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Why is Induslnd Bank under pressure

Bengaluru, March 18, 2025: With the recent Induslnd fiasco, Krishna Appala, Senior Analyst at Capitalmind Research has come up with the report.

The report suggests that new investors exercise patience and refrain from bottom fishing, as it may be wiser to wait for more clarity on the asset quality to emerge.

For Existing Shareholders, it suggests that it's better to avoid averaging down and keep a trailing stop loss. While for depositors, the report says that there is nothing to worry about regarding the deposits as according to RBI the bank is well-capitalized and maintains a strong liquidity coverage ratio.

The report content is as follows:

Why is IndusInd Bank under pressure?

Over the last few years (primarily since the retirement of Mr. Romesh Sobti, former MD & CEO, in 2020), the bank has been focusing on garnering NRI deposits by offering attractive interest rates. As of Q3, NRI deposits stood at 58,600 Cr.

Behind the scenes of this NRI deposit growth, a complex structure was in place to manage risk across balance sheets, trading desks, and forex. Understanding this is key to grasping what happened with the bank.

Let's break it down:

Step 1: Foreign currency deposits

Imagine an NRI walks into an IndusInd Bank branch and deposits $1 million in an NRE account for a 5-year tenure. NRE deposits are converted into INR at the prevailing exchange rate at the time of deposit.

The bank may use these funds for INR lending, but at maturity, the depositor can withdraw or repatriate the funds in foreign currency, creating currency risk. This is where hedging comes into play.

Please note that hedging is a strategic decision and not a mandatory requirement.

Step 2: The ALM desk

The Balance sheet management or ALM desk is the next stop. Their job? Managing the bank's overall assets and liabilities, including foreign currency deposits. They ensure the banks manage asset liability cash flows, currency fluctuations risks etc.

At this point, the ALM desk may want to convert the $1 million into INR at the prevailing exchange rate. Let's assume that rate is ₹87 per USD, so the bank will get ₹8.7 Cr. But the bank still has a dollar obligation. To handle this, the ALM desk transfers the exchange risk to the Trading desk via an internal agreement called an Internal Derivative Trade.

Step 3: The Trading desk

Now, the Trading desk steps in. The ALM desk hands them $1 million, and in return, the Trading desk gives back ₹8.7 Cr.

Here's the deal:

Over the next five years, the two desks will periodically exchange interest payments, depending on USD and INR interest rates.

At maturity, the trading desk will return $1 million to the ALM desk, and the ALM desk will return ₹8.7 Cr (plus some agreed fee) to the trading desk.

This agreement happens at what's called Swap Cost the pre-agreed exchange rate and interest differential at which the internal deal is settled. At this point, the currency risk has moved from the ALM Desk to the Trading desk – But the risk is still within the overall bank right?

That's where the external trade leg comes into picture.

Step 4: The Trading desk's external hedge

The Trading Desk doesn't want to hold excessive currency risk. With hundreds of thousands of similar transactions piling up, it needs to offset this exposure.

To do this, they enter an external derivative trade with an international bank. This is the final step in the hedging process.

Here's how it works:

The Trading desk agrees to receive USD and pay INR to the external bank, mirroring the internal swap. This locks in the exchange rate and kind of protects the bank from future USD/INR fluctuations.

The external trade is marked-to-market – its value is adjusted daily based on the latest exchange rate. At this point, IndusInd Bank should, in theory, have perfectly hedged its exposure. However a key accounting difference between the internal and external swaps would later cause problems.

The accounting mismatch – where the problem lies

Internal Swaps (Fixed at Swap Cost): The ALM Desk still holds the internal swap at the original exchange rate of ₹87 per USD.
External Swaps (MTM): The external hedge, however, is marked-to-market. With me till now?

Now, fast forward five years. Let's say by December 2024, the USD/INR exchange rate has moved to ₹80 per USD (just for example, hard to believe, but just say).

This creates a cash flow mismatch right? The internal swap is still valued at ₹87 per USD, but the real market rate is now ₹80 per USD.

If the bank were to unwind the trade, it would only get ₹80 million instead of the ₹87 million it originally accounted for. For every $1 million NRI deposit, this would create a 70 Lacs INR shortfall. Multiply that across thousands of such deposits, and the discrepancy balloons into a significant balance sheet distortion.

The external hedges were MTM, reflecting real market conditions. But the internal swaps remained at swap cost, creating an illusion of stability.

Now, this is only with USD. Imagine the scenario with Yen, Euro etc. And this is exactly what happened.

What is the impact on the books?

According to management, the impact will be around 1500 Cr post-tax (or approximately 2100 Cr pre-tax). That amounts to 2.3% of the bank's net worth, or roughly the equivalent of one quarter's profitability.

Is it significant? Not really, when compared to the overall size of the bank (4 Lac Cr deposit book, 3.5 Lac Cr loan book, 65,000 Cr networth).

On the face of it, as the bank has stated, this is a one-off scenario and will be managed without any major impact.

Will the impact be taken on the Balance Sheet or P&L?
So, the management has acknowledged a 1500 Cr loss from these derivative transactions, and they had to decide where this loss would be recorded in their books.

The management clarified that the loss will be reflected in the P&L statement in Q4. They cannot simply adjust it against their balance sheet reserves (they specifically mentioned that their general reserves cannot be used for this purpose). This will hit their profits as an extraordinary item in the upcoming quarter.

IndusInd Bank has been making headlines for the wrong reasons. In Jan 2025, former CFO Gobind Jain stepped down, citing a desire to explore other opportunities. More recently, the RBI approved Sumant Kathpalia's reappointment as MD & CEO for just one year, instead of the three-year tenure the bank had requested.

Now, the main question:

How safe are the bank depositors?

IndusInd Bank's balance sheet size stands at ₹5.5 lakh crore, with a deposit base of ₹4 lakh crore and loans of ₹3.6 lakh crore as of Q3 FY25. The bank has Tier 1 capital of ₹65,132 crore and total investments of ₹1.18 lakh crore across G-Secs, bonds, and other money market instruments.

The bank maintains strong liquidity of ₹1.8 lakh crore, which accounts for 45% of total deposits. The remaining 55% can be arranged through asset sales at a 30% discount. In other words, even if 30% of the loans turn toxic, the bank would still be in a position to honour all depositor commitments.

On March 15th, the RBI has reassured IndusInd Bank depositors about the bank's robust financial health and stability, despite concerns over potential financial discrepancies. The bank is well-capitalized and maintains a strong liquidity coverage ratio.

What about Shareholders?

As the saying goes, there is never just one cockroach in the kitchen.

The key question is whether this is a one-off event or the start of something bigger—which no one can say for certain yet. Long-term investors should closely track both fundamentals and technicals.

Yes, valuations look attractive—the stock is trading at 0.9x book value, 7x PE, and at PSU-like valuations despite being a private bank. But here's the catch:

In financials, perception drives price. These kinds of concerns take time to settle, and there is no rush to buy this stock as a long-term bet.

For existing long-term investors, avoid averaging down just to reduce your cost price. If you choose to stay invested, knowing the price recovery may take time, consider using a trailing stop-loss to protect your portfolio from further downside.

How about fresh positions in the stock?

Not yet. For now, it would be prudent to stick with larger banks, as we don't yet know if this is an IndusInd-specific issue or part of a broader banking sector concern. Trying to catch the bottom in IndusInd Bank at this stage may not be the wisest move.

Tatparya ye hai ki:

Depositors: The RBI says there is nothing to worry about regarding the deposits. The bank is well-capitalized and maintains a strong liquidity coverage ratio.
Existing Shareholders: Better to avoid averaging down. Keep a trailing stop loss. New Investors: Bottom fishing? May not be a good idea.

Disclaimer: No holdings in IndusInd Bank across our portfolios.