ETHICAL ★ DIGITAL ★ BANKING ★ SOCIAL-GOOD

IDFC FIRST Bank

ALWAYS YOU FIRST

POWERING AHEAD

ANNUAL REPORT 2021-22

Contents

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"Statements made in this Annual Report may contain certain forward-looking statements based on various assumptions on the Bank's present & future business strategies and the environment in which it operates. Actual results may differ from those expressed or implied due to risk and uncertainties. For further details kindly refer the "Cautionary Statement" in the Management Discussion & Analysis on page 123."

Vision

To **build** a **world class** bank in India,
guided by **ethics,**
powered by **technology,**
and be a force for **social good**

Chairman's message

Strongly positioned for the future

Sanjeeb Chaudhuri
Chairman

With a strong foundation in place, a clear strategy of Customer First and a rich product suite, your Bank is well-positioned for the future. Your Bank has turned the corner and we can all look forward to a bright and sustainable future.

Dear Shareholders,

It gives me great pleasure as Chairman of the Board to write to you in the 2021-22 Annual Report of your Bank.

The year gone by has been challenging for the global ecosystem. Particularly, in the last few months, global challenges have intensified.

The financial year 2021-22 started with the second wave of COVID-19, which spread to rural India resulting in lockdowns and disruptions in business and supply chains across the country. But the situation recovered quickly from then and there was a smooth pick up in the economy in the second, third and fourth quarters of the year across all key parameters. However, towards the end of the year, the Ukraine conflict triggered higher energy prices, food and commodity shortages and global inflationary pressures. There is widespread talk of monetary tightening globally as well as in India, and its potential spillover effects on economies.

The Indian economy's near-term prospects have been affected by a spike in retail inflation which hit an 8-year high of 7.8% per cent in April 2022. Coupled with a slowdown in global growth, high energy prices, a cycle of rising interest rates and a tightening of monetary policy by global central banks and India, will all be key headwinds. In the recent monetary policy review, the RBI hiked repo rate by 50 bps to 4.90%, retained FY23 GDP growth forecast at 7.2% and raised the CPI inflation forecast to 6.7%.

Against this backdrop, India is relatively better placed than other emerging economies and even many developed nations. Despite economic growth slowing during the January-March 2022 quarter, India's recovery is expected to remain strong and it continues to be the fastest growing major economy. For the full year FY22, India's economic growth of 8.7% was lower than the 8.9% projected earlier, but higher than 6.5% contraction in the previous year.

According to the IMF, growth at 8.2% will be the highest among the large countries and by FY27, India will be the world's fifth largest economy with a GDP of $5 trillion at market prices.

The momentum in the services sector, government's focus on enhancing public capital expenditure, the re-surfacing of consumption demand, and positive growth in core infrastructure industries, will continue to be key drivers for growth.

A STRONG YEAR

Against this defining backdrop, I am extremely pleased that FY22 has been an incredible year for your Bank. Your Bank emerged strongly from the Q1-FY22 second COVID wave, and during the remainder of the year, i.e Q2, Q3 and Q4 FY 22, the Bank has seen consistent rise in profitability with healthy all-round improvements across all key operating metrics.

You will be happy to know that you have a very involved Board. We are fortunate that our Board includes seasoned leaders from diverse backgrounds, with rich experience in senior positions globally. Our discussions at the Board are free, frank and constructive with the common goal being to realise the ambitious vision of your Bank. Management keeps in constant touch with Board members even within the quarter as required. We are extremely focused on corporate governance and would like your Bank to be among the top institutions respected by all stakeholders globally.

Given the nature of the business, the Board is very focused on all aspects of risk management including credit and fraud risk, operational risk, market and other risks to ensure stable and sustainable growth for your Bank. At the Board, we take compliance of all regulatory requirements very seriously.

Your Bank has taken an integrated approach to embed Environmental, Sustainability and Governance (ESG) considerations into everything we do as an organisation. Your Bank is constantly reimagining how to create a sustainable business which creates value for our customers, communities and all our stakeholders.

We are very fortunate to have a world class and enlightened regulator. We would like to thank them for their guidance and constant support to your Bank.

We would like to thank all our customers who are the reason we are in business. Their support and loyalty are our most valuable assets as we drive towards our ambitious vision for the future.

The Board would like to appreciate the management for their efforts in building a strong foundation for the future. Our employees are key partners in achieving the ambitious growth vision of your Bank. They have displayed exemplary commitment, spirit of innovation and perseverance in the face of a lot of adversity in the last year. Our sincere thanks to all of them for their passion and loyalty in building this great institution.

We are fortunate that our Board includes seasoned leaders from diverse backgrounds, with rich experience in senior positions globally. Our discussions at the Board are free, frank and constructive with the common goal being to realise the ambitious vision of your Bank

With a strong foundation in place, a clear strategy of Customer First and a rich product suite, your Bank is well-positioned for the future. Your Bank has turned the corner and we can all look forward to a bright and sustainable future.

I thank all of you, our dear shareholders, for your constant support to our Bank over the years in challenging circumstances. We sincerely appreciate your patience, insights and support in helping us build a great institution that would be increasingly valuable to all of you.

Yours sincerely

Sanjeeb Chaudhuri

Chairman
IDFC FIRST Bank Limited

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

We have demonstrated our capability to raise retail deposits.

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.

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 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. <u>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,</u>

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