ANNUAL REPORT 2002-2003 THE FEDERAL BANK LIMITED

Life is like a balancing act. At Federal Bank

we help you find the right balance

between tradition and technology,

and bring you the perfect banking experience.

# BOARD OF DIRECTORS

Shri. K. P. Padmakumar
Chairman

Shri. M.S. Parthasarathy
Director

Dr. C.K. George
Director

Shri. M. Joseph
Director

Shri. T.N. Jayachandran
Director

Prof. A.M. Salim
Director

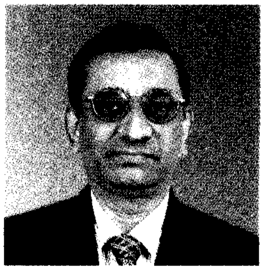
Shri. S. Santhanakrishnan
Director

Shri. M.J. Subbaiah
Director

Shri. F.R. Joseph
Director (RBI)

Shri. S. Mohanty
Director (RBI)

# MANAGEMENT TEAM

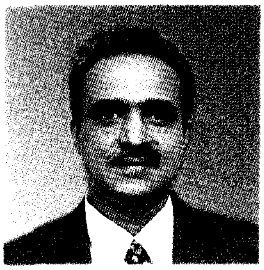


Shri. P.R. Sankaranarayanan
Executive Director

Shri. A. Akbar
General Manager

Shri. M.M. Antony
General Manager

Shri. George John
General Manager



Shri. P.C. John
General Manager

Company Secretary
Shri. Girish Kumar Ganapathy

Auditors
M/s. Varma & Varma, Kochi

Contents

## REPORT OF THE BOARD OF DIRECTORS

Your Directors are pleased to present the Bank's 72nd Annual Report, and the audited financial statements, for the year ended 31 March 2003 (FY03[1]).

## PERFORMANCE DURING THE YEAR

Over the past few years, the Bank has sought to reinforce its financial strength and thus lay the foundation for sustained high growth with enhanced profitability in the coming years. The Bank's strategy has helped it identify and seize opportunities in an increasingly competitive market. The success of the strategy is reflected in the Bank's impressive performance in FY03, albeit the operational environment posed difficult challenges as interest rates continued to decline and spreads narrowed, and banks engaged in intense competition to attract and retain better-quality borrowers even as credit demand remained sluggish. The Bank's performance was, however, marked by significant growth in its resources and assets, substantially improved profitability, and sharply reduced portfolio delinquency.

### Highlights

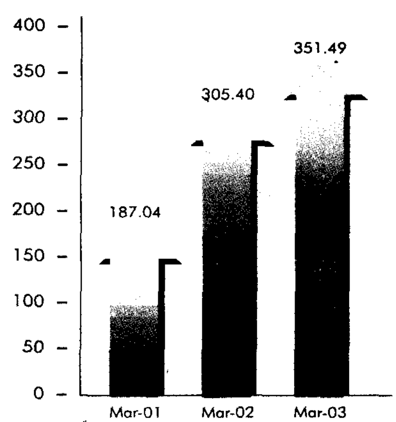
- Record operating profit of Rs. 351 crore (Rs. 305 crore in FY02)
- Highest ever net profit of Rs. 105 crore (Rs. 82 crore in FY02)
- Return on equity improved to 21.5% (19% in FY02), earnings per share to Rs. 48.36 (Rs. 37.76 in FY02), and book value to Rs. 244 per share (Rs. 207 in FY02)
- Net owned funds grew to Rs. 529 crore (Rs. 449 crore at end in FY02)
- Capital-adequacy ratio rose to a comfortable 11.23% of risk-weighted assets (10.63% a year earlier), much higher than the regulatory minimum of 9%
- Sharp decline in net non-performing assets (NPAs) to 4.95% of net advances, from 8.60% a year earlier, and loan-loss provisions held at end-FY03 equal 41% of NPAs, up from 29% a year earlier

### Proposed dividend

In tune with the Bank's improved performance, the Board is pleased to recommend a dividend of 40% for FY03, up from 35% paid for the previous year, subject to the approval of the Reserve Bank of India (RBI).

## BUSINESS GROWTH AND PROFITABILITY

During the year the Bank achieved most of the key business targets it had set for itself. Total business reached Rs.17,165 crore by end-FY03, 22% higher than a year earlier. Gross income increased by 6.58% to Rs. 1,346 crore. The return on average total assets improved from 0.87% to 0.98%, almost level with the international benchmark of 1%.



**Operating Profit (Rs. crore)**

### *Resource mobilisation*

The Bank crossed a significant milestone as its deposits grew by 23.5% to cross the Rs.10,000 crore mark and reach Rs.10,947 crore by end-FY03. The average total deposits during the year increased by 17.9% to Rs.9,552 crore. Reflecting the general fall in interest rates, the average cost of deposits declined from the previous year's 8.70% to 7.63%. A substantial proportion of the Bank's resource base continued to be derived from non-resident Indian (NRI) deposits, which rose from Rs 3,864 crore to Rs 4,479 crore (41% of total deposits) over the year.

### Credit operations

The Bank continued its policy of efficient, prudent, and profitable utilization of its resources. In credit operations, the aim was significant portfolio growth with upgraded quality, so as to optimise returns while limiting risks to acceptable levels.

[1] FY represents the financial year ended on 31 March of the year noted.

**REPORT OF THE BOARD OF DIRECTORS**

The credit portfolio increased by 19.8% to Rs. 6,217 crore by the end of the year, representing 56.8% of total deposits. About 19% of the total advances were by way of retail lending, in a market characterized by stiff competition, reflected particularly in aggressive credit pricing by major players. The Bank achieved considerable success in expanding its gold loans, especially in Kerala. Such lending produces high yields with diversified, low risk.

In corporate lending, the Bank targeted selected borrowers of high credit standing by offering them large advances at attractive interest rates. Helped by this strategy, the Bank's corporate advances grew by over 25% during the year, although industrial credit offtake generally remained subdued.

The Bank's lending to the priority sector accounted for 43.7% of the net credit, exceeding the RBI-prescribed minimum of 40%.

In a year of sharp and pervasive decline in interest rates, the Bank managed to restrict the fall in the gross return on its credit portfolio to about 65 basis points to 12.5%.

### Management of impaired loans

The Bank's continued and concerted initiatives in tackling portfolio delinquency paid rich dividends during the year. The Bank's policies and actions in this regard were marked by pragmatism, prudence, and transparency. Keeping a close watch on defaulting borrowers, the Bank explored various options for recovery of its dues. Where appropriate, the Bank resorted to loan *adalats*, recovery *melas*, and negotiations with borrowers, and also sought recourse to the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 and the Bank struck negotiated compromise deals with 92 borrowers with total dues of Rs. 15.65 crore to the Bank. In all recoveries of NPAs during the year amounted to Rs.132 crore.

Equally important, the Bank continued to lay emphasis on close and effective monitoring of all its borrowers, with special attention to those showing signs of potential weakness. Warranted by particular circumstances, the Bank restructured its credit facilities to some borrowers with a view to improving their debt-servicing capacity and thereby mitigating the Bank's credit risk.

Net NPAs declined sharply from Rs. 446 crore to Rs. 308 crore over the year. As a proportion of net total advances, net NPAs shrank to 4.95% from 8.60% in the previous year. The rising trend in gross NPAs was also reversed during the year. NPA management will assume further importance as the RBI-prescribed 90-day loan delinquency norm comes into force from FY04.

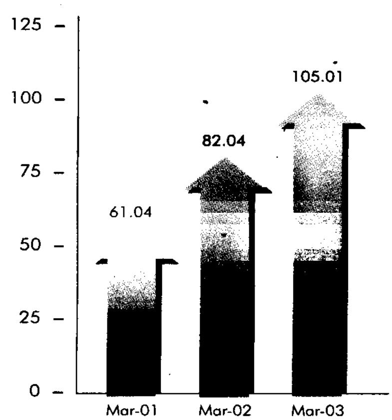
### Investment operations

The Bank's investment portfolio grew by 21.2% from Rs. 3,756 crore to Rs.4,552 crore over the year. During the year, the Bank began retailing government securities on a significant scale. Steps were also initiated for integrating treasury and foreign exchange operations to promote efficient overall resource management.

The further softening of interest rates during the year opened up opportunities for the Bank to engage in active and profitable trading in debt securities in its investment portfolio. Such trading gains boosted the total income from investments to Rs 565 crore (Rs 522 crore in FY02), translating into an average return of 13.6% during the year (14.9% in FY02).

### Risk management

Risk management is increasingly important in a scenario where quality asset creation is becoming difficult and operating margins are getting squeezed.



**Net Profit (Rs. crore)**

The Bank's risk-management policies and systems have been strengthened by adoption of RBI guidelines. During the year, a Credit Risk Management Department was established. The Bank had the distinction of being one of seven banks in India selected by RBI for a Quantitative Impact Study3 (QIS3) on the Basel Capital Accord. The Bank completed the study during the year. The Bank has initiated steps that would help RBI move to a system of risk-based supervision.

More borrowers have been brought within the ambit of the Bank's internal credit-rating system by lowering the threshold for rating, in terms of the Bank's credit-risk exposure to a single borrower, to Rs 1 crore. The Bank's entire assets and liabilities have been covered by an asset-liability management system, which adequately addresses the market risks in operations and helps the Bank manage liquidity risks more efficiently by identifying and correcting maturity mismatches. A prudential limit has been fixed for earnings at risk (EaR), and the value at risk (VaR) concept applied to investments in Central Government securities. The duration of the debt investments is being closely monitored and varied as necessary. All these measures have helped a more accurate assessment of the interest-rate risks and their potential impact on the Bank's equity. The management information system is being reoriented to facilitate more effective risk management.

**Diversification of products and services**

As a strategic initiative for improving profitability, the Bank has been diversifying into activities that can be undertaken by banks within the prevailing regulatory regime.

**Cash management services (CMS)**

To consolidate and further streamline CMS operations, the Bank opened CMS hubs in Ernakulam and Chennai during the year. A comprehensive CMS software package, developed in-house, was implemented to meet the varied requirements of clients. Despite the strong competition from an increasing number of market players, the Bank achieved a growth of 195% in turnover and of 166% in fee-based income from CMS. The Bank entered into an arrangement with Bharat Sanchar Nigam Ltd for collection of telephone-bill payments in Kerala, Tamil Nadu, and Bangalore.

**Depository services**

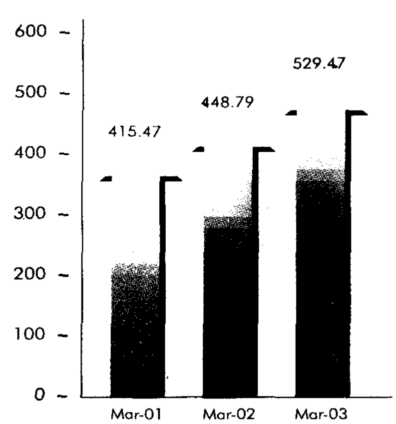
Substantial enlargement of the clientele for these services led to a 78% rise in the income from depository business during FY03 over that in the previous year. As corporate debt securities are increasingly dematerialised, the prospects of significant further expansion of the services appear bright.

**Insurance marketing**

Following the success achieved in implementing an arrangement concluded in the previous year for marketing life-insurance products of ICICI-Prudential Life Insurance Co. Ltd., the Bank entered into a memorandum of understanding with United India Insurance Co. Ltd. to act as a corporate agent for marketing its non-life insurance products.

**Merchant banking**

The lacklustre conditions and uncertainties that prevailed in the capital markets were not conducive for the Bank's merchant-banking activities during the year. The Bank therefore concentrated on, and was fairly successful in, providing "at par payment" services to select corporate customers.




**Net Worth (Rs. crore)**

### Foreign exchange operations

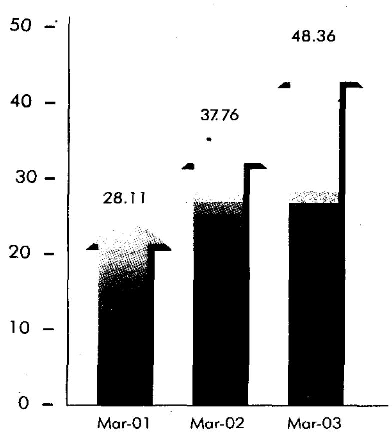
The aggregate foreign exchange customer business of the Bank reached Rs.6,143 crore during the year. The Bank continued to enjoy the patronage of a large number of NRIs, particularly in the Middle East. The Bank's express remittance facility, "FedFast", proved popular with users. Remittances totalling Rs.3,323 crore from the Middle East were routed through the Bank during the year by 13 Exchange houses and seven banks under rupee-drawing arrangements with the Bank. Similar arrangements with more exchange houses and banks are envisaged.

## AUDIT AND INSPECTION

As part of efforts to strengthen control systems and to adopt best corporate- governance practices, the Bank continued to attach great importance to audit and inspection. During the year, the Bank introduced credit audit of larger borrowers with facilities exceeding Rs 2 crore, special audit of branches with gold loans over Rs 1 crore, and sporadic audit of branches to improve surveillance. The Bank also recognized the desirability of introducing management audit. Given the expanding role of information technology (IT) in its operations, the Bank got its IT system performance and capabilities and security aspects critically reviewed by Price Waterhouse and Wipro Ltd. A regular information system audit and risk-based internal audit are being planned. Guided and overseen by the Audit Committee of the Board and an internal audit committee of executives, significant progress was made in rectifying irregularities observed in the course of detailed, concurrent, revenue, computer, and RBI inspections.

## LEVERAGING TECHNOLOGY FOR CONVENIENCE BANKING

The Bank has come to rely heavily on modern technology to offer a wider range of efficient, competitive, value-added services to its customers. Eighty-four automatic teller machines (ATMs) were added to the Bank's ATM network, most of them in smaller towns, including *panchayats*. By the end of the year, 120 ATMs were in operation. The Bank's secure wide area network, called FedWide, links all Regional Offices and 220 major branches across the country. During the year a centralised management information system (MIS) was developed to consolidate dispersed branch data bases at a central server at the Head Office and thus meet the information needs of different Departments more expeditiously. The FedNet Internet banking service has been well received by the Bank's customers, as evidenced by the 120% rise in the number of users during the year. The Bank designed and launched a highly innovative, flexible, and comprehensive banking short messaging service (SMS) that would immediately notify customers, wherever located, of specific transactions in their accounts. The Bank has recently connected its ATM network to the International Visa Network, enabling customers to access the worldwide network of ATMs and retail outlets where Visa-branded cards can be used. The Bank is developing a centralised telebanking service by assigning a single contact number to a customer that can be recognized by all branches. The Bank is at an advanced stage of testing a system that will enable online Anywhere Banking Service at interconnected branches of the Bank. The Bank has been authorized by the Institute of Development and Research in Banking Technology (IDRBT) to function as a Registration Authority for registering and certifying digital signatures to its officials.




**EPS (Rs.)**

## HUMAN RESOURCES

The Bank's human resource development policy aims at attracting, motivating, and retaining qualified and competent employees, and upgrading their knowledge and skills, where necessary. At the end of FY03, the Bank had a 6,217-strong staff, including 2,145 officers.

REPORT OF THE BOARD OF DIRECTORS

*To meet its growing needs for special skills, especially in the area of IT, the Bank recruited* some specialist officers during the year. The Bank also initiated a process of recruitment of generalist staff to meet operational requirements. A number of training programmes were conducted for employees at different levels in general areas of banking and in operational automation. Productivity per employee increased to Rs.2.70 crore during the year from Rs.2.17 crore in the previous year.

## PREMISES

The Bank's spacious, symbolic, landmark premises on Marine Drive in Ernakulam, built in memory of the Bank's founder, late K P Hormis, was inaugurated during the year. The new Federal Towers now houses the Marine Drive Branch and the Ernakulam Regional Office. The International Banking Department, Cash Management Services Branch, Depository Services Division, Service Branch and the Treasury, Accounts, Asset Liability Management and Inter Branch Reconciliation Departments will shortly move there from the Head Office. The Bank's own premises at the rapidly developing Bandra-Kurla Complex in Mumbai have been occupied by the Mumbai Regional Office. Construction is progressing on the Bank's eleven-storied building at Aluva, which will accommodate the Aluva Bank Junction Branch, Stationery Department, and the Federal Staff College. In Kozhikode, new premises for the local Regional Office, currency chest, and Mavoor Road Branch are under construction.

## BOARD OF DIRECTORS

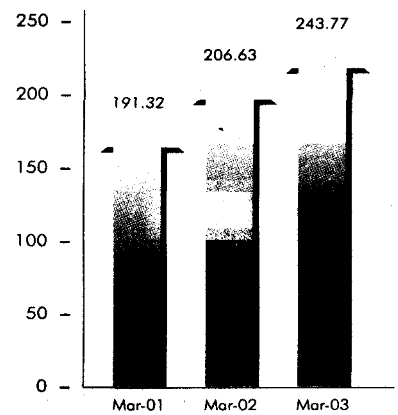
The Board consists of nine members, including the Chairman and Chief Executive Officer, and a nominee of RBI.



With RBI approval, Shri K P Padmakumar was reappointed as the Chairman and Chief Executive Officer for a period of two years from 1 January 2003 on the existing terms and conditions.

Shri T N Jayachandran, was appointed to the Board by shareholders at the annual general meeting (AGM) in 2000, and is due to retire by rotation at the forthcoming AGM, and being eligible, has offered himself for re-election. In a distinguished career as a member of the Indian Administrative Service, he had held several high posts in the Kerala Government, including First Member, Board of Revenue. He was also the Vice-Chancellor of Calicut University. The Bank will benefit from his continued membership of the Board.

Shri M J Subbaiah was appointed by the Board as a Director in January 2002 in the casual vacancy caused by the resignation of Shri U Mahesh Rao from the Board. Since Shri Rao would have retired at the ensuing AGM had he continued on the Board, Shri Subbaiah is holding office till then. Shri Subbaiah has about four decades of valuable experience and specialised knowledge in banking and finance. His past career appointments include those as the Managing Director of Centurion Bank Ltd., Senior General Manager of ICICI Ltd., and Deputy General Manager in the State Bank of India. He is on the boards of seven other companies viz. Eicher Ltd., Eicher Motors Ltd., ABG Shipyard Ltd., Western India Shipyard Ltd., Jaiprakash Industries Ltd., Usha Beltron Ltd and Taj Lands End Ltd. The Bank will gain from his continued membership of the Board.



**Book Value Per Share (Rs.)**

Shri F R Joseph, who was the RBI nominee on the Board from 13 November 2000, was succeeded by Shri S Mohanty, effective 6 May 2003. The Board records its appreciation of Shri Joseph's valuable contributions to the Board's discussions and the Bank's progress during his Directorship. The Board looks forward to a fruitful association with Shri Mohanty as a Director.