Derivative loss or a deeper crisis

March 11th 2025 was a regular working day for most of us. But the Banking sector was getting ready for a big surprise.

'It is in the structure of the business where negative surprises will ALWAYS outweigh positive surprises,' the founder & CMD of First Global said in a post on X platform

IndusInd Bank shares crash 20%

This news echoed through the Banking community and market too faced a minor setback. The Nifty Bank index fell 0.7%, while the broader Nifty 50 declined by 0.27%. Now let us explore further –

IndusInd Bank, a prominent Indian private sector bank, was founded by Mr. Srichand P Hinduja, in 1994 as one of the first new-generation private banks, with a vision from the Hinduja Group, they began operations on April 17, 1994. The name 'IndusInd Bank' was inspired by the Indus Valley Civilization - one of the greatest cultural examples of combination of innovation with sound business and trade practices.

"We are the preferred banking solutions provider and partner for approximately 42 million customers across the country, including individuals, large corporations, various government entities and PSUs. Our banking network spans 3063 branches/ banking outlets and 2993 ATMs spread across India, covering 1,60,000 villages, and we also have representative offices in London, Dubai, and Abu Dhabi. The Bank offers a wide range of products and services for individuals and corporates, including microfinance, personal loans, personal and commercial vehicle loans, credit cards and SME loans." - *IndusInd Bank Ltd.*

March 11th 2025 - Shares of IndusInd Bank Ltd. crashed 20% in trade, after the bank reported discrepancies in its derivative portfolio. The bank's stock recorded its biggest ever single day fall. One that wiped out nearly Rs 1,600 crore of the bank's net worth, roughly 2.35% of its equity. Adding to the worries, the bank's credibility, and governance practices were being re-evaluated by the investors and customers.

We will break down each concern and understand it better now.

- IndusInd Bank has been trading in derivatives market to *hedge* foreign currency risk. The issue arose from using two different ways to account for these derivatives:

The external method: The bank's trading desk with external counterparties (like foreign banks) recorded derivatives based on their real-time market value. This meant any change in the value, whether a gain or a loss, was immediately reflected in the bank's balance sheet.

The internal method: Another part of the bank, managing internal currency risk, recorded derivatives at the original purchase price, ignoring daily market changes. So, if the value of a derivative dropped from Rs 2,000 crore on the books, delaying the recognition of losses.

The validation behind this was to reduce short-term volatility and present more stable financials. But it meant the bank's real financial position was masked.

On January 5, 2024, the RBI stepped in with new rules to ensure greater transparency across all Banks. All derivatives now had to be revalued at their market prices, eliminating the internal method. As IndusInd Bank revalued these trades, it had to reveal its unrealised losses. While this one-time hit is expected to be resolved soon, it has left investors asking serious questions about the integrity of the bank's financial reporting.

- CFO and CEO positions

The crisis is accompanied by a shorter than expected re-appointment of CEO Sumant Kathpalia. With his tenure up for renewal, the board had recommended a three-year extension. However, the RBI approved only one year. There was another update that the CFO resigned just before the Q3 earnings in 2024 adding to the existing concerns.

- History of Credibility crisis
  - In 2018, IndusInd bank had exposure to IL&FS, whose default sparked a wider banking crisis.
  - In 2021, it was accused of evergreening loans, offering new loans to customers who were unable to repay their existing debts.
  - The bank's microfinance slippages expected to rise further QoQ, and NIMs likely to contract in Q4.
  - Despite its strong financial performance over the years—its return on equity (ROE) averaged at 13% over the past decade.
  - Most of the leading broking house downgraded the stock to 'reduce' or 'Neutral' cutting its target price to Rs 750/- -850/-per share.

All these issues could affect investor confidence in banking stocks, particularly regarding risk management practices.

Bank's Response

- The bank has launched a detailed internal review and appointed an external agency to validate its findings.
- The bank has assured investors that its liquidity has not been impacted by this.
- Banks profitability and capital adequacy remain strong enough to absorb the one-time impact. The loss will be accounted for in either Q4 FY25 or Q1 FY26.

Quoted from Devina Mehra, Entrepreneur. Co-founder, First Global First Indian Investment

The risk of losses is very high as a bank is "inherently a leveraged institution". More important, as an outside investor, you never know where the problems are hiding in either the credit or the trading book.

So it seems appropriate to conclude with this quote – All investments are subject to market risk, read the offer document carefully before you invest and consult your investment advisor before you proceed.

<u>References:</u>

- Money control articles
- The Economic Times News
- IndusInd Bank website and other search engines like Google

- Sanjna TG