Managing Director & CEO's Message

Looking forward to FY23

V Vaidyanathan
Managing Director & CEO

We know that we are on to a wonderful model, and I am confident that if we stay the course and play with a straight bat, we will meet all aspirations of investors and other stakeholders. Hence, no matter the pressure, we communicate our strategy to all stakeholders in simple terms, stick to the plan, and deliver on the stated strategy. I am confident that with this approach, results will follow, it's only a matter of time.

Dear Shareholders,

It gives me great pleasure to write to all of you on the occasion of the Annual Report 2021-22.

There have been global headwinds to the Indian economy due to rising inflation globally, particularly in developed markets, and the consequent tightening of interest rates across the globe. Higher crude prices because of the Russia-Ukraine conflict, coupled with pressure on the Rupee has resulted in higher levels of imported inflation in our country.

During the COVID crisis, India had used its resources rather conservatively and most of the benefits given to micro-entrepreneurs in the Indian system were through government guarantees, and not cash transfers. The benefit of such conservative fiscal management is showing now, as the increase in inflation in India is only marginal compared to the pace of increase of inflation in developed countries. The RBI has been raising interest rates off late to deal with the situation.

Nevertheless, the fundamental strengths of the Indian economy continue to be strong. India has a large domestic consumption. The government is continuing to pursue market-oriented "macro level" reforms like GST, Insolvency and Bankruptcy Code, and divestments, etc., and at the same time, implementing "micro level" reforms such as welfare schemes of toilets, electricity, LPG, DBT, tap water, housing, education, and subsidies to the poor without leakage. This combination augurs well for our country in the long term. In parallel, a massive digital infrastructure is being created like e-gov, DigiLocker, Aadhaar, e-NAM, UPI, ONDC etc. about which much has been written. All these initiatives have massive long-term positive implications for our country and our business.

Our Bank, over the last few years, has undertaken numerous steps to create the foundation for sustainable growth going forward. Before I get into the details of the businesses, I would like to first discuss about the two fundamental pillars of our foundation – Governance and Culture.

GOVERNANCE

Corporate Governance is the key element of our business model. We maintain high standards of governance in terms of accounting and business practices, disclosure levels, prudent risk management, internal financial control, regulatory compliance etc. guided by our Board of Directors. The first priority of our Board is corporate governance, and all material matters are discussed and resolved transparently. The Board is focussing on all strategic issues including strategy, risk management, business environment, business planning, regulatory compliance, people, internal control functions and so on. On matters that are regulatory, our Board members are highly sensitive and insist on immediate action on identified issues. We transparently share details with the Board, regulators, shareholders and other stakeholders.

CULTURE

Culture is a wide-ranging subject, so let me focus on only a few elements here for purposes of brevity.

Long-run thinking: The first norm we follow is to keep our focus on the long run. All our metrices may not yet compare well with other banks as we are an early-stage bank, hence the pressures of public commentary, earnings, analyst reviews, stock price, quarterly reporting, investor pressure etc. could be immense. And we must face you every quarter publicly. At the same time, we know that band-aids and shortcuts to earnings to please stakeholders will mess up our culture and foundation. Such short-cuts will get coded into the genes and business model. Hence, keeping in mind our vision to build a world-class bank, we have been focusing on building a strong foundation and a strong business model on which future growth can be built sustainably.

We know that we are on to a wonderful model, and I am confident that if we stay the course and play with a straight bat, we will meet all aspirations of investors and other stakeholders. Hence, no matter the pressure, we communicate our strategy to all stakeholders in simple terms, stick to the plan, and deliver on the stated strategy. I am confident that with this approach, results will follow, it's only a matter of time.

Customer First Bank: One of the core tenets of our culture is to be a customer-first bank. Let me explain with examples. There are many features of our products that are customer friendly, that we publicize widely, like say, paying monthly interest on savings account, not charging premature FD breakage charges for senior citizens etc. But our real meaning of customer-first goes beyond that - it's how we deal with them when they are not looking. This is key.

Let us say we give rewards points to our customers for spending on our credit cards. World over, card issuers introduce frictions in redemption process so the actuarial cost of rewards points to the bank is lesser. Instead, we flash the reward points earned by the customer upfront on the app's login screen itself. We then took it one step further. We allowed customers to redeem their points against their next online purchase through a payment gateway and not insist on our product e-catalogues! Then we made our rewards points evergreen, so we don't extinguish rewards points earned by customers who forgot to redeem them in time. So, customers get their benefits even when they are not looking. Another example, we earn fees when a customer inadvertently spends over the limit, but instead of making money through this line item, we proactively start sending them messages when they reach 80% credit limit utilisation, and thus they save on fees.

This customer-friendly philosophy cuts across the bank's products. On the savings account side, there are many services for which we avoid billing our customers, say for issuing a statement of account from the branch, or non-home branch transaction charges and many more. I'm not expanding these here for brevity. These are not features that we can advertise, as there would be no recall among customers, but this is the way we are building our bank. Over time, IDFC FIRST Bank customers may appreciate our Bank when they understand our ethos. We truly care for our customers.

Near Dear Test: Last year, I wrote to you that we apply this test while designing our products and services. We tell our employees to only design such products which we can sell to our family members. And we take this test rather literally. Because we encourage our employees to ask their near and dear ones to open accounts with the Bank. So, our service, and changes therein, will be experienced by our near and dear ones too. That's our "Near-Dear" test.

Work culture: We are constantly attempting to build an organisation with lesser conflicts, more coordination, and hire employees with appropriate intellect, hard work, drive, and commitment to the organisation.

We are a universal bank with highly diversified sources of income. Apart from lending, we have launched several other new businesses such as cash management, Trade Forex, Wealth management, toll and transit, credit card business, segmented current accounts, start-up banking, and distribution of insurance and investment products.

We have demonstrated our capability to raise retail deposits.

We will not dilute credit norms to get more business. We are very careful with our portfolio quality and we monitor indicators minutely. We rigorously subject the applications through 10 specific filters. We generally reject about 40-60% of the applications received by us based on product category as part of the above stringent filtration process.

Now coming to business, let me answer some key questions that may be on your mind.

BUSINESS OPPORTUNITIES

Retail and commercial business opportunities

I would like to share with you that the total consumer, commercial (micro and small business <10 crore), MFI and agriculture credit market is about ₹ 72 trillion ($960b). Of this, the consumer business credit is ₹ 44 trillion ($586b), which includes home loans of ₹ 24 trillion ($320b), personal loans of about ₹ 7.0 trillion ($93b), car loans of ₹ 4 trillion ($53b), credit cards of ₹ 1.8 trillion ($24b), education loan of ₹ 1 trillion ($14.5b) and a few other products bring up the balance. This translates to personal credit of only about 18% of India's GDP, while personal credit to GDP of developed countries of between 80% to 120%. Considering a nominal GDP growth of 10-12% including inflation, even if retail credit compounds at 20% for 20 years, India will still be much unserved and underserved as compared to today's levels of credit penetration for global peers on personal credit. (I've tried it on a spreadsheet).

Small business financing (< ₹ 10 crore, $1.3m) such as Loan Against Property, Mudra, Kisan credit card, Commercial Vehicles, Construction equipment, small business working capital banking, etc. is only ₹ 12 trillion ($160b), and is seriously underserved, and will most certainly multiply in the years to come as data quality increased in India. Agricultural financing market of about ₹ 14 trillion ($186b) which is underserved as well. The MFI market is about ₹ 2.6 trillion ($346b). As a bank, we are just about 1.4% of these four businesses and we have ample opportunities to grow.

We are well placed to participate in this opportunity.

Opportunity is one thing. But what is more important is that we have developed deep specialization in all these lines of businesses to be able to do this business with low Gross NPA of 2% and low Net NPA of 1% for a decade, through stress tests like slowing economy and high inflation (2010-2014), demonetization (2016), GST implementation (2017), IL&FS crisis (2018-19). Even after COVID (2020-2022, our Gross and Net NPA is trending down back to long term average (Refer graph from Section 4.5). Thus, as the Indian retail credit increases by say 15-20 times over the next 15-20 years, our bank is extremely well poised to participate in such growth and indeed even contribute to such growth.

Corporate Banking opportunities

Corporate banking (> ₹ 10 crore) is a market of about ₹ 65 lac crore ($850b) and is an important part of our bank. Our corporate banking offerings include trade finance, working capital, term loans and treasury solutions. We also have a cutting-edge corporate banking portal with industry-first features such as single window experience across products, intelligent report builder capability and online trade regulatory portal. While we have reduced the infrastructure financing portfolio, we look forward to increasing our non-infra corporate book moderately and opportunistically, but only with strong credit evaluation process. I'm happy to say that we have sanctioned over ₹ 18,000 crore ($2.4b) of new exposures on the corporate banking side in the last three years of which about ₹ 11,000 crore ($1.5b) have been disbursed and the quality of this book is pristine.

New business opportunities

Beyond lending, our bank has also launched several other new businesses which will will provide us income streams in future years. We have launched or recently scaled up our best-in-class Digital Cash Management solutions (3,000 clients), Trade Forex, wealth management (AUM ₹ 6,536 crore ($870m), up 97% over last year), FASTag (8.5 million, up 50% last year), toll acquiring business (420 toll plazas, up 50% over last year), credit cards (7 lac cards), We have also launched many variants of current accounts catering to different segments such as merchants, professionals, start-ups and new businesses.

We have significantly grown our Mobility and Transit payments over the last 2 years. We are one of the largest banks in the FASTag ecosystem and we help 8.5 million vehicles pay their toll, fuel and parking payments in a digital mode.

We have also started distribution investment products, mutual funds, PMS, AIF, insurance, Sovereign Gold bonds, and many such products where we will make distribution

One key development is that our funding costs have come down over time, and as a result we have migrated to safer customer segments while maintaining similar margins.

fees. Our wealth management business is near-doubling every year which will provide fee income.

We are therefore evolving into a highly diversified universal bank with multiple sources of income cutting across lending, saving, investing, protection, trade, and transaction banking.

Retail Liabilities Opportunities

We have demonstrated our capability to raise retail deposits. Last year, our CASA balances and CASA percentages increased despite reducing our savings account interest rates, because of our strong brand, high corporate governance, our transparency, our service levels, and customer-friendly products. We believe we should be able to continue to raise deposits, and we will add more branches as required. (Refer graphs from Section 4.1)

Digital Initiatives

The bank has taken a number of digital initiatives across all its lines of businesses. We launched a new mobile app with several unique features like universal search facility, customer service, Mutual Fund investing, ASBA IPO facility etc. On our app too, we provide many services free that is usually charged in the market. 91.76% of our retail transactions are digital. Virtual Payment Addresses have grown 95%, person-to-person and person to merchant transactions have grown by 155% in FY22 as compared to FY21. We have launched UFILL for fuel prepayment on UPI for a petroleum company. Our bill payments have increased by 121% over last year. For BBPS, we were ranked third among 30 biller operating units in March 2022. We saw 79% growth in transactions on our POS devices this year. We believe that growing our organisation digitally on an incremental basis will be one of our strengths, as the scalability of digital infrastructure far exceeds the physical.

Strong guardrails built in India on a structural basis

In India, excellent supporting ecosystems have been built while retail credit to GDP is yet at a nascent stage. Hence, as India reaches global penetration levels, the business will be built on strong guardrails. These support ecosystems include four international grade credit bureaus (Transunion, Equifax, Experian and CRIF Highmark), advanced payments system for repayments through UPI, digitisation of bank accounts, advanced cash flow evaluation technologies (since bank statements are digitized) and a stable legal system.

Even without these newer guardrails, India's experience in retail credit has been quite good for all banks, NBFCs, and even state-owned banks for the last 50 years because of inherent diversification and Indian cultural norms. But with these additional guardrails and supporting payment systems, there are more safeguards to do retail credit more safely. Our bank has developed strong capabilities to use these guardrails and ecosystems. Further, retail is diversified over 25 lines of businesses, and further diversified across millions of customers.

We launched an organisation-wide mass initiative (You Can)^ X to improve customer service. We trained 22,000 employees on our culture, soft skills, launched recognition program, root-cause analysis, increased empowerment, and opened multiple gates for customers to access us.

We know that in India, for decades, retail customers could not get funds to upgrade their day-to-day life, to borrow for productive purposes like higher education, or for business purposes to earn a livelihood. Credit was largely to large business earlier. Credit is a lever for growth, it's called "lever"age for a purpose. So, this development is also good for India from an inclusive all-round development point of view.

RISK MANAGEMENT

We will not dilute credit norms to get more business. We are very careful with our portfolio quality and we monitor indicators minutely. One key development is that our funding costs have come down over time, and as a result we have migrated to safer customer segments while maintaining similar margins. For ample transparency, we would like to share with you our detailed underwriting processes, our monitoring mechanisms, and the precise key risk indicators that we track in this section.

Underwriting processes- Retail & Commercial Loans

The Bank has established a time-tested and robust credit underwriting framework with strong checks and control which help us filter the loan applications. In the retail and commercial businesses, credit Underwriting in our Bank is rule-based, scorecard based, and cash flow based. We rigorously subject the applications through 10-11 step filtration process, namel, deduplication (against existing records), Credit Bureau, Risk Scorecard, Banking statement analysis, Cash-flow Analysis,

During FY22, our bank has achieved a key milestone in profitability, where the core operating profit at ~ ₹ 850 crore ($113m) in Q4 FY22 has exceeded the normalized expected credit loss of the book, by a significant margin.

Financial Ratio Analysis, Personal Discussion with Customer, Contact Point Verification, Collateral Checks, Fraud Checks and Industry checks. Loans are disbursed only to customers who clear this stringent filtration process, which is why NPA is historicly low in this segment. These processes and checks are modified depending on ticket size and nature of product.

In addition to the above the bank has developed strong capabilities for monitoring the portfolio with latest tools, for collecting from customers, and for recovering payments from customers where we have already taken provisions.

Rejections

We generally reject about 40-60% of the applications received by us based on product category as part of the above stringent filtration process, and we have no hesitation in doing so. Even with such rejections, we are comfortably meeting the business volumes and seeing improving asset quality.

Key Risk indicators for retail and commercial loans:

We track seven leading indicators for asset quality.

1. **Onboarding profile:** Our new-to-credit customers as a proportion of total bookings has reduced from 17% in 2019 to 9% in 2022 because of better underwriting and disbursing to safer credit profiles. Of the credit tested customers, customers with good bureau score > 700 has sharply improved from 61% in 2019 to 85% in 2022. (Refer graphs from Section 4.3)
2. **Cheques returned on presentation:** The percentage of returned repayment instruments on 1st EMI presentation are an early indicator of booking quality. Our number of cheque bounces have consistently reduced, from 10% of presentations by value, to 7% of presentations, indicating better quality. Thus, our need for field collections has reduced significantly over time. (Refer graphs from Section 4.3)
3. **Collections efficiency:** Post return of cheques, debt management team contacts customers. Our collection efficiency across buckets have improved. Specifically, early bucket collection efficiency, including cheque clearance plus field collections, has increased from 98.9% (pre COVID) to 99.6% (post COVID) (Refer graphs from Section 4.3)
4. **SMA (Pre NPA) Position:** All SMA positions i.e. SMA 0, 1 and 2 have reduced considerably, and are even better than Pre-COVID levels indicating lower NPA formation in future. (Refer graphs from Section 4.4)
5. **NPA:** We are happy to share that COVID related increase in NPA is consistently coming down, and we have almost reached the pre-COVID levels again. We have guided for Gross NPA of < 2% and net NPA of < 1% (Refer graphs from Section 4.5)
6. **Provisions:** Based on lower SMA, and lower NPA, we have guided for credit provisions of less than 1.5% in FY23. We have thus far met all our guidance.
7. **Vintage Analysis:** Here we compare performance of cohorts of portfolio by respective vintages. Our vintage metrices show that credit quality is getting better with newer vintages because of improved Through-The-Door quality, and improved underwriting through constant learning over time.

The trend line on ROE is very encouraging. In Q4 FY21, our annualized ROE was 2.92%, in Q4 FY22 was 6.67%, and for Q4FY23, we have guided for double digit ROE. You can see for yourself how this chart is rising.

We do not need to dilute credit norms for business growth

As I have said before, we have no intention of diluting our credit criteria for business. Based on attractive pricing (our funding costs have come down), good processes (time tested), strong brand (improving), distribution, and strong demand in our product segments (based on growing economy and increasing per capita income), we can continue to grow our business for decades.

In case we need more business volumes in established products like home loans, loan against property, business loans, car loans, business banking (property backed working capital) or digital loans, all we need to do is to simply open more locations or penetrate deeper without diluting norms.

Also, to get volumes, we could also introduce new product lines where we are not present today. For instance, we have recently launched new products such as Gold Loans, new car loans through our branches, credit cards which we issue largely to our existing customer base, etc.

Thus we have many options to grow our business safely and hopefully this will explain to you why we will not need to dilute credit quality to get more volumes. We cherish our track record of asset quality of GNPA and NNPA of 2% and 1% respectively for a decade and will do nothing to disturb it.

Risk management in Wholesale Financing

We have learned from experience that large exposures, that are disproportionate to the Bank's net worth, have the potential to cause damage to the Bank's asset quality and profitability. As a prudent risk management measure, in the last three years, the Bank has reduced the exposure to corporates from 29% to 18%, reduced exposure to infrastructure sector from

19% to 5%, reduced exposure to Top-20 borrowers from 16% to 9% and reduced exposure to top five industries from 41% to 24%. This has helped us substantially reduce risk on our balance sheet. (Refer graphs from Section 4.6)

Before sanctioning corporate loans, we look at industry, company, net worth, financial ratios, cash flows, background, references and many such information. We have a Board-approved delegation of authority for sanctioning corporate loans.

We have already identified and provisioned for stressed legacy accounts. We expect no major issues from legacy accounts anymore.

CUSTOMER SERVICE

We launched an organisation-wide mass initiative (You Can)^X to improve customer service. Under this initiative, we trained 22,000 employees on our culture, on soft skills, launched recognition program for outstanding employees, established processes for root-cause analysis, complaint management, product knowledge, increased empowerment, and opened multiple gates for customers to access us (through website, app, Whatsapp). We used tools like role plays, roadshows, e-modules, X-cellerators (accelerating Train the Trainer), Learning Shorts (2-minute quick learning videos). As a result of these initiatives, the number of complaints per 1000 customers reduced by 20% during the year. We will launch more initiatives next year.

PROFITABILITY

a. **Strong Income Generating Model:** Our Net Interest Income (NII) has grown at a 3-year CAGR of 26%. Further, the Fee and other income of the bank has grown at a 3-year CAGR growth of 32%. In the last year alone, our Fee and other income has grown by 66%. We expect to post strong growth in income going forward as well. (Refer graphs from Section 4.2 and Section 4.7)

b. **Core Operating Profit Growth:** The core operating profit (NII plus fee and other income less operating expenses, excluding trading gains) of the bank has grown by a 3-year CAGR of 36% from ₹ 1,104 crore ($147m) in FY19 (H2-FY19 annualised) to ₹ 2,753 crore ($367m) in FY22. In FY22, our core operating profit rose 44% as compared to FY21 (Refer graphs from Section 4.8)

c. **Key inflection point for stable profitability achieved:** During FY22, our bank has achieved a key milestone in profitability, where the core operating profit at ~ ₹ 850 crore ($113m) in Q4 FY22 has exceeded the normalized expected credit loss of the book, by a significant margin and hence we expect to have stability in our profits from here on. For context, this was ₹ 276 crore on merger. This is thus an inflection point for us. We expect that the core operating profit will continue to rise going forward, building further cushions.

d. **Net Profit:** If you recall, all banks in the country took significant charge to the P&L during COVID, and our provisions were similar to other banks. The issue we faced at that stage was that because we were an early-stage bank, we did not have the necessary core operating profit to absorb these provisions. As explained earlier, we now therefore have strong cushions, and rising, to absorb such situations in the future. In FY22 our provisions as a % of average funded assets in was only 2.5% despite the severe COVID second wave disruptions and some legacy corporate accounts. the good news is that in retail business, we continue to get recoveries even after taking ageing-based provisions (Refer graphs from Section 4.8)

e. **Return on Equity:** Here the trend line is very encouraging. In Q4 FY21, our annualized ROE was 2.92%, in Q4 FY22 was 6.67%, and for Q4FY23, we have guided for double digit ROE. You can see for yourself how this chart is rising. That the ROE is rising as strongly of the whole base, shows tht the incremental business of the bank has much more ROE than the stock.

f. **Cost to Income Ratio:** The Bank's cost to income ratio is higher compared to other players in the industry. But we must understand why this is so.

Structure: Our bank has been created by the merger of IDFC Bank and Capital First in December 2018. IDFC Bank was a DFI recently converted to a Bank. Capital First was a NBFC with no retail deposits. Naturally on merger, both players were only lenders, and there was low retail deposits and low CASA of ~9%. But the funded assets were large at about ₹ 1.04 trillion ($14b). So, we quickly set up ATMs, branches and hired over 12,000 employees. This led to increase in operating expenditure.

Capability building: Most peer banks have been in operation for over 20 to 25 years and thus have already had spent on building essential systems such as their mobile banking application, savings account systems and current account propositions, merchant account solutions, credit cards, branches, ATMs etc over the last 15-20 years. Since we are a relatively new bank with a large loan book to start with, we too had to quickly build these capabilities, and thus we had to spend on building the same, either to catch up with the existing ecosystem, and to build for the future.

New Business lines launched: We built new businesses like credit cards to complete our offerings, which have high cost to income ratio as they are currently loss making. We expect this business to be profitable from FY24 onwards.

Legacy liabilities: We carry ₹ 25,181 crore ($3.4b) of legacy liabilities as on March 31, 2022, costing us about 8.7% which we will replace at significantly lower costs.

Cumulatively, we expect these to get addressed over the next three years either by scale or repayments of high-cost debt, and the cost to income ratio will come down naturally. We are

I have always maintained that we are building a world class bank for the longer run and are not rushing it. We tick all boxes except one. We currently don't make the cut on only one count- net profits. I believe we will address this issue in FY23 comprehensively.

working seriously on the same. The cost to income ratio is coming down every year since the merger and will continue to trend materially down from hereon.

TREASURY ACTIVITIES

The Bank's treasury operations are largely to service client's hedging requirements and for balance sheet management. We have a comprehensive limit framework including Present Value of a basis point (PV01), VaR, NOOP limits, Stress testing etc. which we adhere to. As far as proprietary trading is concerned, our advice to the trading team is to be conservative at all times.

ESG INITIATIVES OF THE BANK

On ESG, our business itself is naturally ESG centred–the way we think about our business, the way we treat our employees, the customer segment we operate in, all blend naturally into ESG. We set very high standards of corporate governance. However, we had not thought of ESG as a practice earlier. Based on emerging global trends and the feedback we got from shareholders in the last AGM, we have given specific responsibility to Shikha Hora, a senior person at our bank, for focussed attention on this matter. She has written a note for us on the initiatives of the bank in this report.

We believe we will have strong ROE, with the growth potential of a youthful-stage bank and strong technology orientation to leverage the future.

CLOSING COMMENTS

I have always maintained that we are building a world class bank for the longer run and are not rushing it. We have ticked all boxes except one. We are strong on many fronts, including customer orientation, technology orientation, team, culture, growth potential, intellectual property, corporate governance, diversified business lines, and strong capabilities in a growing market.

We currently don't make the cut on only one count i.e. net profits. I believe we will address this issue in FY23, where we expect to see an upswing. From FY23 onwards, we expect to see a strong trajectory on profits. It took us three years to get here to this position of strength on net profits. Our core operating profit growth is strong.

We look forward to reaching 15% ROE in the medium term as a first step, and then expand the same from there on. We believe we will have strong ROE, with the growth potential of a youthful-stage bank and strong technology orientation to leverage the future. More importantly, the quality of our ROE will be very high as we are building it on a granular and sustainable business model.

I thank everyone of you for your indulgence and for supporting us patiently even as we built this out. Such public market support at build-out stage is rare and we are grateful to you for this. I would also like to share with you that our employees are highly motivated and are working very hard for a better tomorrow for the bank. I thank them all. Within our bank, I specially want to thank and appreciate our control and support functions whose role is invaluable in building the bank, who provide us the guardrails, and without whose support we could get blindsided. Our regulator has given us excellent guidance during this entire period, we would not be here without them - I sincerely thank them for the same. I also thank our Board for their invaluable contribution in guiding the bank and to bringing us to this position of strength. We also thank our customers for their association and for availing services from us and bestowing us with their goodwill.

Yours sincerely

V Vaidyanathan

Managing Director & CEO
IDFC FIRST Bank Limited

Note: All $ denominated numbers have been calculated at $1 = ₹ 75. ₹ 1 trillion= ₹ 1 lac crore.