further. One well-known telecom exposure didn't eventually cause losses but made for a tough period to navigate for over a year because of our outsized exposure of ₹ 3,244 crores, speculative reports, and our large exposure at that time. We learnt from all these instances. The retail loan book the Bank had built pre-merger was excellent.

For our Bank, this was a tough spot to be in. Having low operating profits is a big issue, because there is no space to invest in anything. It's also a hard to solve issue because it is a structural problem where we needed to change the business model and in a safe manner. If we invested in branches, ATMs, and people to address the low retail deposits issue, the already low operating profits with Cost to income ratio of 95% would push us further into the red. If we didn't invest, couldn't address the issue. It was hard to resolve in itself. Amid this, COVID appeared.

I am happy to share with you all that our Bank has addressed all these issues, step by step, during the last 4 years. It's safety first at our Bank, so we first grew retail deposits, and paid off bulk deposits. To aid the process, we exercised discipline and slowed down loan growth for three straight years. We now have a good CASA ratio of 46.5% as of June 30, 2023. Next, we addressed all legacy corporate accounts. Finally, we addressed profitability; we made Core Operating Profits of ₹ 4,607 crores and PAT of ₹ 2,437 crores in FY23. CORE Operating Profit as % of average assets has increased from 0.32% pre-merger to 2.33% in Q4 FY 23 and is still growing. Our capital adequacy is strong at 16.82% as of March 31, 2023.

Appreciating our progress, three reputed rating agencies, CRISIL, ICRA and India Ratings upgraded our long-term credit rating to AA+ (Stable) in the last six months which is a significant external endorsement of the strength of the Bank.

Such progress has been possible with the guidance and support from the RBI, who have been patient with us and guided us to improve and become a stronger institution. The progress was also because of the exceptional goodwill of our customers and shareholders towards us. Our employees are working hard to strengthen the Bank. They say it takes an entire village to raise a child, we are a perfect example.

Universal Bank: We are a universal bank. You may have heard about our several innovative products for retail deposits, retail loans and credit cards. But what is less known is that we have also built many new capabilities for SME solutions, Wealth Management, NRI banking, Transaction Banking Services encompassing Receivables & Payables solutions, Nostro & Vostro accounts operations, Escrow facilities, Correspondent Banking, Fastag, and Toll-acquiring. We built out Trade Finance capabilities such as issuance of LCs & BGs, providing SBLC, Packing Credit, Pre-shipment and Post-shipment Finance, Dealer Finance and Purchase/Sales Invoice discounting. We also built out Treasury products including risk hedging solutions like Forwards, Swaps, Options, and other Forex Solutions to give complete end to end solutions to corporates. These are all essential builds for the long term for our Bank. As our Bank gradually scales up, we expect these to aid profitability.

Culture: We have built a culture that places ethics and customer's interest at the centre of everything we do. This culture reflects in the way we are designing our products and services. I'll tell you a small story of how we arrived at our Zero Fee Banking proposition for Savings Accounts. In April 2022, our product management teams discovered that we were charging less for our debit cards compared to the market, so they benchmarked us with competition, revised the fees upwards, and sent a mail to customers to this effect, to be effective June 30, 2022. We got customer feedback on receiving this communication saying we are your founding customers; can you reconsider this. This triggered an internal debate and we introspected on our entire fee structure and its descriptions.

On introspection, we found the rate card for Fees and Services for savings accounts quite complex. During the debate, I showed this rate card *"Free limits: First 5 transactions or ₹ 1.5 lakhs whichever is earlier of cash deposits/ withdrawals (Self/ Third Party). Cash transactions at Non-Home Branch: Cash transactions up to ₹ 25,000/ day, Exceeding which for self, ₹ 5/ ₹ 1,000, Minimum of ₹ 150"* to a smart young Management Trainee and challenged her to compute the charges for a simulated cash deposit of ₹ 1,00,000 at our branch. She struggled. On the other hand, product managers

Technology: We have invested and built technology platforms and analytics capabilities to create differentiated end to end digital products and services to address the needs of our customers. We still have a lot of ground to cover to catch up with the breadth of services offered by other established banks and we will work on the same.

People: Being a young bank, we are less bureaucratic, we have more contemporary systems, latest technology, more growth opportunities. Also, today's youth also relate to ethical practices and social impact. We are thus attracting the best talent in the industry. When we put out any job offer, we get overwhelming number of applications from top rated employees of best institutions.

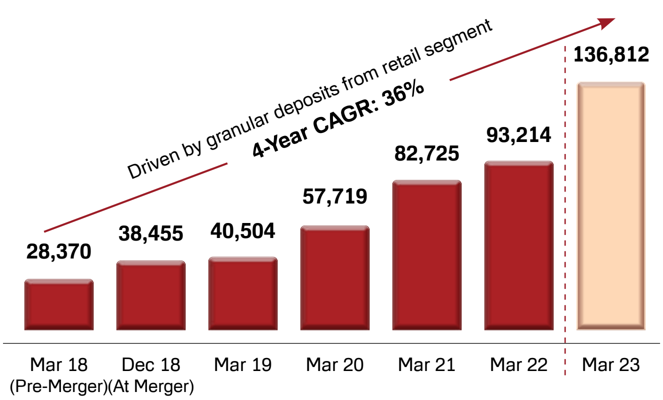
Market opportunities: At ₹ 1.60 lac crore of loans and advances, we are around 1% of the overall credit outstanding of ₹ 160 lac crore of bank credit and NBFC credit, after netting off Banks' exposure to NBFCs, as of March 31, 2023. On the deposits side, again, we are a fraction of overall deposits of ₹ 180 lac crore. In addition, these markets are growing. So, to grow, we don't need to take any undue risks, we don't have to relax our credit norms. To grow we just need to grow with the system, and for the alpha, we simply need to increase productivity with technology, or open new locations or branches. What we will need to focus on is to continuously evolve our models with time.

Let me now share with you progress at our Bank.

1. Our total customer deposits are growing well. With the image of a strong positive brand, if we open a branch in any city, we are immediately getting a gush of deposits. We will calibrate addition of branches and digitisation according to our deposit requirements.

Total Customer Deposits (₹ in crore)

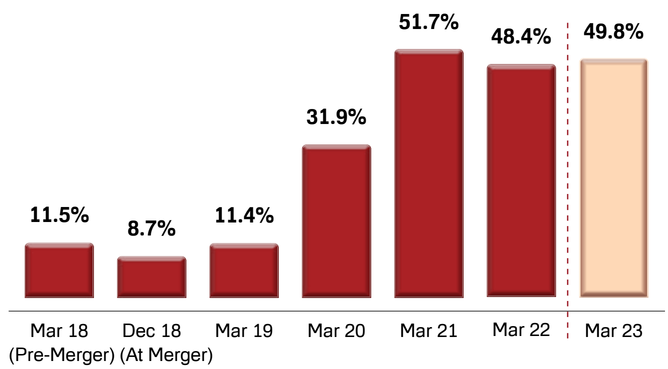
YoY – Mar-23 vs Mar-22 ▲ 47%



2. Our CASA % is quite respectable at 46.5% as of June 30, 2023. This has come down from March 31, 2023, as customers moved savings accounts to Fixed Deposits because of the interest rate environment. Customers should do what is good for them and we are happy with that.

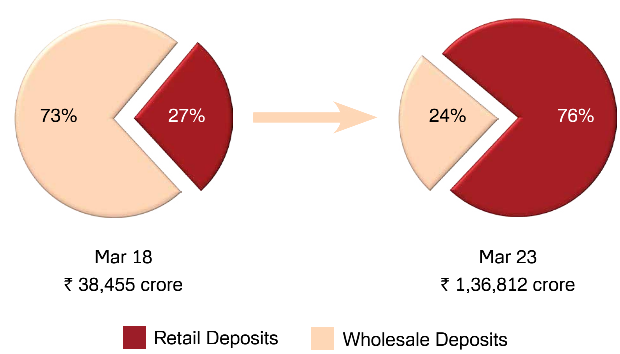
CASA Ratio (%)

CASA Ratio stable at ~ 50%



3. In a major transformation, our Bank has replaced our institutional deposits with retail deposits.

Customer Deposit Composition (%)

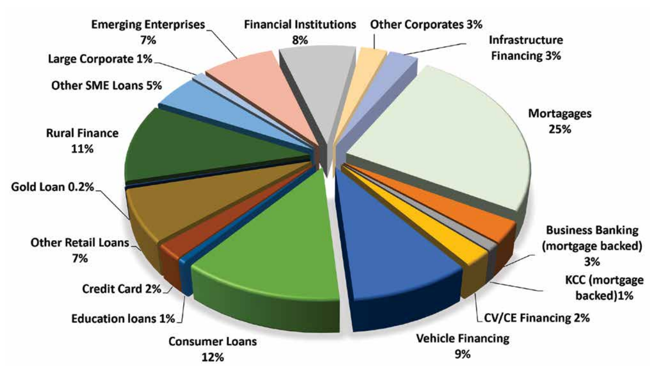


We are building a solid foundation for the long run. I request you to be patient and stay with us in the journey of building this institution. If we hurry, we will make mistakes.

4. On the asset side, we are highly diversified into over 20 business lines.

Diversified loan book across more than 20 businesses

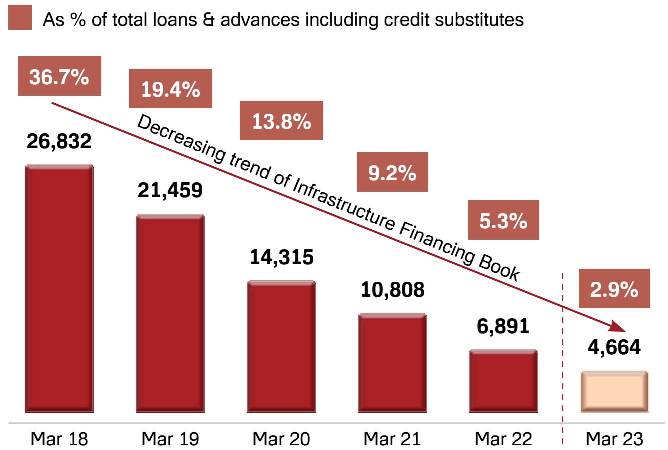
Loan Book: March 31, 2023 ₹ 1,60,599 crore



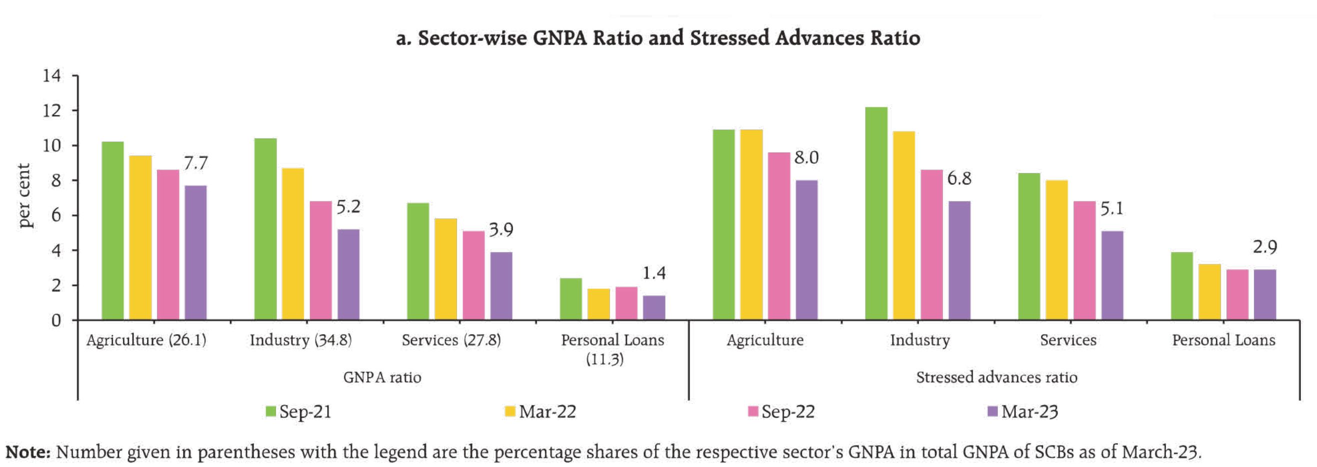
- *Other SME Loans consists of Loans to small business owners and entrepreneurs through products like business installment loans, micro business loans, trade advance etc with most loans < ₹ 5 crore.*
- *Loans & Advances are net of IBPC and include advances & credit substitutes; Consumer Loans include personal loans, and consumer durable loan.*
- *Other Retail Loans include digital lending, revolving credit, retail portfolio buyout etc.*

5. Infrastructure "Project Financing", like financing road or power plant projects are subject to project execution risks, and we have no appetite for such risk. Hence, we have brought down infrastructure Financing book from ₹ 21,459 crores as of March 31, 2019, to ₹ 4,664 crores as of March 31, 2023, and we will continue to run it down further.

Infrastructure Financing Book (₹ in crore)



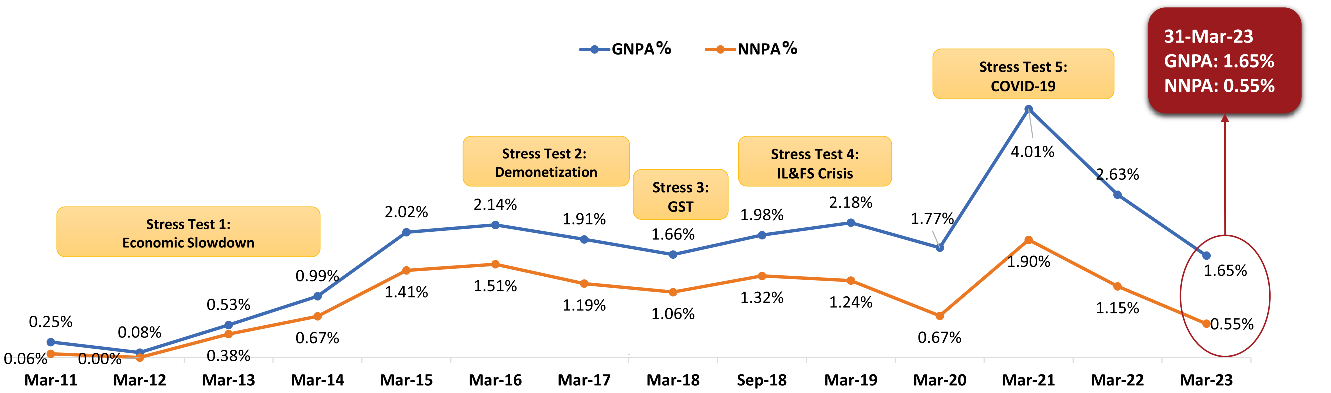
6. **Asset quality:** The Indian Banking system has seen low Gross and Net NPA in retail financing through over the last 30-40 years because of inherent diversification, evolution of credit bureaus, and more so, because in India, lending is done based on assessing the income and cash flow of customers. Off late, the tools have improved because of greater financialization, more formalisation of the economy, transactions through bank accounts, GST etc. In addition, all Indian lenders take debit mandate from the borrower's bank account. Here is an extract of the RBI Financial Stability Report of June '23.



Source: RBI (Financial Stability Report, June 2023)

In our case too, our GNPA and NNPA have stayed low at around 2% and 1% since the last 13 years, through multiple crises such as slowing economy, demonetisation, GST implementation, IL&FS crisis. In the retail and MSME segment, we are now lending to the prime customers of every product as our cost of funds reduced over time since the last decade. Also, the credit evaluation and monitoring tools have become more advanced with digital analytics and the ecosystem including credit bureau maturity, UPI, GST etc. Hence, we are confident that our Gross NPA, Net NPA and credit cost would trend lower as compared to last decade. Currently, in the retail, rural and MSME segment, the Gross NPA and Net NPA are at 1.53% and 0.52% respectively (as of June 30, 2023). We will continue to track the key lead indicators of asset quality and will be very watchful on NPA trends going forward.

NPA trend in Retail, Rural and MSME loan book



There are two main reasons for this stable performance:

One, we lend basis **"CASH FLOW ASSESSMENT"** of our customers. We usually finance already operating businesses where we can see or assess the cash flow of the borrower by many methods, such as income, bank balances, bank transactions, GST, salary credits, or by use of Scorecards where some of the variables used are indicative of cash flow or repayment capability. For salaried individuals, we assess salary information.

Two, we take **DEBIT INSTRUCTION** to debit EMI to the customer's bank account, so we **PULL** money from the customer's operative account. In JLG, our employee visits the customer on the due dates and collects the money which practically works as well as a debit instruction.

This combination of CASH FLOW FINANCING + DEBIT INSTRUCTION practically works as an escrow and helps us get our collections seamlessly.

Products like Credit Cards have no direct debit mandate and we cannot pull money from customer's account, and we are extra conservative here with our norms.

To elaborate our **Risk Management Funnel** works as follows:

a) **10 step detailed process:** We follow a 10-11 step process in underwriting loans that includes (i) entry-level go no go criteria, (ii) de-duplication, (iii) credit bureau, (iv) risk scorecard, (v) bank statement analysis and cash flow analysis, (vi) financial ratio analysis, (vii) personal discussion with customer, (viii) contact point verification, (ix) fraud checks, (x) industry checks, and (xi) collateral checks. These checks change from product to product. Some of these steps are subsumed in our digital processes.

b) **New Digital ecosystem:** We use the latest tools and digital ecosystems which gives more accurate and updated information; this is improving our credit underwriting further.

c) **Cash flow assessment:** As described earlier in this note.

d) **Debit instruction taken upfront:** As described earlier in this note.

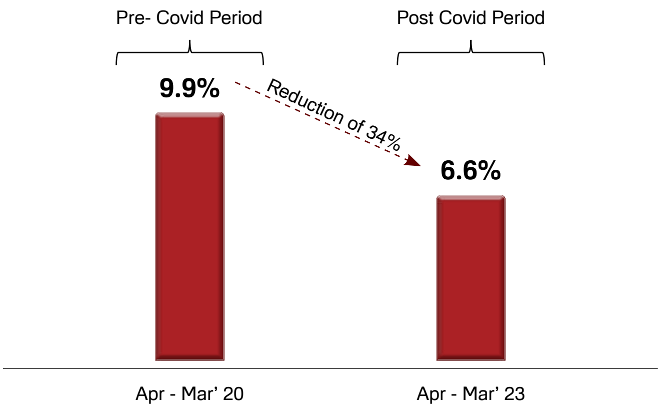
e) **Bureau deterrence:** Customers have become more aware and are sensitive about their credit bureau score.

f) **Legal processes:** Legal mechanisms of recovery are the final layer of protection for the Bank. This is a small fraction of our collections, as most repayment is received by banking the debit mandate.

g) **Monitoring First EMI clearance %:** We monitor the EMI clearance % of First EMI after Booking every month. It is a direct indicator of the Quality of incremental Booking done the previous month. We report these publicly every quarter.

MD and CEO's Message

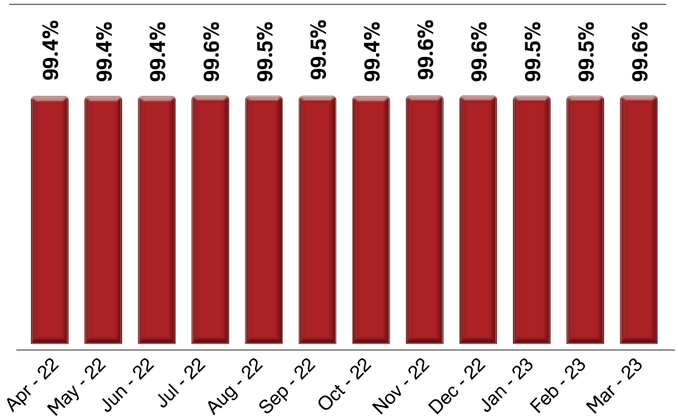
Our First EMI cheque bounce dropped to only 6.6%



Note: Numbers pertains to urban retail portfolio

h) **Monitoring Collection Efficiency:** Our current bucket collection efficiency in the urban retail & MSME loans has remained at 99.5% over extended periods of time. This excludes prepayment collections and arrears collections and accurately reflects our collection efficiency. We continuously improvise and take corrective actions. We report these numbers publicly every quarter.

Current Bucket Collection Efficiency (%) trend

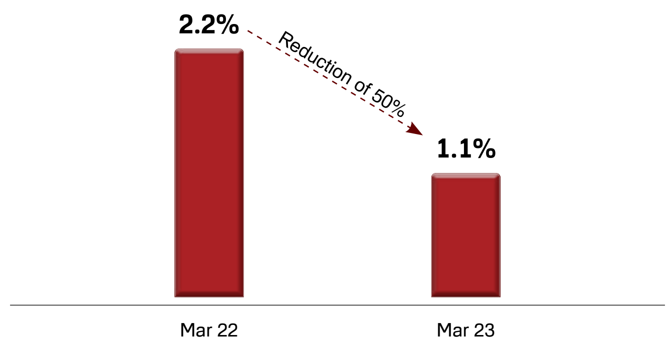


Above figures are for Urban Retail and MSME Loans. Similar trend and collection efficiency levels are seen in Rural Loans as well.

i) High collection percentage leads to low SMA, which is the Pre-NPA Stage. (Definition: SMA1 = 31-60 days overdue, and SMA 2 = 61-90 days overdue. NPA = 90 days overdue.).

Bank has low SMA (SMA1+SMA2) as 1.1% as of March 31st, 2023 for retail, rural and MSME financing. This has further improved to 0.85% as of June 30, 2023.

Retail, Rural and MSME Loans: SMA (SMA1+SMA2) as % of total book

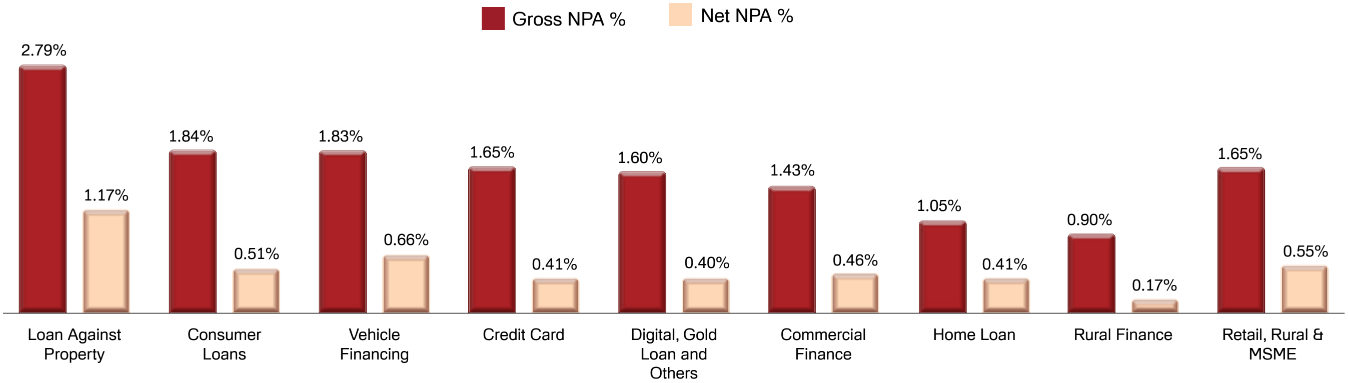


j) Our Low SMA (0-90 DPD) in turn leads to low NPA (90+). Our product wise Gross and Net NPA % as of March 31, 2023 are provide below. These NPA levels have further improved as of June 30, 2023.

Our Credit costs (Provisions) have been quite low and steady. Even in FY22, the year impacted by the second wave of COVID national lockdowns and no moratorium, our Credit cost was only 1.81% of assets. For FY23, the credit cost was only 0.79% of assets. This is again reflective of strong Risk Management practices.

In summary, we are building a world class bank with high levels of corporate governance, good risk management practices, consistent growth of 20-25% with high asset quality, contemporary technology, customer friendliness, a positive work culture and can reach high teens ROE in a sustainable manner. We are making steady progress in this direction.

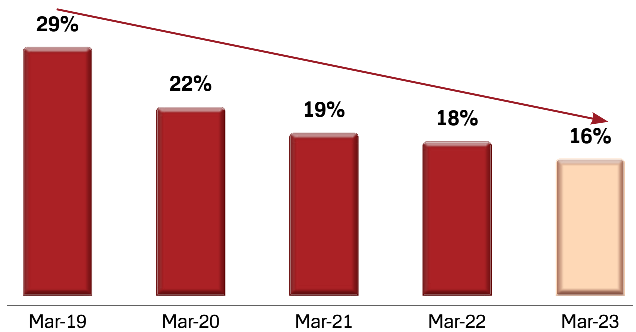
Retail, Rural & MSME Financing: Product wise NPA levels as of March 31, 2023



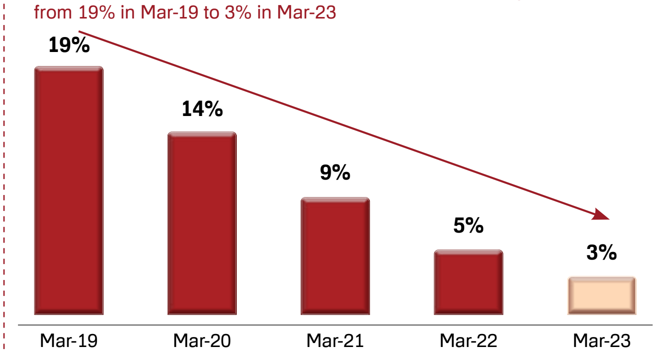
k) Our portfolio is reviewed in great granular detail by Vintage analysis, LTV cuts, geography, customer segments, product schemes and many other such cuts, real-time, by the Risk Management Division. This is further reviewed every quarter by our Risk Management Committee of the Board headed by an Independent Director. Our Board of Directors further reviews these trends and provides independent guidance.

Risk Management in Wholesale Banking

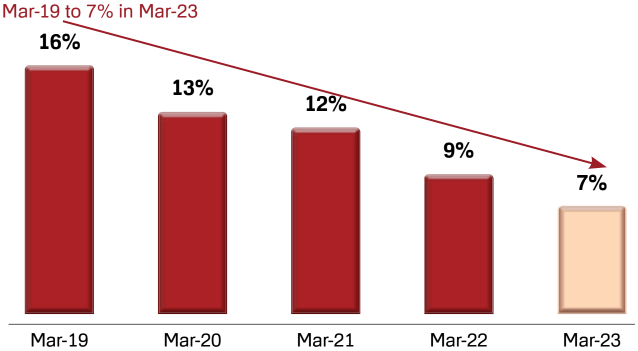
The Bank has reduced its corporate (non-infra) book from 29% in Mar-19 to 16% in Mar-23



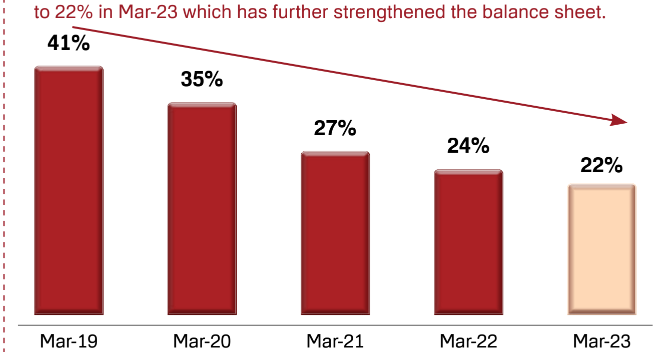
Similarly, the Bank has reduced its infrastructure financing portfolio from 19% in Mar-19 to 3% in Mar-23



Also, the exposure to top 20 single borrowers reduced from 16% in Mar-19 to 7% in Mar-23

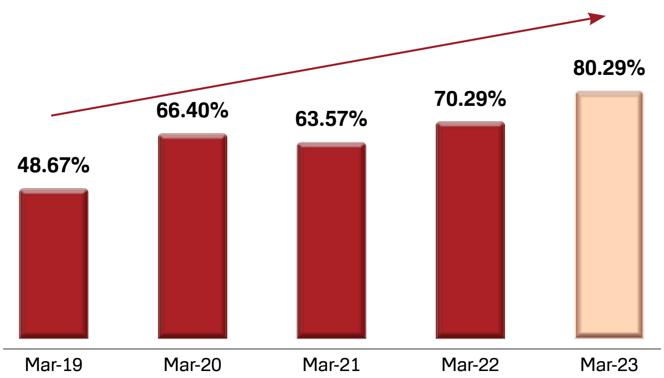


Further, the exposure to top 5 industries also reduced from 41% Mar-19 to 22% in Mar-23 which has further strengthened the balance sheet.



l) The bank has increased Provision Coverage Ratio for further protection.

Provision Coverage Ratio (%)



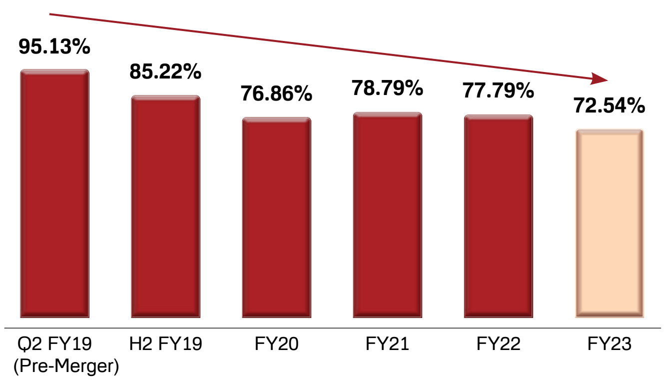
7. **Cost to Income:** We are a set up stage bank. The investment we made in Branches, ATMs, technology and product builds were particularly unavoidable for a large DFI with wholesale liabilities converting to a Bank. Despite these expenses, we have brought Cost to Income Ratio down from 95% pre-merger to 72% today. This achievement was possible because of the strong incremental profitability at the Bank.

   Our Cost to Income ratio as well as ROE is clouded because of two issues at our Bank. One, our Bank is paying an interest of around 9% on legacy liabilities of ₹ 17,000 crores which we will replace at around 6.5% with incremental deposits. Further, the bank has launched many new businesses such as home loans, credit cards, gold loans, which are currently loss-making because of nascent stage, but will all turn profitable with scale. As this scale phenomenon plays out, the Cost to Income ratio will come down gradually and the true picture of our profitability will emerge.

   We should look at Cost to Income ratio in the context of profitability and Return on Equity because costs finally feed into profitability. At the time of the merger, we guided for ROE to reach 13-15% by exit quarter FY 25. We are confident reaching the guidance comfortably by the target date, despite many significant setbacks including legacy corporate income reversal and impact of COVID, enhanced expenses of the new technology wave. It tells you that we are taking our commitments seriously and we are making judicious investments which are paying back. And the trajectory of increase of ROE will rise beyond 2025 too with scale. When comparing our profitability with other banks please see our progress in the context that we are practically 5 years old Bank while other banks have been around for 20-30 years.

   We are building a solid foundation for the long run. I request you to be patient and stay with us in the journey of building this institution. If we hurry, we will make mistakes.

Core Cost to Income Ratio% (excluding trading gain)

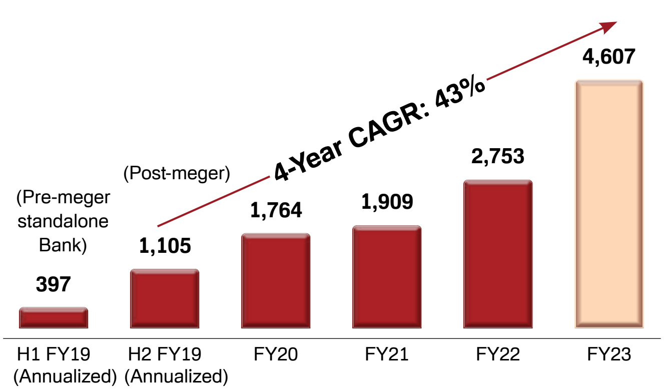


8. **Profitability:** On the Net Profit, we have firmly turned the corner. In mid 2021, two AGMs ago, I had announced to all of you that our Bank will never post a loss again as our operating profts are now strong. We have lived up to it.

   Our **Core Operating Profit** (NII plus Fees less Opex, excluding trading gains) has risen steadily over the years. During FY 22-23, the loan book grew by 24% while operating profit grew by 67%. This assures you that the incremental business is very profitable.

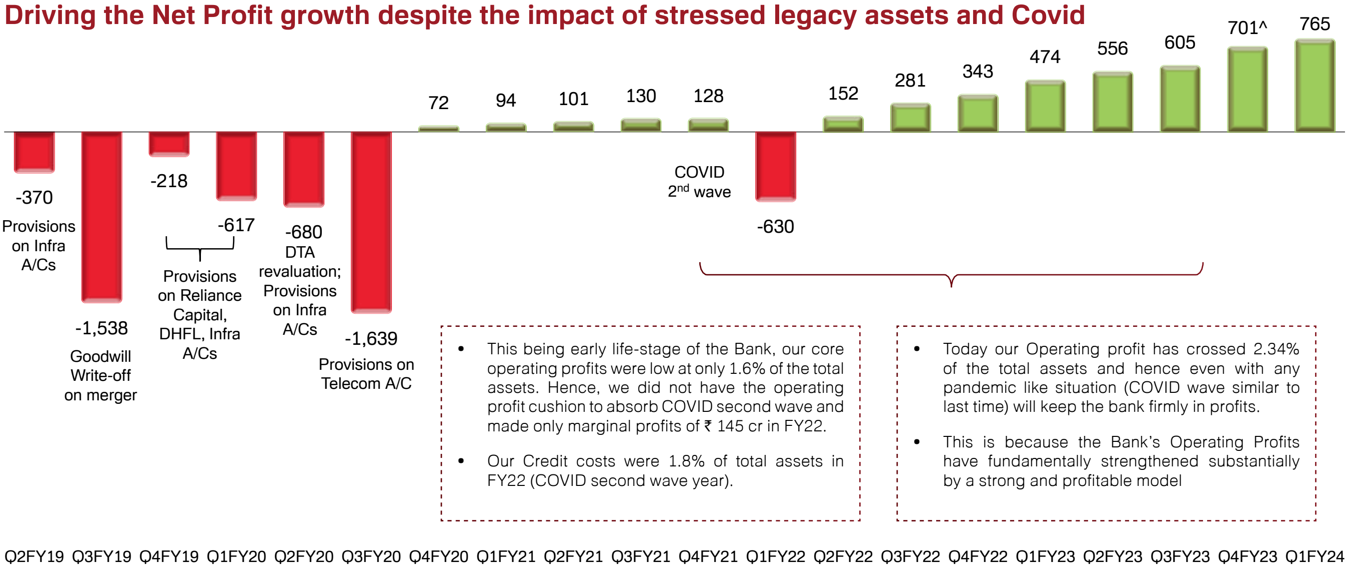
   We have already shared with you that our retail loan book is delivering return on equity of more than 20% after adjusting for Operating expenditure, credit costs and tax.

Core Pre-Provisioning Operating Profit (In ₹ Crore)



Our **Net Profit** has been rising steadily every quarter for the last 8 quarters (see chart below) which talks to the inherent strength of our business model.

Quarterly Net Profit / Loss (₹ in crore)



^ The Bank reported net profit of ₹ **803 crore for Q4 FY23.** The Bank has already called out in Q4-FY23 that the net profit of Q4-FY23 was ₹ **701** crore adjusted for the one time items in the P&L.

In summary, we are building a world class bank with high levels of corporate governance, good risk management practices, consistent growth of 20-25% with high asset quality, contemporary technology, customer friendliness, a positive work culture and can reach high teens ROE in a sustainable manner. We are making steady progress in this direction. We are very conscious to build this Bank for the long run.

ESG: Our Bank has made strong progress on aligning itself with ESG. Our ESG scores have improved materially. The Chairman of our Board is particularly passionate about ESG and somehow manages to connect every conversation in the Board room to the topic of ESG.

Merger: Finally with the announcement of merger, the uncertainty and overhang about the merger is over. The IDFC Limited team worked hard for over two years to unwind their structures to enable this, and we appreciate their efforts a lot. If you observe global corporations such as JPMorgan Chase, HDFC Bank, ICICI Bank, they all have diversified public and institutional ownership and grow for decades and centuries. In that sense, the merger is an epochal moment for the Bank.

Our Board members are highly accomplished and senior people who have run large, reputed corporations or have been in senior regulatory positions. They understand corporate governance and are extremely sensitive about it. They are involved in formulating the strategy of the Bank. I sincerely thank every member of the Board for their very involved and meaningful involvement, great ideas, advice, and for bringing checks and balances to our approach.

Our employees are working very hard to meet the vision to build a world class bank in our country. To build a world class bank for our country is a great privilege of our lifetimes.

Once again, I sincerely thank the RBI, for their continuous guidance, patience with us, and support for us, as we are building the Bank. I thank our rating agencies for their insights and endorsement.

I thank all of you, shareholders, for your trust and for giving us a long rope.

Thank you.

Sincerely,

V. VAIDYANATHAN

Managing Director & CEO

IDFC FIRST BANK LIMITED