



Report and Recommendation of the President to the Board of Directors

Project Number: 49268-001
September 2016

Proposed Loan
IndusInd Bank Limited
Supporting Access to Finance for Women in Less-
Developed States Project
(India)

This is an abbreviated version of the document approved by ADB's Board of Directors that excludes information that is subject to exceptions to disclosure set forth in ADB's Public Communications Policy 2011.

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 31 July 2016)

Currency unit – Indian rupee/s (Re/Rs)

Re1.00 = \$0.0145

\$1.00 = Rs66.7080

ABBREVIATIONS

ADB	–	Asian Development Bank
CAR	–	capital adequacy ratio
CSR	–	corporate social responsibility
MFI	–	microfinance institution
MSE	–	micro and small enterprise
MSMEs	–	micro, small, and medium-sized enterprises
NPA	–	nonperforming asset
PSL	–	priority sector lending
RBI	–	Reserve Bank of India
TA	–	technical assistance

NOTES

- (i) The fiscal year (FY) of IndusInd Bank Limited begins on 1 April and ends on 31 March. “FY” before a calendar year denotes the year in which the fiscal year ends, e.g., FY2013 ends on 31 March 2013.
- (ii) In this report, “\$” refers to US dollars.

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I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan of up to \$200,000,000 to IndusInd Bank Limited for the Supporting Access to Finance for Women in Less-Developed States Project in India.

II. THE FINANCIAL INTERMEDIARY

A. Investment Identification and Description

2. **Finance sector overview.** The Indian finance sector is still developing, with banks dominating the sector. At the end of FY2016, the sector comprised 216 banks, including 149 scheduled commercial banks. The total deposits of all banks stood at Rs99.3 trillion and total loans outstanding amounted to Rs77.2 trillion.¹ In addition, 11,682 nonbank financial companies were registered with the Reserve Bank of India (RBI), with estimated total loans outstanding of Rs13.0 trillion.² Notwithstanding the size of the finance sector and the significant strides the government is making in this sector, including the successful *Pradhan Mantri Jan Dhan Yojana* scheme (Prime Minister's People Money Scheme),³ access to finance in India remains a key issue. Gross nonperforming assets (NPAs) for the banking subsector (according to the RBI's definition) worsened from 4.6% in FY2015 to 7.6% in FY2016. The capital adequacy ratio (CAR) of the banking subsector has decreased slightly in recent years, from 14.0% in FY2013 to 13.2% in FY2016.

3. **Microfinance industry.** At the end of FY2016, the Indian microfinance industry had provided microcredit to 33.2 million customers through 9,736 branches, disbursing 34.7 million loans amounting to Rs670 billion, with an average loan size of \$265.⁴ The number of disbursements grew 78.2% in FY2016, while aggregate gross loan portfolio grew by 91.0% during the same period. Since FY2013, the industry has seen a compound annual growth rate of 88.6% in disbursements and a 93.7% compound annual growth rate in the gross loan portfolio.⁵ CRISIL Research, a ratings agency, expects the aggregate microfinance institution (MFI) loan portfolio to grow by 30%–34% annually until the end of FY2021. Problem loans among MFIs have seen a steadily decreasing trend, falling from 0.5% in FY2013 to 0.3% in FY2016 for 30 days past due.

4. The Government of India continues to support the microfinance industry and has encouraged banks to provide further support for micro and small enterprise (MSE) financing. The RBI's 2013 circular defines MSEs as manufacturing or service businesses subject to certain sizes of investment or machinery amounts.⁶ MSEs are eligible for priority sector lending (PSL)—an RBI requirement to support financial inclusion that obliges commercial banks to lend at least 40% of their adjusted net bank credit of the previous year to specified priority sectors, with a focus on underserved and rural borrowers.⁷ Given the operational difficulties of reaching this

¹ Reserve Bank of India, 2016. *Database on India Economy*. Mumbai (accessed 27 June 2016).

² RBI. 2016. *Fiscal Stability Report–June 2016*. Mumbai.

³ As of 27 July 2016, over 226 million accounts have been opened. www.pmjdy.gov.in

⁴ The information pertains to nonbank financial companies and microfinance institutions (MFIs) which, on an aggregated basis, constitute over 90% of the total microfinance industry business in the country. The data exclude Bandhan, which was the largest MFI and became a bank in August 2015.

⁵ Microfinance Institutions Network. 2016. *Micrometer Issue 17*. Delhi.

⁶ RBI. 2013. Master Circular – Lending to Micro, Small & Medium Enterprises (MSME) Sector. 1 July. <http://rbidocs.rbi.org.in/rdocs/notification/PDFs/96010713MSFL.pdf>

⁷ RBI. Frequently Asked Questions: Priority Sector Lending Targets and Classification. <http://www.rbi.org.in/scripts/FAQView.aspx?Id=87>

market, many commercial banks' wholesale lend to MFIs or create originating relationships with MFI business correspondents, whereby banks work effectively with these institutions to increase financing in the underserved MSE segment and meet PSL targets.

5. **Business correspondents model to drive financial inclusion.** Policy makers in India know the ramifications of leaving a large section of the population out of the development process. Therefore, they are designing policies for financial inclusion that will increase the availability of financial services to the poor and marginalized segments of society, and have been encouraging banks to prepare a road map to cover all unbanked villages with populations of less than 2,000. To achieve sustainable rural operations, banks are considering alternate low-cost channels for delivery of banking services. The RBI has encouraged them to improve the outreach of banking services through the business facilitator and business correspondent models. The recommendations of the Nachiket Mor Committee also include accelerating the flow of credit to the poor and enlarging business correspondents' catchment areas, including the use of new entities as business correspondents.⁸

6. The RBI has collated best practices with respect to business correspondent lending and issued guidelines to commercial banks on the use of the business correspondent lending model, including cash management practices.⁹ A business correspondent can help banks mobilize deposits and drive credit penetration in rural and semi-urban areas. A business correspondent can be an individual (such as a grocery store owner), MFI, or agent of a corporate business correspondent.¹⁰ The transaction cost for a business correspondent is estimated to be 1/15th the transaction cost in a rural branch.¹¹ The lower costs are primarily enabled by technology, which allows real-time transactions. To increase the profitability of rural operations, banks are expected to expand their reliance on this model. CRISIL Research estimates that 8%–12% of rural transactions are done through business correspondents, and this is projected to increase to 25%–30% by 2018–2019 (footnote 11).

7. **Investment rationale.** Given the continued need to address access to finance issues for many customer segments in India, the Asian Development Bank (ADB) has sought to identify financial institution partners that have demonstrated the ability to reach underbanked segments while maintaining profitability and good asset quality. In 2014, ADB approved a project with two private banks in India to address access to funding gaps for agri-lending.¹² In 2015, it approved a project with another private bank to support financial inclusion in India.¹³ In 2016, ADB approved a project to support microfinance lending to women borrowers and sanitation financing.¹⁴ To build on ADB's initiatives to promote financial inclusion in India, ADB met with a number of private banks that are reaching underbanked segments and seeking to expand their operations in this area. IndusInd Bank Limited (IndusInd) is ADB's partner as a local currency

⁸ RBI. 2013. *Committee on Comprehensive Financial Services for Small Businesses and Low Income Households: Report*. Delhi. <https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/CFS070114RFL.pdf>

⁹ RBI. 2010. *RBI Circular 2010-11/217: Financial Inclusion by Extension of Banking Services—Use of Business Correspondents*. Mumbai.

¹⁰ RBI. 2006. *RBI Circular 2005-6/288: Financial Inclusion by Extension of Banking Services—Use of Business Facilitators and Correspondents*. Mumbai.

¹¹ CRISIL Research. 2014. *Tailwinds gather for rural banking rebound*. Mumbai.

¹² ADB. 2014. *Report and Recommendation of the President to the Board of Directors: Proposed Loans and Technical Assistance Grant to Axis Bank Limited and YES Bank Limited for Strengthening Rural Financial Inclusion and Farmer Access to Markets Project in India*. Manila.

¹³ ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Equity Investment and Loan to RBL Bank for Supporting Financial Inclusion Project in India*. Manila.

¹⁴ ADB. 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Debt Financing to Janalakshmi Financial Services Private Limited in India*. Manila.

lender in ADB's Microfinance Risk Participation Program.¹⁵ IndusInd is one of the few banks in the country that has consistently achieved PSL targets. In FY2016, IndusInd's priority sector advances reached out to more than 2 million poor households, including almost 1.5 million agriculturalists, across 25 states and 395 districts. About 40% of the loans were for agriculture and animal husbandry (covering such areas as vegetable cultivation, borewell digging, pump sets, livestock loans for buffalo, cow and sheep rearing, and kitchen poultry units); and the balance was for other microenterprises (including saree trading, street vendors, milk vendors, fruit and vegetable businesses, cycle repair shops, weavers, bangle vendors, tea stalls, and tailoring). These types of microenterprise activities are also the subject of IndusInd's business correspondent model lending.

8. ADB's funding will help support IndusInd's financial inclusion program, enabling it to reach a wider geographic segment of the underbanked and unbanked. IndusInd has a strong and expanding footprint in underserved regions of India, and focuses on maximizing development impact by reaching a large number of women borrowers to whom ADB cannot lend directly. This shows clear alignment with ADB's development objectives. IndusInd has been identified as an excellent partner for a direct ADB funding initiative as it provides a unique opportunity to expand work with a bank that has a strong ongoing commitment to inclusive finance, having built it profitably as a core business.¹⁶

B. Business Overview and Strategy

9. IndusInd is a private sector bank in India that was incorporated in 1994. It offers a full range of banking services and is the fifth-largest private sector bank in India by total assets and 33rd largest bank overall. The bank operates across four divisions: (i) corporate and commercial banking, (ii) consumer banking, (iii) global markets group, (iv) and transaction banking. It has a diversified loan book and services the spectrum of customers including individuals; micro, small, and medium-sized enterprises (MSMEs); and corporate groups. IndusInd has a strong deposit franchise, mobilizing customer deposits through 1,000 branches and 1,800 ATMs spread across the country. It has a long-term debt rating of AA+ from ICRA (Moody's), India Ratings and Research (Fitch), and CARE Ratings.

C. Ownership, Management, and Governance

10. **Ownership.** Integrity due diligence has been conducted in accordance with ADB's Integrity Due Diligence Guidelines for Nonsovereign Operations. No significant or potentially significant integrity issues were identified. IndusInd is promoted by IndusInd International Holdings Limited and its subsidiary Indusind Limited. Both are entities established by non-resident Indians led by S. P. Hinduja. IndusInd International Holdings Limited and IndusInd Limited collectively hold 16.7% of all shares and is the largest shareholding group. IndusInd is listed on the National Stock Exchange of India Ltd.

¹⁵ ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Microfinance Risk Participation Program*. Manila.

¹⁶ IndusInd has won several awards and has been recognized internationally for its inclusive financing and corporate social responsibility (CSR) practices. These awards include the Best Financial Inclusion Initiative at the India Banking Association Awards in 2016, the Best Rural Outreach Award at the Sustainability Leadership Awards 2014 in Dubai, Top CSR Advocates in Asia at the Asia Corporate Excellence and Sustainability Awards 2014 in Singapore, and the Financial Inclusion and Payment Systems Award 2014 for the bank's partnership program under its business correspondent model.

11. **Management.** IndusInd's senior management team has full executive powers and is responsible for the day-to-day operations of the bank. It includes an experienced team of professionals, led by Romesh Sobti who has 34 years of banking experience, having worked at ABN Amro and ANZ Grindlays, and consists of 12 other senior managers who head individual business lines and associated support functions, as well as an independent risk function.

12. **Governance structure.** As a listed company, IndusInd must comply with the governance requirements of the exchanges on which it is listed. The bank is supervised by a board of directors consisting of nine members, with board membership approved by the RBI. Of the nine board members, six are considered independent under Indian law.

D. Financial Performance

13. **Capital.** IndusInd has a CAR under Basel III guidelines of 15.5% and Tier 1 CAR of 14.9% at the end of FY2016. This compares with a CAR of 12.1% and Tier 1 CAR of 11.2% at the end of FY2015. The bank has a demonstrated record of mobilizing equity capital at regular intervals to support its growth. Total capital at the end of FY2016 was Rs180 billion, against Rs107 billion in FY2015. In July 2015, the bank raised Rs43.3 billion through the placement of shares with institutional investors, as well as Rs7.5 billion from the promoters to enable them to retain their 16.7% stake.

14. **Loan portfolio.** At the end of FY2016, IndusInd had total assets of Rs1,400 billion and the loan portfolio reached Rs884 billion. This represented loan growth of 29% during FY2016 (against 25% in FY2015). The bank's loan portfolio in FY2016 was split 59:41 between corporate banking and consumer finance (59:41 in FY2015).

15. **Asset quality.** IndusInd's asset quality is sound, with a gross NPA ratio of 0.87% under RBI guidelines at the end of FY2016. This was a slight increase from the FY2015 level of 0.81%. The asset quality of the bank has remained stable in recent years, although gross NPAs increased slightly during FY2014 in line with industry trends as a result of slippages in the commercial vehicle segment. This has since stabilized as growth has slowed in this segment. NPAs across other portfolio segments have been decreasing. The bank's very limited exposure to stressed sectors such as infrastructure, power, iron and steel, and textiles has helped its asset quality. Net NPAs were a low 0.36% at the end of FY2016 (0.31% in FY2015).

16. **Earnings.** The bank has continued to increase profitability since 2010, returning net profit after tax of Rs22.9 billion in FY2016, a 27% increase over FY2015 net profit of Rs17.9 billion; (FY2014: Rs14.1 billion). This resulted in sound profitability metrics for FY2016—a return on assets of 1.9% and return on average equity of 16.8% (FY2015: return on assets of 1.9%; return on average equity of 18.6%). The decrease in return on average equity was due to the significant capital raised during FY2016.

17. **Funding.** IndusInd's liability funding is diversified, with deposits to total liability funding standing at 76% at the end of FY2016. The remaining funding consists of a mix of domestic bank and institutional borrowings and subordinated debt, the majority of which has a maturity of less than 3 years. The bank has seen steady improvement in its deposit base following a strategy of new product launches and expanding its branch network. This contributed to the 25% increase in deposits during FY2016.

III. THE PROPOSED ADB ASSISTANCE

A. The Assistance

18. ADB will provide a senior loan of up to \$200 million for up to 7 years to IndusInd to help support its microfinance activities under its business correspondent model. The objective is to drive financial inclusion¹⁷ by providing credit to significantly underserved market segments, predominantly women in rural areas of India's less-developed states. ADB also expects to provide capacity building technical assistance (TA) in an amount of up to \$1 million, which will accompany the ADB funding and will target financial inclusion initiatives that IndusInd is implementing or developing. This includes financial and legal literacy programs for women, and digitized processing and product development initiatives.¹⁸

B. Implementation Arrangements

19. ADB will carry out project monitoring. IndusInd will provide ADB with reports at predetermined regular intervals including (i) unaudited financial statements on a quarterly basis; (ii) audited financial statements on an annual basis; (iii) compliance certificates for financial covenants; (iv) reporting on the inclusive finance and business correspondent loan portfolio; (v) reporting on selected development indicators agreed between ADB and IndusInd, including the gender action plan; and (vi) compliance with ADB's Safeguard Policy Statement (2009).

C. Value Added by ADB Assistance

20. **Support to financial inclusion.** ADB's funding will help IndusInd to grow and reach significantly underserved customer segments in India. Additional funding will enable it to meet and exceed PSL targets—a key government objective. By providing long-term funding support to a leading private bank focused on financial inclusion, ADB has the opportunity to support PSL initiatives and promote financial inclusion to women in less developed areas in India.

21. **Access to long-term funding.** Banks in India largely lend from short-term, less stable deposits because of difficulties in sourcing sufficient long-term financing. Bond markets in India are not well developed, except for raising short- to medium-term paper (up to 3–5 years), thereby restricting wholesale sources of medium- to long-term funds. Increasing competition for deposits and the Basel III requirement for more stable funding sources requires banks to borrow from diversified sources to fill large funding gaps, including international financial institutions. ADB's loan will provide scarce long-term funds to IndusInd to help support the expansion of its dedicated financial inclusion business.

22. **Gender equity theme.** Only 29.4% of women compared with 43.8% of men have formal savings, and only 11.3% of women against 15.8% of men have access to credit.¹⁹ Lack of land title—exacerbated by other constraints, including lack of collateral needed to obtain credit, low

¹⁷ The RBI defines financial inclusion as “the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost.” S.P. Vijaya Bhaskar. 2013. Financial Inclusion in India—An Assessment. Speech delivered by Shri P. Vijaya Bhaskar, Executive Director, Reserve Bank of India at the MFIN and Access-Assist Summit. New Delhi. 10 December. https://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=862

¹⁸ The TA will be approved separately and is estimated to cost at least \$2 million, of which (i) \$1 million will be financed on a grant basis by ADB's Technical Assistance Special Fund (TASF-other sources); and (ii) at least \$1 million will be financed by IndusInd.

¹⁹ World Bank. Financial Inclusion Data / Global Findex. <http://datatopics.worldbank.org/financialinclusion/indv-characteristics/gender>

income, lack of financial documents, and unfamiliarity with paperwork and procedures—limit women’s access to credit.²⁰ The project includes gender measures to improve women’s financial planning and literacy, legal literacy, and awareness of consumer protection issues. The financial and legal literacy training programs of the bank are expected to provide a basic knowledge of savings, investments, and loans to women borrowers; and introduce successful women entrepreneurs as mentors.

IV. DEVELOPMENT IMPACT AND STRATEGIC ALIGNMENT

A. Development Impact, Outcome, and Outputs

23. **Impact.** The project will enhance financial inclusion in India.

24. **Outcome.** The outcome will be improved and sustainable financial intermediation to micro-borrowers, with a specific focus on women.

25. **Output.** The project’s output will be IndusInd’s increased financial capacity to service women microfinance borrowers under its inclusive finance business operations.

B. Alignment with ADB Strategy and Operations

26. Under the Midterm Review of Strategy 2020, ADB aims to strengthen the finance sector by promoting inclusive growth.²¹ Inclusive finance will be supported by the focus on rural areas where productivity is low and the potential for income generation is high. The assistance is also consistent with the country partnership strategy, 2013–2017 for India, which highlights the importance of inclusive growth through inclusive financial systems.²² ADB will assist IndusInd to expand its services to low-income women in less-developed states, which is consistent with the government’s efforts as emphasized in the Nachiket Mor Committee Report and the fourth pillar of the RBI’s framework to guide development and regulatory measures focused on financial inclusion.²³ The project is also aligned with ADB’s Gender Equality and Women’s Empowerment and Operational Plan, 2013–2020.²⁴ It is designed to have a gender equity theme and will directly target the provision of financial services to women.

V. POLICY COMPLIANCE

A. Safeguards and Social Dimensions

27. The investment is classified category FI treated as C for impacts on the environment, involuntary resettlement, and indigenous peoples. IndusInd’s existing and likely future portfolios were assessed for potential environmental and social impacts, as well as its commitment to and capacity for environmental and social management. The bank’s inclusive finance business activities have minimal or no adverse environmental impacts, and are unlikely to entail impacts on the environment, involuntary resettlement, and indigenous peoples. The financial intermediary will apply ADB’s prohibited investment activities list; exclude all projects classified category A or B for environment, resettlement, and indigenous peoples; and ensure that investments using ADB funds abide by applicable national laws and regulations. IndusInd will

²⁰ ADB. 2013. *India: Gender Equality Diagnostic of Selected Sectors*. Manila.

²¹ ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

²² ADB. 2013. *India: Country Partnership Strategy, 2013–2017*. Manila.

²³ Reserve Bank of India. 2013. *Second Quarter Review of Monetary Policy 2013-14*. Delhi.

²⁴ ADB. 2013. *Gender Equality and Women’s Empowerment Operational Plan, 2013–2020*. Manila.

comply with ADB's Safeguard Policy Statement and confirm this in its periodic report to ADB. IndusInd will comply with national labor laws and, pursuant to ADB's social protection strategy, will take measures to comply with internationally recognized core labor standards.²⁵

B. Anticorruption Policy

28. IndusInd was advised of ADB's policy of implementing best international practice relating to combating corruption, money laundering, and the financing of terrorism. ADB will ensure that the investment documentation includes appropriate provisions prohibiting corruption, money laundering, and the financing of terrorism, and remedies for ADB in the event of noncompliance.

C. Investment Limitations

29. The proposed loan is within the medium-term, country, industry, group, and single investment exposure limits for nonsovereign investments.

D. Assurances

30. Consistent with the Agreement Establishing the Asian Development Bank (the Charter),²⁶ ADB will proceed with the proposed assistance upon establishing that the Government of India has no objection to the proposed assistance to IndusInd. ADB will enter into suitable finance documentation, in form and substance satisfactory to ADB, following approval of the proposed assistance by the Board of Directors.

VI. RECOMMENDATION

31. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of up to \$200,000,000 from ADB's ordinary capital resources to IndusInd Bank Limited for the Supporting Access to Finance for Women in Less-Developed States Project in India, with such terms and conditions as are substantially in accordance with those set forth in this report, and as may be reported to the Board.

Takehiko Nakao
President

29 August 2016

²⁵ ADB. 2003. *Social Protection*. Manila (adopted in 2001).

²⁶ ADB. 1966. *Agreement Establishing the Asian Development Bank*. Manila.