Business Strategy at IndusInd Bank*©

Smita Aggarwal (Senior Program Director, Centre for Advanced Financial Research and Learning)
Nidhi Prabhu (Program Officer, Centre for Advanced Financial Research and Learning)

December 2015

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The authors would like to thank Sanjay Mallik, Head, Investor Relation and Strategy, and Paul Abraham, COO, IndusInd Bank, for their cooperation in the preparation of this note.

IndusInd Bank is a mid-sized, Indian private sector bank with total assets of Rs. 1,091,159 ml as of March 31, 2015 (Exhibit 1), total income of Rs.120,958 ml (Exhibit 2), and a net profit of Rs.17,937 ml for the year ended March 31, 2015. Its RoA (Return on Assets) for the year was 1.9% (Exhibit 3), with the CASA (Current Accounts and Savings Accounts balances as a ratio of total deposits) standing at 34% (Exhibit 4), and NIM (Net Interest Margin) of 3.6%. It is today acknowledged as one of the better managed banks in India.

1994-2004

This was, however, not always the case. The bank was given a banking license along with 9 other private players under Reserve Bank of India's (RBI) licensing guidelines of 1993. It was one of the many new players, and was not backed by an established brand in the financial sector. As an unrecognised brand, it found it difficult to attract low-cost deposits (current account and savings accounts – CASA). As a result, it could not establish its presence in the retail assets business, as the margins there are typically tight and need low-cost resources to be competitive. At the same time, it did not have the financial strength to break into the large corporates' business. It therefore focussed on the Small and Medium Enterprises (SME). As the interest rates shot up in the year 2000, the bank's borrowers came under a lot of pressure. With a small capital base, the balance sheet of the bank therefore, continued to be under stress till 2004.

2004-2007

The Situation at the Beginning of the Period

The bank had significant exposure to certain risky sectors, there was a high degree of loan concentration to a particular borrower, and the bank was facing capital constraints.

The Strategy

In 2004, the promoters decided to shore up the bank's capital and to broad base its asset portfolio by merging a Commercial Vehicle Finance company - Ashok Leyland Finance (ALF), controlled by them, with the bank. ALF had a tie-up with a major producer of commercial vehicles (CV) In India (Ashok Leyland) and used to provide vehicle finance to its buyers. ALF was well-capitalised from a CV financing point of view. It used to originate loans and then securitise them immediately, enjoying the yield differential.

The Execution

While the merger resulted in recapitalisation of the bank, the combined management did not have a clear strategy on how to use the capital for the bank in a manner that would improve profitability. Further, in 2006, RBI issued guidelines on securitisation, which prevented the bank from following the ALF model of securitising its assets in a profitable manner. Hence, the practice was discontinued. As the existing assets now required continued funding over their entire life cycle, the bank required significant fund augmentation, for which the bank resorted to wholesale corporate and inter-bank funding.

The Result

The merger resulted in a more balanced asset portfolio for the bank, with 35% of the portfolio in corporate loans. However, the concentration of the loans continued, both industry-wise and borrower-wise. The results started becoming evident in Financial Year (FY) 2006, when the NPA provision of Rs.902.9 ml included a Rs.487 ml write off on a single account.

The dependence on wholesale funds (26% of all deposits in March 2006) caused its own set of problems. Wholesale funds had a reset every six months, while the assets were largely fixed rate in nature, with the repayment period being around 40-48 months. This, in turn, gave rise to the typical maturity and interest rate mismatches. The interest rate rise in 2007 brought the problem to the fore. As on March 31, 2007, 35% of the bank's portfolio was in corporate loans to mid-sized, high-risk corporates, with the rest 65% being in consumer finance (largely vehicle finance). 80% of the latter, was in turn, composed of commercial vehicle finance, which is the lowest-yielding asset in the category. As a result, the RoA was abysmally low at 0.41%, with NIM being at 1.53%. With no significant investments in technology and branch network, the cost-to-income ratio was almost 70%, and the bank found that good talent was hard to come by. In short, the bank had issues both on product and people front.

<u>2008</u>

The promoters, at that point, decided to replace the management with a highly experienced team of bankers in February 2008. Romesh Sobti was appointed as the new MD & CEO. He had more than 30 years of experience in the banking industry, having worked at State Bank of India, ANZ Grindlays and the ABN Amro Bank. He brought with him 4 more people, who had earlier worked with him. These 4 people were experts in four distinct areas, and were given responsibilities at the bank accordingly. The team analysed the situation and formulated a new growth and risk management strategy, which emphasised restructuring of the balance sheet and business mix and improving operating efficiency. The approach was to align the assets in line with the maturity and interest rate risk profile of the liabilities in a dynamic manner. On one hand, the assets had to be rebalanced in line with the liabilities' existing profile. At the same time, an attempt had to be made to improve the profile of the liabilities, so that a more profitable asset mix could be targeted, without increasing the risks. Romesh Sobti and his senior management team worked on developing a coherent strategy, implementing it over time, and rapidly driving change within the organisation. The speed of change was essential to the successful implementation of the strategy.

The long term strategy was divided into 3-year phases. The strategy to be followed in each phase was decided upon at the beginning of each phase, after considering the extant situation and environment. It was continuously reassessed through monthly and quarterly reviews and at annual Board meetings, with stock taking and course correction happening as and when required.

Though each strategy was to be set at the beginning of each period, three underlying themes were decided upon at the beginning, which were to run through the different phases. These were:

- Capital efficiency and conservation
- Liability-driven asset mix
- To be a universal bank to the targeted market

Given the performance of the bank, it was not feasible to go for fresh capital-raising immediately. However, in order to gain investor confidence, clear and measurable targets were identified and reported – Return on Equity (RoE), Return on Assets (RoA), Cost-to-Income Ratio, Net Interest Margin (NIM), CASA ratio, Revenue per Employee, and Net NPA at product level.

Phase I – FY 2009-11

The Situation at the Beginning of the Period

The new management inherited the legacy issues of concentration of wholesale deposits, poor quality corporate loan book, and an asset liability mismatch resulting in interest rate and liquidity risk. Moreover, the Global Financial Crisis caused global turmoil and reduced availability of finance.

The Strategy

The first phase from FY **2009-11** concentrated on **restoring the health and profitability of the bank**. This was to be done by a rapid cleaning up of the balance sheet, rebalancing the asset and liability portfolios in line with the theme of having a liability-driven asset mix, and raising additional capital. For rebalancing the portfolios, the management decided to go slow on the Consumer Finance portfolio, and expand the corporate loan portfolio with a focus on quality assets. On the liabilities side, it focussed on raising current account deposits. Given that an effective change could not be brought in unless the right people were there to implement it, the bank decided to emphasise on its human capital.

The Execution

With a view to conserve capital, operations were centralised to bring operating costs down, and capital expenditure on IT was restricted. Although the bank realised that it needed to upgrade its

IT systems, it had to postpone major purchases at this time, as it had limited resources at its disposal and was determined to improve its profitability. Hence, only the essential plug-ins for the CBS (Core Banking System) were sourced, especially those required at the branch level. Customer-facing processes were standardized, and a number of operations flows were digitized. Further, the management decided that it would be more prudent to distribute various products rather than originate all of them. The bank actively entered into tie-ups to be the distributor of home loans, insurance, micro-loans etc. originated by others. The branch network was expanded in a limited way, but the existing branches were made more effective.

The top 3 major accounts that had turned non-performing, were chased and the loans recovered. While expanding the corporate loan portfolio, a conscious choice was made to increase loans to high-rated corporates rather than to the mid-market riskier segment that was earlier being catered, even though it initially brought the NIM down. The 2008 Global Financial Crisis (GFC) resulted in a unique opportunity coming the bank's way in this aspect. As funding dried up across the market, these high-rated borrowers were facing a funding crunch. With a small existing corporate loan portfolio, the bank was not weighed down by legacy issues and could enter this market. Most of these loans were in the form of working capital loans with a 6-monthly interest rate reset, in order to avoid interest rate mismatches, as the bank was still largely funded by short-term wholesale funds. The new relationships with high-rated corporate borrowers were also used to generate fee-based income. In addition, an attempt was made to re-price the existing SME book, and to weed out the unwanted accounts.

There was a targeted focus to increase Current Account balances as much as possible, in order to reduce the overall cost of funding and to have a more stable source of funds. This was driven by reaching out to PSUs and commodity exchanges. While the strategy of opening a select few new branches every year was maintained, the execution was regularly fine-tuned. The bank had opened 30 large branches in the second year of this phase, but it soon realised that as these branches took time to break-even, it would have a negative effect on the profitability. Consequently, while 90 branches were added in the third year, the branch model was restructured so that branch break-even was achieved within a year. Some of the existing branches, especially those inherited from ALF and located in areas like transport hubs were relocated in areas where more Current Account customers could be found. The look and feel of the branches was upgraded as required. As the consumer finance portfolio was no longer a focus area, the branches did not have any asset-side pressure, and could commit their energies to raising deposits. The reporting structure at the branches was reorganised to enable this commitment, with the current account business reporting to Transaction Banking division, and savings account business reporting to Consumer Banking division. Earlier, all businesses at the branch level used to report to the Branch Manager.

During these three years, capital adequacy was shored up through multiple sources including QIP and Tier II issues. Almost Rs.21,000 ml of enhanced capital emanated from three rounds of capital-raising. Instead of attempting to raise a huge sum in one go, the bank took small chunks of capital, demonstrated improved performance, and thus built credibility in the market. The bank introduced an Employee Stock Ownership Plan (ESOP) in order to attract and retain the required talent from the market. A culture of meritocracy was put in place and delivering results was emphasised upon. A performance measurement matrix was put into place and used effectively to enhance performance.

The Risks

The strategy devised by the new management, though necessary in the light of the constraints faced, was not entirely free of risks. The bank was increasing its Corporate Loan book in an era of a general spike in credit and liquidity risk. Liquidity risk was an issue not just for the bank with its overexposure to wholesale deposits, but also for these borrowers, translating into a credit risk for the bank. Though the bank tried to mitigate these risks by focussing on top-quality borrowers and imposing a half-yearly reset on the loans, the prevailing market situation did not help. Besides, with limited capital at its disposal, the bank could not expand the branch network enough to secure the required retail deposit growth.

The Result

At the end of March 2011, NIM increased to 3.5%, RoE to 19.3%, RoA to 1.5%, and CASA to 27%. The Cost-to-income ratio had come down to 48.3%, the share of corporate loans had increased to 56%, with 26% of this coming from large corporates. While the CA deposits had grown upto 18% of total deposits, there was still a need to improve SA deposits from the 9% levels that it was at the end of March 2011. While the retail participation in deposits had increased, the bank still had the industry's highest concentration of deposits.

Phase II – FY 2012 – 14

The Situation at the Beginning of the Period

With an improved profitability, efficiency, capitalisation and a rebalanced asset portfolio, the bank was still funded largely by wholesale deposits, and it needed to scale up.

The Strategy

With the consolidation phase largely behind it, the bank decided to enter the **Invest to Grow** Phase – with the strategy to increase scale without losing out on profitability. To achieve this aim, the bank needed to concentrate on longer term sources of finance, which included improved Savings Accounts deposit balances through branch expansion and innovative products. Cost-effective, active brand building was made a priority.

The improved liability profile put the bank in a position to rebalance the asset portfolio in favour of more profitable assets, without increasing the asset-liability mismatch risk. Adjacent businesses were made a priority. At this stage, increased spend on IT capabilities became not only possible, but essential, as a part of the continued focus on increasing efficiencies. This capacity building would be equally required to empower the bank in its attempt to increase its savings accounts deposits.

The Execution

Though the bank's Current Account balances had increased, the growth in Savings Accounts balances had been quite limited. As the bank's performance and stability improved, the bank was better positioned to open more branches. The bank was also better capitalised, having raised money through GDR and QIP issues. Over this period, the bank doubled its branch network to 602 branches. Nevertheless, the bank realised that just opening new branches would not be enough in a competitive savings account market. In order to create an edge over its bigger and older competitors, innovative, first-in-the-market products and services were launched. Some examples of this were

- Branches that were open 365 days a year
- Choice of denomination of currency notes at the ATMs
- Cash-on-Mobile ATM (whereby customers could transfer money to others' mobile numbers, with the receiver being able to withdraw this money at the bank's ATM without an ATM card).

Technology was extensively leveraged to reach out to new customers and to cross-sell to existing ones. Efficiencies continued to be brought in using technology. An example of this was the feature of "choice of currency denomination" in the bank's ATMs. As this service was a first-in-the-market, it was also used by customers of other banks. This resulted in a positive inter-change charge for the bank, leading to the expansion of the ATM network at a faster pace. The bank further monetised this unique feature, by on-boarding customers of other banks when they used IndusInd Bank's ATMs.

The bank bought the credit card business of Deutsche bank in June 2011, in line with the theme of offering all services to its target customers, and with the strategy of building adjacencies. New products like loan-against-property and mortgage distribution were offered to customers. Fast response times and quick identification of needs were used to claim a service premium from large corporates. Forex products for corporate clients were brought into focus. Brand-building was also undertaken through advertising of specific products and services that would lead to improved sales as well as brand recognition.

With a balance in Corporate loans and Consumer loans being achieved, and more stable and cheaper funds coming in as CASA deposits, the bank decided to refocus on non-vehicle consumer business and on small business portfolio. More products and services were added for these segments. Differential risk-based loan pricing for each customer segment was adopted. In India, it is typically the large-size businesses that have access to capital market related services. The bank started offering Investment Banking services to mid-sized businesses, which were traditionally not necessarily targeted by large investment banks. With IndusInd being the only bank to focus on these services to the mid-market segment, it created a niche-market for itself. Further, as Investment Banking is more relationship oriented, clients tend to be comparatively sticky. These relationships also give the bank access to other businesses from these clients.

Longer-term sources of finance like refinance from Financial Institutions were tapped to further improve the fund-mix and provide a base for vehicle finance. This was especially important as the vehicle-finance portfolio was becoming less risky as it aged. The risk profile of the portfolio reduced further as some of the riskier assets inherited from ALF's Commercial Vehicle Finance portfolio matured and moved off the balance sheet. In line with the theme of being a universal bank to its targeted customers, vehicles from different producers were financed, rather than just from one manufacturer. Used-vehicle finance was explored as an adjacent business, and provided the bank an opportunity to increase its book size and profitability without significantly increasing the risk profile. Channel financing for vehicle producers was another category the bank entered.

Active mapping of various sources and utilization of funds was undertaken, based on maturity and type of source. For example, long-term sources of funds were mapped against vehicle financing, wholesale funds mapped against corporate loans, CASA and retail FD funds mapped against consumer finance. Depending on the increase in funds from a particular source, the target for various assets was actively managed. With an improvement in the bank's balance sheet, the bank supported its IT systems with regular updations. The CBS was overhauled. Scalable technology was adopted in different areas.

The Risks

Though a dynamic rebalancing of the asset portfolio in line with the emerging liability portfolio is a laudable effort, it is easier said than done. Acquiring new customers, and reacquiring old ones, is a tedious process in the highly competitive banking space. There is also the possibility of underestimating risks associated with a particular asset. E.g., while the risk of non-repayment of loans may be lower in used-vehicle financing due to the owner's rising equity, in case of an actual default, the resale value of the vehicle is much lower than that of a new vehicle. So the lower default risk is balanced by lower value of the security.

The Result

By the end of this planning cycle in March 2014, the bank was able to build a quality franchise while keeping the 6 identified vectors in control. NIM stood at 3.7%, the RoA at 1.8%, the RoE at 17.5%, the Cost-to-Income ratio at 45.7%. CASA was at 32.6%, with CA contributing 16.2%, and SA contributing 16.4%. Although the RoE had come down marginally, this was a period where capital was raised extensively to build a platform for future growth.

Phase III – FY 2015 – 17

The third phase is being approached by the bank from a position of confidence, with the strategy being of **increasing market share while retaining the profitability**. As banking becomes more commoditised, the bank aims to create "Intelligent Specialisation and Domination", which is expected to generate a specialist premium for the bank. The bank's aim is to identify its areas of strength like vehicle financing, gems and jewellery financing, e-procurements, investment banking for mid-sized clients, commercial vehicle financing, and micro-finance and become a dominant player in some of these markets. The bank plans to continue to come up with innovative products and services and explore adjacencies, to keep its customers engaged and increase their stickiness. Increasing its fee-based income is another area of commitment for the bank.

The bank has announced a new digital and mobile strategy, whereby the digital channel will be offered as an integral part of business across various customer lifecycles, and not just as an alternate channel. It would be focussed on finding new customers, fulfilling new and existing customers' requirements efficiently and keeping them engaged through 'experiences', while retaining the human connect. The aim of this strategy is to generate profitability through productivity and efficiency. The bank is also increasingly using business intelligence to draw-in first time customers and to improve sales force productivity. It plans to have an off-shore banking unit in India in the near future.

Exhibit 1

Balance Sheet

In Rs mn (as of)	March 2007	March 2008	March 2009	March 2010	March 2011	March 2012	March 2013	March 2014	March 2015
Capital & Liabilities									
Capital	3200	3,200	3552	4,107	4,660	4,677	5,229	5,256	5,294
Reserves and Surplus	7370	10,297	13,092	19,866	35,843	42,741	71,074	85,173	1,01,151
Deposits	176450	190,374	221,102	267,102	343,653	423,615	5,41,167	6,05,023	7,41,344
Borrowings	5920	10,954	18,565	49,343	55,254	86,820	94,595	1,47,620	2,06,180
Other Liabilities and Provisions	16330	17,793	19,836	13,278	16,948	18,108	21,000	27,187	37,190
Total Liabilities	**209270**	**232,618**	**276,147**	**353,695**	**456,358**	**575,961**	**7,33,065**	**8,70,259**	**10,91,159**
Assets									
Cash and Balances with RBI	10210	15,263	11,908	20,992	24,560	29,036	32,498	44,139	40,351
Balances with Banks	15740	6,518	7,329	5,040	15,686	26,360	35,989	23,555	67,440
Investments	58920	66,297	80,834	104,018	135,508	145,719	1,96,542	2,15,630	2,48,594
Advances	110840	127,953	157,706	205,506	261,656	350,640	4,43,206	5,51,018	6,87,882
Fixed and Other Assets	13560	16,587	18,370	18,139	18,948	24,206	24,830	35,917	46,892
Total Assets	**209270**	**232,618**	**276,147**	**353,695**	**456,358**	**575,961**	**7,33,065**	**8,70,259**	**10,91,159**

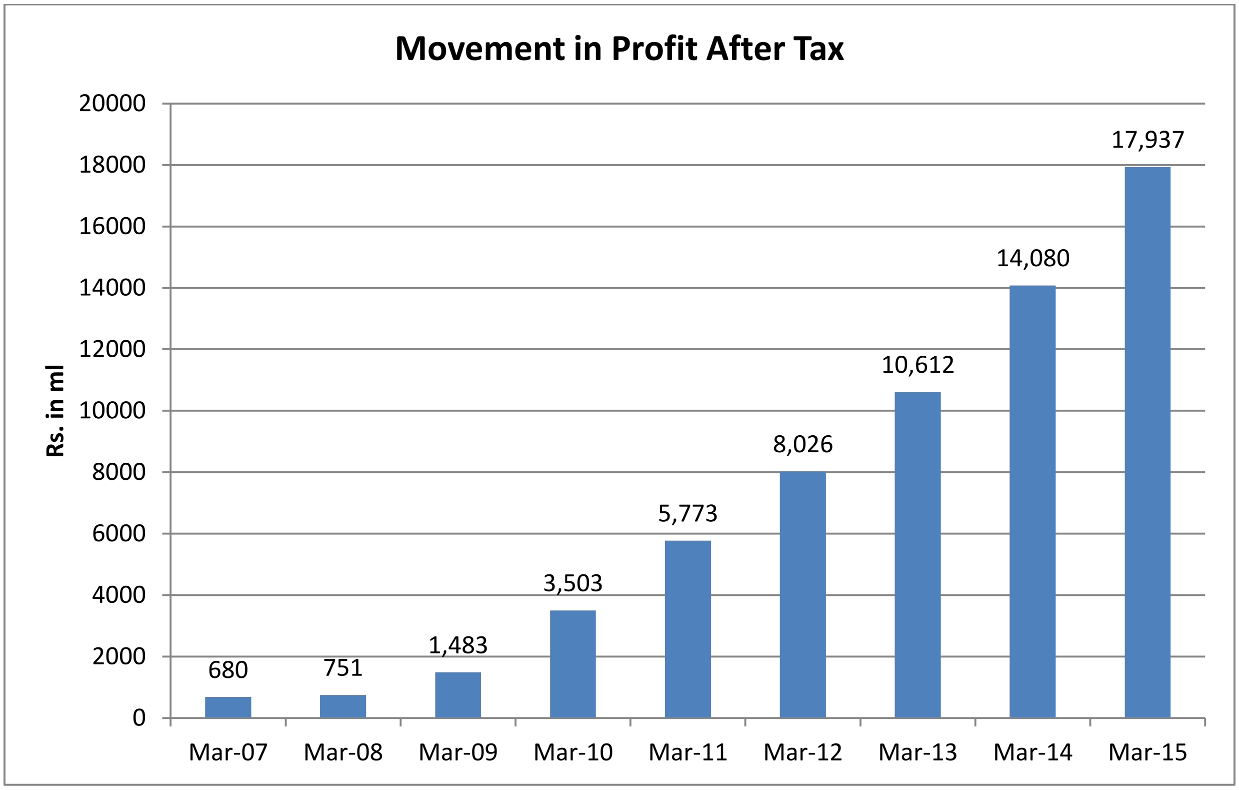
Source: IndusInd Bank website - Corporate Presentations, Investor Presentations

Exhibit 2

Profit & Loss Account

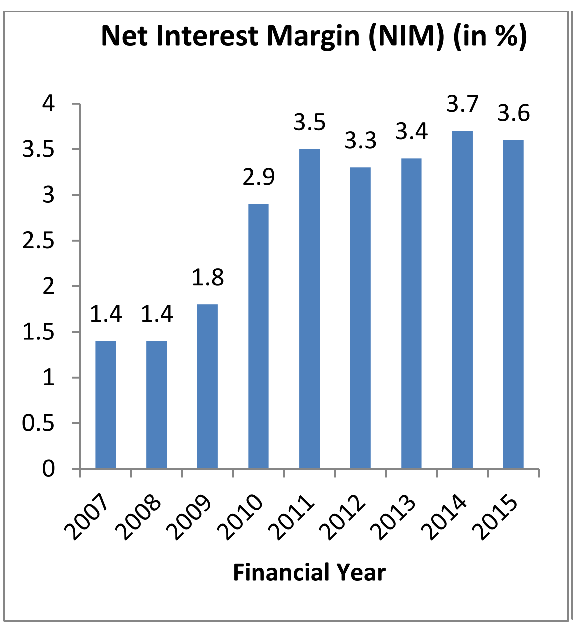
In Rs mn (for the year ended)	**March 2007**	**March 2008**	**March 2009**	**March 2010**	**March 2011**	**March 2012**	**March 2013**	**March 2014**	**March 2015**
Net interest income	2710	3,008	4,590	8,864	13,765	17,042	22,329	28,907	34,203
Non-Interest income	2440	2,976	4,563	5,535	7,137	10,118	13,630	18,905	24,039
Total Income	**270**	**5,984**	**9,153**	**14,399**	**20,902**	**27,160**	**35,959**	**47,812**	**58,242**
Operating expenses	3440	4,022	5,470	7,360	10,085	13,430	17,564	21,853	27,259
Operating Profit	**1710**	**1,962**	**3,683**	**7,039**	**10,817**	**13,730**	**18,395**	**25,959**	**30,983**
Provisions and Contingencies (Excluding provision for tax) (*Includes Provision for tax)	103*	819	1,408	1,708	2,019	1,804	2,631	4,676	3,891
Profit Before Tax		**1,143**	**2,275**	**5,330**	**8,798**	**11,926**	**15,764**	**21,283**	**27,092**
Provision for Taxes		392	792	1,827	3,025	3,900	5,152	7,203	9,155
Profit After Tax	**680**	**751**	**1,483**	**3,503**	**5,773**	**8,026**	**10,612**	**14,080**	**17,937**

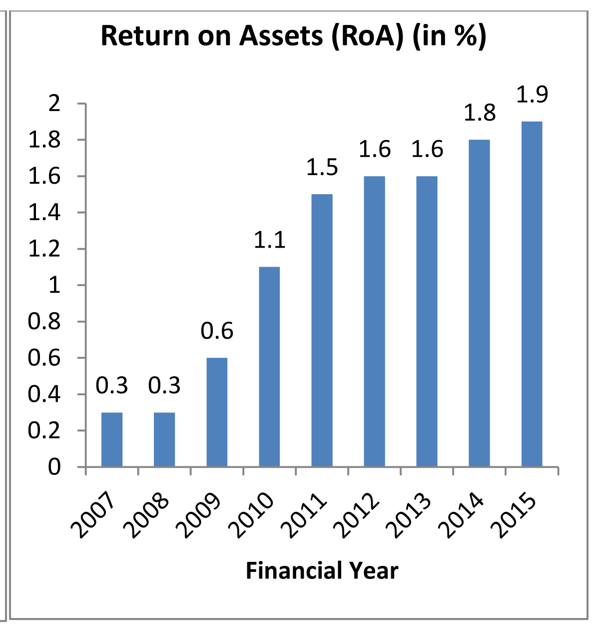
Source: IndusInd Bank website - Corporate Presentations, Investor Presentations

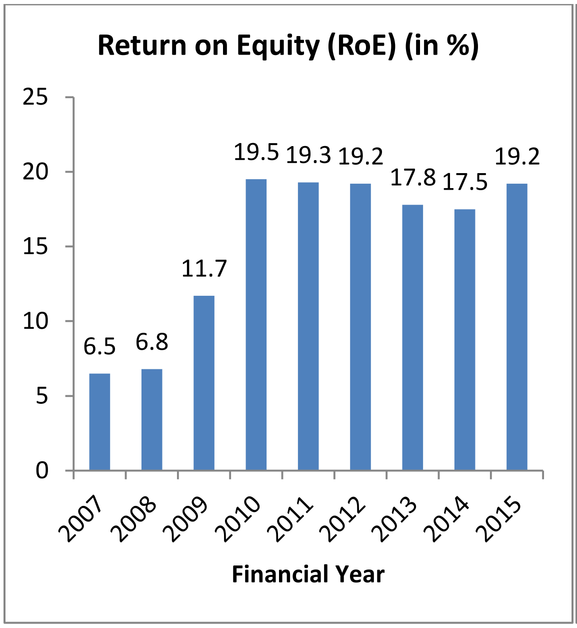


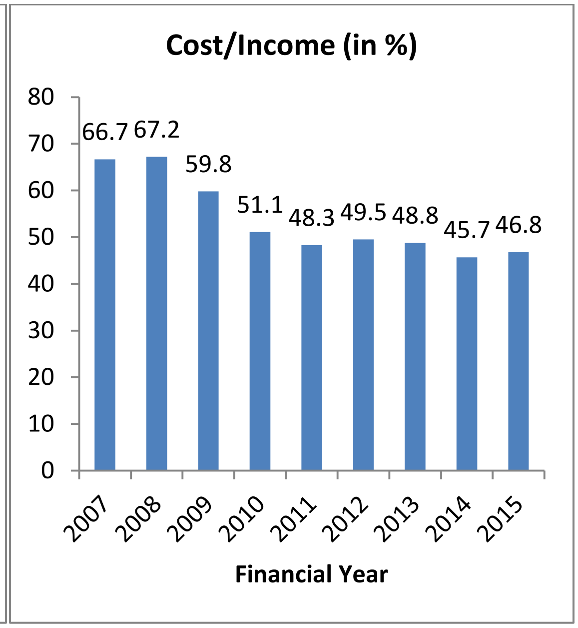
<u>Exhibit 3</u>

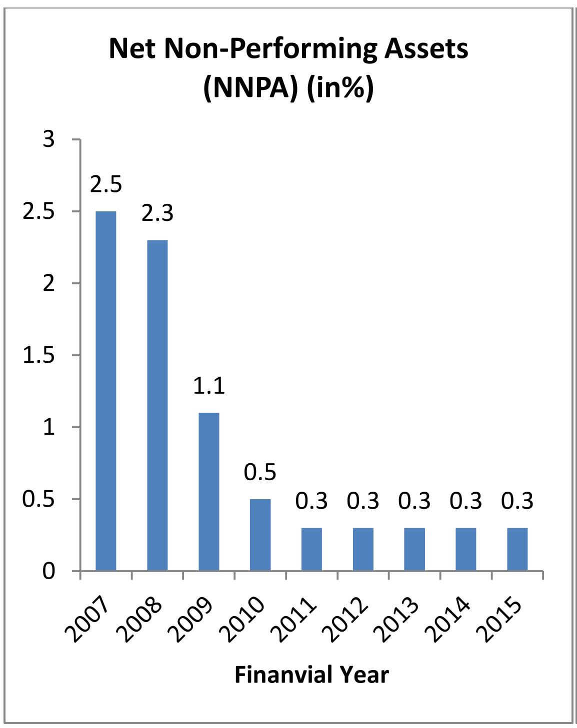
Performance Across Key Financial Vectors

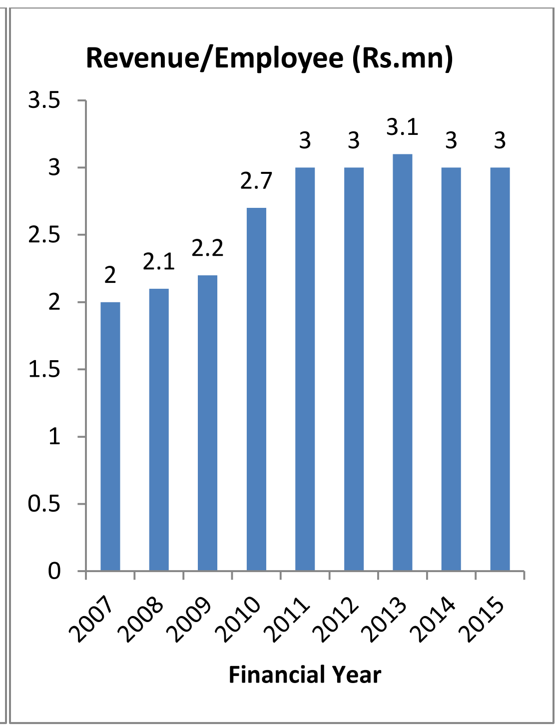








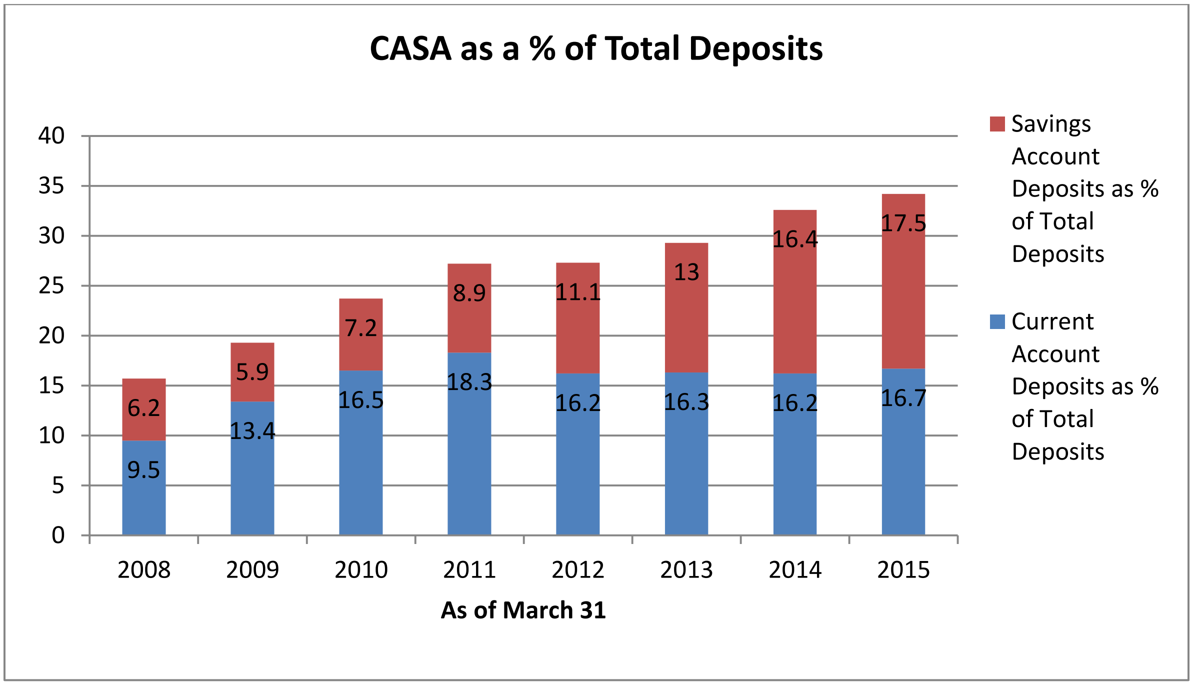




Data Source: IndusInd Bank website - Corporate Presentations, Investor Presentations

Exhibit 4

Movement of CASA as a Percentage of Total Deposits



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