IndusInd Bank

Analyst Conference Call

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MANAGEMENT:
MR. SUMANT KATHPALIA– MANAGING DIRECTOR AND CEO
MR. ARUN KHURANA– EXECUTIVE DIRECTOR, DEPUTY CEO AND CFO
MR. INDRAJIT YADAV- HEAD, INVESTOR RELATIONS AND STRATEGY

Moderator: Ladies and gentlemen, good day, and welcome to the IndusInd Bank Limited Analyst Conference Call. As a reminder, all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the address concludes. Should you need assistance during this conference call, please signal an operator by pressing star then zero on your touchtone phone. Please note that this conference is being recorded.

I now hand the conference over to Mr. Sumant Kathpalia, MD and CEO, IndusInd Bank Limited. Thank you, and over to you, sir.

Sumant Kathpalia: Good evening, and thank you for joining the call at a short notice. We have made a stock exchange disclosure post our Board meeting and wanted to answer if there are any queries relating to that. During an internal review of processes relating to other assets and other liability accounts of the derivatives portfolio, the Bank has noted some discrepancies. Since then, the Bank's internal review has estimated an adverse impact of 2.35% on the Bank's net worth as of December '24.

The difference has been accumulated over a period of time. The Bank's profitability and capital adequacy remains healthy to absorb this one-time impact. Just to reiterate the issue was identified by the Bank. We also appointed an external advisor to review the processes and ascertain the root cause.

While the impact is expected to be largely in the range mentioned earlier, we should have all the explanations once the final report is submitted by the advisor. We can now take questions. I also have Arun who heads our Global Markets and is Deputy CEO and Indrajit, with me to answer any specific queries.

Moderator: Thank you very much. Our first question comes from the line of Chintan Joshi from Autonomous Research. Please go ahead.

Chintan Joshi: A few questions. So firstly, which area is these derivatives linked to? Are these hedging? Are these trading derivatives, like what is the exact area in which these derivatives were applied to. Secondly, where is the corresponding gain booked, which line item in the P&L, 2.35% of equity will probably reflect somewhere in the P&L? Is it on the NII line? Or would it be on the trading line. It would be interesting to understand what adjustments we need to make to historical numbers to reflect this 2.35%. And thirdly, when can we expect this investigation to be completed so that we know that this issue is behind us?

Arun Khurana: So these are hedging instruments of derivatives being used by the Balance Sheet Management Desk, which is also the ALM desk of the Bank. What really emanates is on account of the foreign currency deposits and borrowing in foreign currency, which lead to a balance sheet and foreign currency for converting them into INR, the derivatives are used. That was your first question. Second question is where did the income line go to? In most cases, it went to the net interest income line. So that is where it is. Number three, when do you expect the closure of the external agency, we believe that should come around end of quarter 4.

Chintan Joshi: Okay. So it's a relatively quick resolution. So in terms of the NII line, can I just check if you would give us some idea of restatements, perhaps for the last 9 months this year, at least, if not for the previous year, just so that we can understand what was accrued on the NII line. If you could disclose that in your presentation with the results, that would be helpful?

Sumant Kathpalia: Yes, we will actually disclose the full information along with the Q4 results or maybe prior to results itself. And we will make sure that you get the full information.

Chintan Joshi: And then finally, while I have you, could I ask you for an update on what MFI trends are you seeing? Is that something you would like to cover on this call?

Sumant Kathpalia: So the MFI, the flows from the x buckets look good, except in Karnataka, where the flows are now stabilizing. But otherwise, the flows are looking good in the other parts of our business. Of course, the October, November flows from x bucket, which we said will flow to NPA, have flown to NPA bucket. And you will see an elevated NPA slippages number this quarter. And we should see our 30-plus bucket actually reflecting the normalized view. So we should be fine on our slippages numbers as we go forward from quarter 1 onwards. So quarter 4 should be the bottom of the pyramid on this.

Moderator: Your next question comes from the line of Rahul Jain from Goldman Sachs.

Rahul Jain: Just a couple of questions. So just wanted to understand how would this be rectified? So will it go through the book value? Or will it go through the P&L, i.e., like you said interest income. So will there be reversal for the accumulated amount? Or how would this be reflected?

Sumant Kathpalia: So we are in discussions as of now. I think the general reserves cannot be touched, and we'll have to take it through the P&L.

Rahul Jain: Okay. And this would be over what period?

Sumant Kathpalia: We are saying quarter 4, but let's see if we get any dispenser, but I would like to just close it in quarter 4, if we can.

Rahul Jain: Got it. Second is, look, the amount is large in absolute terms, right? I mean, the income that got booked. So can you just give us some background as to how this got identified and the scope of the external party validation? What will it cover any particular related transactions in the local books, etcetera, that also needs to be covered under this that eventually, the amount is well within this range? Or could this possibly be also higher if the scope were to be expanded?

Sumant Kathpalia: In the process of aligning with RBI Master Direction, which came in the September '23, we started reviewing our derivatives book. And as effective April 1, '24, in line with the new guidelines, internal trades had to be discontinued. We started reviewing our internal trade book. And we observed some discrepancies in accounting of some of the trades, which was identified by September and October 2024. And then we hired the external agency to start reviewing our business. And that is why we are comfortable that by March end or April early, we should be able to identify the gap, and it seems to be in line with what we are saying, but we want to be sure about it because it's still not validated completely right now.

Having said that, let me hand over to Arun on whether we are comfortable with the derivative books right now. And effective April 1, '24, how are we running our business?

Arun Khurana: Yes. So effective April 1, we can confirm that we have not entered into any internal trades. The internal trades that were there prior to that period, which were existing on April 1, have been unwound and all according to mark-to-markets taken. There will be a small PB impact, which will keep on dropping because these are unwinding of trades, which is insignificant in nature over the tenor or maturity of these internal trades. We now only do external trades with market counterparties for hedging our entire balance sheet foreign currency book.

Rahul Jain: Can I ask a follow-on on this? So I would not be an expert on this, but my understanding was that the Banks are not allow to run any book, which is unhedged over the night. So how could these internal trades be so large that the impact is so significant?

Maybe I'm missing in my understanding, but I believe this underlying is the foreign exchange contracts. So this is linked to any particular industry like gems and jewelry etc. or this is purely from the borrowing standpoint that you were doing earlier? Can you just give us some more color on that?

Arun Khurana: Sure. So your first question, you're absolutely right. We do not run any unhedged positions on the balance sheet side of the business, so that is a confirmation I can give you and right from the beginning itself. Whatever foreign currency comes, if we keep it in foreign currency, if we do not need to hedge it, it will be kept in foreign currency. If it is converted into INR, it is hedged for the underlying tenor, So that way, we were hedged all the time.

Number two, the large number came up because there was a process that was always being followed by the Bank right from the inception of these transactions for the internal trades that were done by the desk. Now let me just give you a bit on the internal trades for the desk also. So internal trades were entered only for trades which had little liquidity in the external market. For example, 3 to 5 years yen deposit coming in to be swapped into INR or 8 or a 10-year dollar borrowing from a multilateral. So these are the typical trades that were entered. We used to take market quotes from at least 3-odd different sources before these internal trades were contracted. So when you do this internal trade with the trading desk, the trading desk will in turn go out and hedge the trade itself because you got to be within your risk limits that are put up or what they've got to work within. So the external trade was mark-to-market, while the internal trade was on swap cost accounting or swap valuation. These 2 legs would vary during the period of contract, but converge on maturity.

Now what happens is in the interim period, if you were to repay your borrowings, you would unwind that trade. And there are lots of cases where we did repay some of these foreign currency borrowings as well, where the internal trades were unwound. And it is in those cases that we found that one of the trades was hitting our P&L and the other was hitting our asset book. So that is where the difference came in. This was a practice that was being followed over a period of time.

Rahul Jain: Understood. That's very helpful. And last question is, is it linked to any particular sector earlier?

Arun Khurana: No. As I mentioned, these are all balance sheet trades. Balance sheet rates are only on account of the balance of the Bank's procurement of foreign currency borrowings or deposits. Nothing got to do with any client transaction in reference to what we had asked earlier.

Rahul Jain: Got it. Very helpful. And so therefore, we should not extrapolate it into the next few quarters in terms of the business growth, whatever.

Arun Khurana: No, nothing got to do with that. And in fact, as MD also said, our entire objective would be to get the validation of whatever comes out as a number, because this is an internal number that we've arrived at, which is an approximate number, but not an exact number. And once that is there, it's our endeavor to take the impact in the financial statements.

Rahul Jain: Got it. And I guess RBI has also been looped into it.

Sumant Kathpalia: Yes. RBI is absolutely looped in. And we gave a preliminary update last week, and we gave a final update now.

Moderator: Your next question comes from the line of Sameer Bhise from Dymon Asia.

Sameer Bhise: Just wanted to ask that, obviously, given the overall macro front, multiple issues generally facing, how one would be comfortable in terms of what we have guided to the market till now? That's one. And secondly, would you be able to comment if the RBI - RBS is over for the bank? These are my questions.

Sumant Kathpalia: RBS was over for the bank 3-4 months ago, the reserve bank supervision are you talking, right?

Sameer Bhise: Yes.

Sumant Kathpalia: That has been over in September-October. This was a different issue, which was discovered and we informed the regulator about it.

The business performance during this quarter continues the way we had guided the market. We should be in line with the expectations shared by us. And from quarter 1 onwards, like I said, we should be back to what we're willing to do and our credit cost should start showing a declining trend because microfinance would have stabilized by then. We would take whatever cost we have to take in quarter 4 for microfinance.

Moderator: Your next question comes from Mahrukh Adajania from Nuvama.

Mahrukh Adajania: So I just wanted to check that a couple of things. Firstly, you said that these were over time. So what is the time period where these trades were rejected? What time frame or how many months?

Arun Khurana: 5 to 7 years.

Sumant Kathpalia: So this is when we started the derivatives desk, it's approximately at that time itself, the process was started.

Mahrukh Adajania: But the transactions that you're talking about right now have been over what period?

Arun Khurana: It's the similar period. So it's about a process that was put in place, which we realized now based on this new framework that we had to adopt on 1st April. And that is when we said, okay, there seems to be a large difference when we got to know about it. And then we started doing an internal review, but also parallelly, we said, okay, what we believe is coming out should be revalidated by external agency as well. So to answer your question, yes, so it's over a period of 5-7 years with no change in the schema that or anything in the intermittent period.

Mahrukh Adajania: Got it. And you said that from April 1, 2024, it's a different methodology?

Arun Khurana: Not a different methodology but now we are not doing these sort of transactions anymore, which I explained earlier along with the reason for doing these internal transactions. So we are not doing them at all. So as a result, the methodology is like how you would value any external trade.

Mahrukh Adajania: Okay. And my other question is that which division of the bank, would you hold responsible for this?

Arun Khurana: I think we are in process of getting deeper into it, Mahrukh. But as I said, because this is amount or the impact of a material nature. We thought it's prudent to come upfront based on our own internal review, to disclose this to the market. To answer those questions, yes, we will absolutely answer your question in full transparency as and when we get the final report of the external agency and collaborated with our financial statements.

Moderator: Your next question comes from Bhavik Dave from Nippon India Mutual Funds.

Bhavik Dave: Sir, just 2 things. One is on this 2.35% of net worth, and you mentioned your inspection is still going on with external agencies. Do you think that number will be materially different in terms of outcomes because you mentioned that this is a ballpark number that the internal guys have picked up? Can the number be significantly different from this or it will be like 10-20 basis points here and there. What would your judgment because you've done a thorough review, an external guy will do a similar kind of review. So can the outcomes be materially different? Or it will be like in the range of 20-30 basis points in that range?

Sumant Kathpalia: I think very difficult to answer this question. We have done all our due diligence when we've come and disclosed it. It's an estimate right now because the validation is still happening. And as the validation get completed, we will come and disclose the number. In my view, the number should not be much different. It should be range bound, like you said, but very difficult to answer that question accurately right now.

Bhavik Dave: Sure. And the other part I wanted to understand is this is something that you all picked up in an internal inspection, right, like not RBI or some other agency.

Sumant Kathpalia: It is our internal checking. We have done it through an internal process.

Bhavik Dave: Okay. And lastly, you also mentioned that the inspection like the RBI annual review is done. So RBI from their end, considering we've just got lower term of our CEO extension. In that context, it is very clear that there's no other impending investigation or any other review that is going on in the bank, right? That will be a fair estimate that this is the only thing that we are working on and there's nothing else that, in terms of improvement in terms of processes. Is that a fair understanding?

Sumant Kathpalia: RBI continues to do thematic reviews in an organization such as KYC process, loan asset reviews, microfinance review, credit card review, corporate bank review etc. It's an ongoing process with RBI. To best of my knowledge, I don't think there is anything else material right now, of which we should to be worried about.

Moderator: Your next question comes from Prakhar Sharma from Jefferies.

Prakhar Sharma: Just wanted to check, 2.35% in rupee crore might be, let's say, closer to INR2,100 crores. Would this have been, let's say, part of your interest cost had the accounting being done correctly?

Sumant Kathpalia: So some part of it would have been in trading income. Some part would have been in the swap cost.

Arun Khurana: Mostly on swap cost.

Prakhar Sharma: So swap cost will go to the interest cost, right?

Sumant Kathpalia: Yes.

Prakhar Sharma: Understood. And the April 1, 2024 reference, just to reconfirm, does that mean that since April '24, the transactions were being correctly recorded because practically those trades and the structure of the trade was not happening, you were not doing internal trades.

Arun Khurana: Yes, Prakhar. Absolutely correct.

Prakhar Sharma: So practically, the entire 2.35% is relating to FY '24 and earlier?

Arun Khurana: Yes, correct. Earlier.

Moderator: The next question comes from M.B. Mahesh from Kotak Securities.

M.B. Mahesh: Just a couple of questions, in these derivative transaction, how does the audit typically happen? Is it done by an external auditor or is it done by an internal auditor?

Sumant Kathpalia: So there are 4 types of audits which happened. So first of all, understand the structure of treasury. They have a front office, a mid-office and a back office and a concurrent audit, which continues to happen. Second, there is an internal audit, which happens. And also they take support of external agencies before everything to do the audit. Then there is a statutory audit, which happens on these and then a compliance audit and then the RBI audit. All these audits continue to happen on treasury on a regular basis.

M.B. Mahesh: Why was it picked up in the last 3 months since it's gone through multiple layers of audit and the auditors have signed the balance sheets for these transactions what has picked up in the last 3 months for this issue to come up?

Arun Khurana: Those are questions which we will answer in detail once our review is complete by the external agency because it's important. Based on this new circular, we did our own internal review. I would say that those questions, we are also, in process of finding out as to where was this missed from. So I'm sorry, I really can't answer it right now. But once we have those answers, we'll be absolutely transparent in getting back to you.

M.B. Mahesh: Just to add to this. See, the CFO had resigned a couple of months back, is there any link to the fact that there has been a transaction around this where he was aware and hence he was not comfortable?

Sumant Kathpalia: No. He was aware of this transaction, and if you see the resignation, it is in public domain. I don't think it is linked to only this transaction. He had a different reason on why he was leaving and we were fine with it.

Arun Khurana: And we are disclosing this, right? So internally, we have decided and we are disclosing the same.

Sumant Kathpalia: So we could have delayed the LODR disclosure saying let us validate the accounts and then we will have the numbers and I don't think that is the right way. I think we should be upfront in what we have and we want to disclose to the market.

M.B. Mahesh: Sure. So, just one clarification. In the third quarter results, you could have kind of reported that we are kind of looking at this transaction as it because it's been under work for some time now.

Sumant Kathpalia: So the review was pending, and there was no available information to say that there is a gap. I did not know that there was a gap. We never had a gap and there were so many audits which have gone through. It's just that we realize it now over a period of last 1 or 2 months, and I said that once it started coming in. We continued to review, and dig deeper. And we said that we should now disclose it.

Arun Khurana: And, we also mentioned that this data pertains to a very long period of time. And as a result, once you say something you should have some substance behind saying it. And once we've got the substance. While again, I'm reiterating that it’s all internal and yet to be verified by the external agency. But we've followed a prudent approach to be upfront and be transparent.

M.B. Mahesh: And last question, Sumant, has this got any bearing to the fact that the appointment for you has been for 1 year? Or has there been any conversation on this issue? The Board has approved for 3 years but you've got only 1 year?

Sumant Kathpalia: So that's for the regulator to answer. I think, this would have had a bearing because they're aware of this issue. There was some inkling towards the issue. I don't know what's the rationale for them to give me 1 year, but I think, they are uncomfortable with my leadership skills of running the Bank is and we have to respect that.

And this is a test for the bank as well. From a succession point that we will see how to take the Bank forward. I don't think the Business As Usual (BAU) of the Bank will suffer. I don't think our growth agenda will get off the track. And I remain committed for 1 year to the Bank. And let's see how the process goes. The Board will evaluate external as well as internal candidates for the CEO position. I don't know whether they evaluate me or they evaluate somebody else. That's for them to decide.

Moderator: Ladies and gentlemen, we will take this as a last question for today. I will now like to hand the conference over to Mr. Sumant Kathpalia for closing comments.

Sumant Kathpalia: Thank you for joining the call. It was a very short time, which we gave you to come to this but it was a critical element. I just want to tell you that the Bank has enough reserves as well as capital to manage this transition. I wanted to be upfront with you to say that we are in a position where we are seeing some losses which are coming in, rather than coming in March and April and doing it. What we did in the microfinance, it hurt us badly. So this is just being transparent and telling you, as we get more information, we will do another call in April or as early as possible to make sure that you get enough information about what has really happened. Thank you, and you can contact me or Indrajit for any further clarification.

Moderator: Thank you. On behalf of IndusInd Bank Limited, that concludes this conference. Thank you for joining us. You may now disconnect your lines.

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