A World-class Bank in the making

V Vaidyanathan
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Dear Shareholders,

It is a great pleasure writing to you once again. It has been two and a half years since the merger and during this period, our Bank has made tremendous progress on laying the foundation for a highly successful and megabank of the future. I would love to explain to you what we are truly building at our Bank. What we are building at the core is a new age digital Bank which is agile and highly scalable. Our pre-provisioning profits (PPOP) are low at this stage because of our DFI background with higher cost of legacy liabilities, coupled with the set-up costs of a new bank, but this is getting fixed at a quick pace because of our strong profitability on an incremental basis.

Chances are, as a shareholder looking at quarterly results, the underlying quality of the bank we are building is not entirely visible at this stage to you. Because the usual conversation from anchors are after any results are "So, what is your exposure to Vodafone Idea? How much more pain is yet to come on infrastructure? What is NPA in retail because of Covid? When do you see the situation normalizing?" If you're an analyst, chances are that to the above questions you will also add "Your ROE is low."

I believe they are so focused on the here and now quarter and its comparison with other established banks that the power of incremental profitability is lost in the noise. And the comparison is with banks who have already been there for 20-30 years or with entities that were already profitable when they converted to a bank. What is not visible to many is the foundation that has been laid and how quickly the picture is changing. So much so that when I was pushed hard on some such subject by a journalist, I responded instinctively "You ask Mr Kamath how hard it is to convert a DFI to a commercial bank, to my knowledge he is the only one who has achieved this". (Refer Financial Express in Press section)

Yes, that's right. Our Bank was created from an infrastructure DFI which had acquired a bank license. An infrastructure DFI, by the nature of its business, usually borrows long term funding from banks/ Bonds at market rates, and usually lends to corporate and institutions. So the margins and profitability are low and individual exposures are large. We are carrying ₹ 27,936 crore of fixed-rate liabilities at 8.66%, largely legacy, and you can imagine the upsides when these are replaced by low cost deposits.

Thus, to understand the future potential of our Bank, you should understand the true incremental profitability of our Bank. If you want to understand this, please jump straight to **Section 4** (Page 9) titled "**The power of incremental profitability.**"

I would now like to explain to you the vision of our Bank.

SECTION 1. VISION OF OUR BANK:

We have defined our vision as "**To build a world class bank in India, guided by ethics and customer-first values, powered by technology, and be a force for social good.**" We find this line highly inspiring and are working towards it day and night. Let me explain what each of these words in our vision statement mean for us.

(a) **"To Build":** To create a world class bank is an opportunity few people get in their lifetimes. Our employees could get opportunities to work in "world-class" organisations, but "building" one is something else.

(b) **"....a world-class bank":** For a country as large and diverse as India, and a country set to be world's third largest economy by 2030, there are few "**world-class**" banks in India. And when we say world-class, we mean banks of global scale and profitability, on the cutting-edge of innovation, providing amazing customer service, highest levels of corporate governance, generate high return on equity, and enjoying international respect and admiration. We aspire to be on that list, and are passionate about building such a bank. We have already sown the seeds for such a bank.

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(c) **"....with ethics and customer-first values":** We advise our product teams to design products in such a way that it is meant to be sold to our "near and dear" ones. We make products with transparent pricing and fees. Working on the theme of Customer First, we came up with many unique features as follows:

We advise our product teams to design products in such a way that it is meant to be sold to our "near and dear" ones.

- **Monthly credits:** We have started "monthly" credit of interest on savings accounts, against the industry practice of Quarterly credits. So, our customers earn "interest on interest" monthly on their savings accounts. To the best of our knowledge, no large bank with a Universal Bank License has ever done this.
- **Low, Dynamic APR for revolvers:** APR (Annual Percentage Rate) on credit card revolvers has always been about 3.49% per month, that's about 42% per annum. So if you carry forward any balances or if you miss your payment by mistake, you pay at 42% per annum for that month. And by the way, 40% of card holders do end up paying these rates. Either customers are insensitive to APR or don't know about it.

  We think about this issue differently. We were the first bank to set dynamic and low rates of 0.75% to 2.99% per month, or 9% to 36% per annum, based on several factors including risk rating. Check the APR on the credit card you have in your pocket right now, chances are you are paying more than our highest rates. If you apply, you might get a rate somewhere in between, and chances are that you can benefit right away. And don't forget our many other such customer friendly features.
- **Cash withdrawal interest rates:** If you withdraw emergency cash from the ATM on your credit card you normally pay ₹ 250 as one-time fee PLUS interest rate of 42% p.a. from Day 1 of withdrawal. We felt this was rather high. We charge you ₹ 250 and charge no interest till next Payment Due date. Yes, you read this right, no interest till next Payment Due date.

- **Customer First:** Where there is a misunderstanding, our instruction to the service team is "credit the customer first" and fix the root cause of the issue.
- **No Fine Print Banking:** We don't follow fine-print banking hoping customer won't notice certain terms or charges. We don't appreciate product managers who talk that language when designing products.
- **We don't pressurize** our employees to "somehow" sell high-margin products to meet fee targets. The list of our "Customer First" features is long.

  So what we are building is a bank that's clean from within. If you are wondering at this stage, if strong **Customer First** approach and great returns for Shareholders is an "either-or" trade-off, please jump straight to **Section 4** (Page 9) on "**Incremental Profitability**" where we demonstrate the power of our business profitability.

(d) **"...and technology"** India is building digital highways Aadhaar, a vast mobile network and UPI. We are coupling these with AI ML technologies, data, cloud, API banking and are committed to investing in the latest technologies to continuously stay ahead. We recently unveiled our new mobile and web app which have a large number of unique features like Google like search capabilities, Personal Finance Management, Pay-to-Contacts, one click FD creation, live mutual fund investing, risk-analyser, and so on.

(e) **"....and be a force for social good"** To create social good is the purpose of our existence. For example, apart from lending to prime segments such as prime home loans and car loans, we have also developed specialization in financing artisans, large medium and small farmers, kirana shops, restaurants, automobile spare parts, tailoring, carpentry, salons, chemists, two wheelers, consumer durables, JLG in rural areas etc. The purposes of financing include business expansion, cattle purchase, water and sanitation financing and so on.

We have financed over 30 million such loans till date in our combined experience. We have developed unique skills in this area with stable and high asset quality of Gross of ~ 2% and Net NPA of ~ 1% for over ten years. Similarly on the deposits, investments, insurance or wealth management, we can create many solutions for customers across cross section of society, that can create great social good.

To create social good is the purpose of our existence.

Propagating our vision statement: We first came up with the idea of a **"seal"** to capture our key themes to share with our employees. We then debated hours over multiple sessions about what should be on the seal. After much debate, we settled in on three themes: **Ethical Banking, Digital Banking and Social Good**. This also goes well with our vision statement.

"Social-Good" is the **purpose** of our existence. Our business must add to larger social good. We exist to serve society- urban and rural, rich and poor, salaried and self-employed, cities towns and villages, and manufacturing, agriculture or services.

"Ethical" is the **means** we want to use in dealing with everyone. There is no point becoming highly profitable if not earned the clean way.

And **"Digital"** is the **medium** we want to use. The seal looks as follows:

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Coding the DNA: By making this seal and sharing with employees, we are attempting to code the DNA of our employees. That's because we are an early stage bank and the DNA code we build will affect the long term conduct of our employees. This also becomes an internal check and balance among employees for good conduct as expected of them.

We are trying to code the DNA of our employees to align with the vision and mission by sharing the seal with them.

SECTION 2. EXPECTATIONS AT MERGER.

As compared to the original estimates at the time of merger, we have outperformed on every front but profitability. On profitability, we would like to share that the issues in infrastructure and certain corporate accounts turned out to be more than expected because of the economic cycle. This resulted in impact on our net-worth by about ₹ 2,000 crore. Our Bank had also sold down loans worth ₹ 6,448 crore to ARCs prior to the merger, and non-accrual of income from these exposures additionally affected operating profit.

I would like to share that we have substantially overcome the situation because of NIM increasing to 5.5% in Q1 FY22, which has resulted in Core Operating Profit crossing ₹ 600 crore in Q1 FY22. The core premise of attaching a well performing asset machine with a bank's liability machine is well intact. We believe the Bank will head towards excellent profitability in upcoming few years and we will cover lost time.

SECTION 3: OVERALL PERFORMANCE OF OUR BANK SINCE MERGER:

1. **A strong Deposit Base:**

   We have always maintained that to have a strong and stable deposit base is the most important foundation for building a great bank for the future. On this count we have achieved the following progress:

   a. **Strong CASA Ratio:** At the time of merger in December 2018, IDFC Bank was a recently formed Bank and thus did not have much CASA, and Capital First was an NBFC with no CASA. On merger we had CASA ratio of 8.68%. At that time every analyst told us that the hardest issue to fix for you will be the liabilities side. We are happy to report that our CASA ratio has crossed 50%. If anything, this describes our capability to raise deposits, a key raw material for growth.

   b. **Strong granular deposit franchise:** During H1 FY21, markets were roiled, exchanges were crashing across the globe, there was crisis at one private sector bank, and it felt the world was falling apart. The general experience in the banking system was that there was a flight of deposits to the top large banks. I am happy to report that precisely during that period of COVID chaos, IDFC FIRST Bank's granular customer deposits (Balances less than or equal to ₹ 5 crore) grew by a whopping ₹ 6,315 crore in Q1 FY 21 and by another ₹ 10,565 crore in Q2 FY21! So the COVID ravaged quarter was our highest ever growth in granular deposits. Such is the confidence our customers bestow on us in a COVID year, and we know it is our job to live up to their trust. We thank them wholeheartedly.

   Overall, during FY 20-21, our granular customer deposits (balances less than or equal to ₹ 5 crore) grew by a whopping ₹ 33,788 crore, or 99% YoY. Today 82% of our customer deposits are granular customer deposits (balances less than or equal to ₹ 5 crore) as compared to 30% at merger.

As on	Mar 20	Jun 20	Sep 20	Dec 20	Mar 21	YoY Growth
Deposits balance upto ₹ 5 cr	₹ 34,267 cr	₹ 40,582 cr	₹ 51,147 cr	₹ 60,383 cr	₹ 68,055 cr	99%

C. **New account opening continues to be strong:** The deposit inflows were strong, and more than our requirements. So, to optimize the flows, we reduced our savings account interest rates. I am happy to share that our new account opening continues apace. On a related note, reducing our savings account interest rates had another positive side benefit; we can now participate in prime Home loans profitably which has multiplied our market opportunities.

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d. **Reducing Concentration risk:** Deposits from our Top 20 depositors have reduced from 40.0% of customer deposits at merger to only 7.7% as of March 31, 2021. This is a conscious risk mitigation measure. You can rest assured your Bank's deposit base is diversified and super safe!

2. Maintaining strong Liquidity:

We always maintain liquidity more than regulatory requirements. We ended Q4 FY 21 with average LCR of 153%, against regulatory LCR requirement of 100%. Again, your Bank will never ever take chances on this count.

3. Maintaining strong Capital:

We have always been and will always keep ourselves capitalized in excess of regulatory requirements at all times. In June 20, even while COVID first wave was raging, we raised ₹ 2,000 crore of equity. Again, in April 21, the COVID second wave had just reared its head, we raised ₹ 3,000 crore of equity. We enjoy support of long-term investors. Our capital adequacy is strong at 15.56% as of June 30, 2021.

4. Excellent Retail Assets model:

This is the core engine of our Bank and is performing exceedingly well. We feel we will easily surpass the five-year guidance of ₹ 1,00,000 crore given at the time of merger.

5. Asset Quality:

a. **Corporate Accounts:** We have had a few issues from large corporate accounts, including a housing finance company, a financial conglomerate, a Mumbai based Toll Road company, an Odisha based power account, a telecom account and a few other such accounts because of downturn cycle in infrastructure financing in India and a few financial conglomerates going down. Barring our exposure to the telecom account, we feel most of the issues are behind us.

b. **Infrastructure financing** is a difficult business because of dependence on regulatory approvals and dependence on ecosystems on which we have limited control. We have brought down the loan outstanding to infrastructure from ₹ 22,710 crore at merger to ₹ 10,808 crore as of March 31, 2021.

c. **On the Corporate Banking side**, we have implemented good controls in our Bank and our recent portfolio performance is pristine.

d. **Significant reduction in the identified stressed list:** We have brought down the Identified stressed asset list (Accounts that we consider stressed over and above the declared NPA) from ₹ 4,138 crore as of March 31, 2019 to ₹ 2,264 crore as of March 31, 2021. (further reduced to ₹ 1,371 crore as of June 30, 2021).

e. **Large borrowers' exposure** As a risk mitigation measure, we have reduced exposure on large borrowers. Our top 10 borrowers as a percentage of total exposure has come down from 12.8% as of December 31, 2018 to 5.9% as of March 31, 2021.

f. **Retail Assets quality:** On the retail side, our asset quality has been pristine at Gross NPA of ~ 2%, Net NPA of ~ 1% for over 10 years, through stress tests of Demonetisation, GST implementation and economic slowdown. During COVID our retail NPA has increased, but we are confident of reverting to our pre-COVID GNPA and Net NPA around end of FY 22, based on the strong pickup in collections post COVID second wave. We should trust our skills, track record, experience and technology, and not doubt ourselves just because of a pandemic that came our way. We learn, adjust, refine, and move on.

g. **Expanding customer segments to cover Prime Home Loans:** Because we have dropped our interest rates, we can sustainably pursue prime home loans, the safest category of loans. We expect mortgage backed loans to form 40% of our loan book in due course.

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h. **Credit Costs:** Our provisions for FY 21-22 is expected to be only 2.5% of the average loan book which is quite reasonable by industry standards, of which a substantial portion has already been taken in Q1 FY22, hence you can expect to see successively reduced provisions in Q2, Q3 and Q4 FY 22. Going forward we expect to keep our provisions at below 2% of the average loan book.

i. **2- 1- 2 Formula:** We will be targeting a 2-1-2 formula, i.e. Gross NPA of 2%, Net NPA of 1% and provisions of 2% on funded assets on a steady state basis.

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SECTION 4. INCREMENTAL PROFITABILITY OF OUR BANK:

Please read the following notes on our incremental profitability to understand the profitability of our incremental business.

a. **Strong incremental profitability of retail lending business:** Our incremental borrowing cost is less than 5% and incremental lending in retail is over 14% at this point of time. So our incremental spreads on retail is over 9%. We have specialization in these segments and our credit costs (provisioning) are expected to be about 2% based on the combination of products we finance. Thus our incremental ROE in the retail lending business is estimated at 18-20%.

b. **Strong incremental profitability of Corporate Lending business:** Here, the estimated incremental business ROE is 14-15%.

But you are not yet seeing this profitability in our books because of the following two points.

c. **Higher cost of ₹ 1,000 crore from Legacy Liabilities currently:** As of June 30, 2021, the Bank has ₹ 27,936 crore of liabilities at 8.66%. These are largely legacy borrowings of our DFI background, and these are the challenges of converting a DFI into a bank. When our Bank will replace this at say, 5.0%, we would save about ₹ 1,000 crore per year on an annuity basis compared to today. This is a legacy issue on the liability side and will go away with time.

When our bank will replace this at say, 5.0%, we would save about ₹ 1,000 crore per year on an annuity basis

d. **Set up costs in retail liabilities because of investments as we are a new bank:** Since merger to March 31, 2021, we have invested in 390 branches, 565 ATMs, added over 12,000 employees, invested and upgraded our technologies, launched or scaled up many new businesses like credit cards, Wealth Management, Fastag, Gold loans and scaled up many retail lending businesses like prime home loans and digital lending, all these are essential capabilities for building a large bank. These investments are giving us a negative drag today but this will become profitable with scale.

e. Incremental return on capital. Now let me tell you something amazing about our progress. Please study the following table:

	Q3 FY 19 (merger quarter)	Q4 FY 21	Increase %
Funded Assets	₹ 1,04,660 cr	₹ 1,17,127 cr	11.9%
Core Income (NII plus Fees)	₹ 1,495 cr	₹ 2,616 cr	75.0%
Core Operating Profit (NII plus Fees less Opex excluding trading gains)	₹ 276 cr	₹ 460 cr	66.9%

So, when we compare the merger quarter with Q4 21, the funded assets grew only 11.9% in two years, but at the same time, the Core Income grew by 75% and Core PPOP grew by 67%. The comparison with Q1 FY22 was even better. Here the core operating profit was ₹ 601 cr which was 118% over the merger quarter, while the book grew only 9% over the merger quarter. This tells you that the incrementally, the operating profit on capital is disproportionately higher as compared to incremental capital consumed. That's the power of strong increase in Net Interest Margins to 5.5%. Numbers in Q4 FY 21 exclude impact of interest on interest reversal of ₹ 55 crore.

Guidance on Profitability:

a. As explained above, our retail lending business is immensely profitable. We expect to grow the retail book by ~25% on a compounded basis for a long period of time. This is already playing out over the last 2 ½ years, as the NIM has already expanded from 1.84% pre-merger to 5.09% in Q4 FY 21 and further to 5.51% in Q1 FY 22. We expect profitability to increase as we expand the loan book.

b. The negative drag because of high cost liabilities will go away as we will repay these liabilities on maturity. The negative drag because of investments will go away with scale. Thus the highly profitable retail and wholesale businesses will shine the results.

c. Basis the above, you can expect to see a significant pickup in NII, ROA and ROE at the Bank from here on as this phenomenon plays out. We feel comfortable guiding for Return on Equity of upwards of 16% as we scale up our business, based on our experience and incremental unit economics.

I believe it is only matter of time, and not a question of whether this will happen.

SECTION 5: OPPORTUNITY FOR SCALE UP.

For our business, the market opportunities are practically unlimited for our lines of businesses. The credit outstanding in the country including banks and NBFCs is about ₹ 120 lakh crore, and as per CIBIL TU report, the outstanding for commercial loans > ₹ 50 crore is ₹ 54 lakh crore (Source: June' 21 MSME report). Thus the MSME, retail and rural and agriculture markets alone is about ₹ 65 lakh crore and growing. India is moving from unorganized to organized, underserved to served, and technology is supporting this change. We are well positioned to ride the technology wave. We are merely ~₹ 75,000 crore in this market, which is barely above 1% of this market. For us to grow at 25% is not a big deal. There is no dearth of opportunities in our great country, and we have the necessary capabilities.

SECTION 6. VODAFONE IDEA EXPOSURE:

I would now like to directly address the concerns that some of you would have about our exposure to Vodafone Idea. Let us hope the government supports the industry; out of the total dues of the company about ₹ 1.5 lakh crore are owed to the government itself and hence they will be keen to solve this issue. In any case, we have a lot of growth capital by our side. We will peruse the matter through law of the land.

With a strong liability base consisting of low-cost CASA of 50%+, we get good margins in our business. We can compound our advances continuously by about 25% for a long time, and we can build this book to any size of our desire in our lifetimes, it could be ₹ 2 lakh crore, ₹ 5 lakh crore, ₹ 10 lakh crore or more. We will ride it through without impacting our long-term future and build a great bank from here.

So we will keep our eyes riveted on the longer story. We have experienced such situations earlier and have always learnt that if we have a strong and profitable model and go on for extended periods of time, then a one-off incident does not dent the long-term story.

SECTION 7. DEALING WITH COVID

On dealing with COVID, I would like to say that were overwhelmed with the way our employees stayed motivated throughout the wave one and wave two of COVID. They were volunteering to run their branches and to assist customers. We announced a one-of-a-kind Covid Care scheme for employees by assuring them 4X their CTC, salary credit to nominee for two years, waiver of employee loan, extension of medical insurance for family for 24 months, scholarship up to ₹ 10,000 per month for two children until graduation, employment for spouse on merits or skill training allowance of ₹ 2 lakh and so on. Our employees appreciated this greatly. We implemented a bank wide cost-rationalization program. We tightened credit criteria and launched new products. We accelerated our efforts for digitising the bank. Our senior management volunteered with salary and bonus cuts to lead austerity by example. I thank them all.

SECTION 8. CLOSING NOTE.

I believe we are on to something very special here. We have set up a strong platform. Don't underestimate the power of the 50% CASA Bank with a powerful and tested lending machine attached to it. We are a mid-size bank today, but I believe we have all the ingredients of becoming a mega bank of the future, with themes of ethics, digital, social-good and customer first. I also believe our best-ever three years are coming up for us.

Don't underestimate the power of the 50% CASA Bank with a powerful and tested lending machine attached to it.

I express our sincere thanks to our regulator the Reserve Bank of India who have constantly guided us on our approach and supported us throughout. Our Board members are eminent people with rich experience, have great intellect, highest levels of integrity and have constantly guided the Bank with strategic inputs and towards very high standards of corporate governance.

I sincerely thank our customers for banking with us. I also sincerely thank each one of our shareholders for your support and confidence even in trying times. Our employees are exceptional, and I thank them all.

Thank you.

V Vaidyanathan
Managing Director and CEO