

## Management Discussion and Analysis

### Macro-economic and Industry Developments

In 2006-07, the Indian economy was characterised by robust overall economic growth, strong macro-economic fundamentals, accelerated growth in both consumption and investment, rising interest rates and higher levels of inflation mainly on account of shortages in the primary agricultural articles. 2006-07 was also marked by shifts in the global economy. While in August 2006, the Federal Reserve, the Central Bank of the United States of America, paused in its tightening interest rate cycle, Japan also embarked on removing its monetary policy accommodation. May 2006 witnessed a sharp unwinding of the Yen carry trades on fears that global liquidity will reduce and led to significant volatilities in the financial markets globally. However, this phenomenon failed to sustain as it became evident that Japan would be very cautious in increasing its own interest rates.

Advance estimates of GDP released by the Central Statistical Organisation (CSO) on February 7, 2007, place real GDP growth for 2006-07 at 9.2% on top of 9.0% in 2005-06. Domestic price levels were affected by continued high levels of international crude oil prices during the first half of 2006-07. Prices of primary food articles and manufactured products exerted upward pressure on headline wholesale price index (WPI) inflation in 2006-07. Year-on-year inflation based on the WPI was within the RBI's projected levels of 5.0-5.5% upto mid-November 2006 but rose higher thereafter. While the headline WPI inflation ended 2006-07 at 5.74%, at a disaggregated level, prices of primary articles, fuel group and manufactured products registered year-on-year increase of 10.72%, 1.04% and 5.77%.

In this year even as the Federal Reserve, the Central Bank of the United States of America paused on its interest rate hiking cycle in June 2006, European Central Bank increased its policy rate five times by 25 bps each. Bank of England also raised its policy rate thrice by 25 bps each while other advanced economies such as Australia, Canada, Japan, New Zealand, Switzerland etc increased their policy rates in this year. Central Banks in the emerging markets such as China, South Korea, Taiwan etc also increased their policy rates. Reserve Bank of India also significantly tightened its policy rates in 2006-07 with the objective of containing inflationary expectations and maintaining financial stability. Reserve Bank of India (RBI) increased reverse repo rate from 5.50% to 5.75% (with effect from June 9, 2006), and to 6.00% (with effect from July 25, 2006). Repo rate has been increased five times during the year by 25 basis points each from 6.50% to 7.75% on June 9, 2006, July 25, 2006, October 31, 2006, January 31, 2007 and March 31, 2007. Similarly, Cash Reserve Ratio (CRR) was hiked to 5.25% (with effect from December 23, 2006), to 5.50% (with effect from January 6, 2007), to 5.75% (with effect from February 17, 2007), to 6.00% (with effect from March 3, 2007), to 6.25% (with effect from April 14, 2007) and to 6.50% (with effect from April 28, 2007). The Bank Rate has been kept unchanged at 6.00% throughout 2006-07.

In 2006-07, in terms of the monthly average of the exchange rate of Rupee vis-à-vis US Dollar, the Rupee depreciated steadily until August 2006, before starting to appreciate thereafter (High: 43.14 on March 28, 2007, Low: 46.95 on July 19, 2006). Year-on-year appreciation in the Rupee vis-à-vis US Dollar was 2.3%. The trend was mirrored in Rupee rates vis-à-vis other

major currencies like Euro and Pound. Against Yen, however, the Rupee started appreciating from June 2006 onwards.

Resurgence in the manufacturing sector and sustained demand from major trading partners resulted in growth of exports by 36.3% (to US \$ 89.5 billion) during the period ended December 31, 2006, though the pace appeared to slacken a bit in the fourth quarter of 2006-07. Foreign exchange reserves increased by US \$ 47.6 billion in 2006-07 to US \$ 199.2 billion.

Capital markets reflected the improved growth prospects of the economy. The benchmark BSE Sensex rallied from a low of 8,929 on June 14, 2006 to an all-time intra-day high of 14,724 on February 9, 2007. The Sensex closed at 13,072 on March 30, 2007 from 11,280 on March 31, 2006 (year-on-year increase of 15.9%). Aggregate resource mobilisation through the primary market, particularly private placements and Initial Public Offerings (IPOs), increased by 30.5% to Rs. 161,769 crore in the calendar year 2006. In order to make Indian markets more competitive and efficient, Securities & Exchange Board of India (SEBI) introduced an additional mode for listed companies to raise funds from domestic market in the form of "Qualified Institutions Placement" (QIP). India's market capitalisation compares well with other emerging economies and shows signs of catching up with some of the mature economies. Net investment by Foreign Institutional Investors (FIIs) in the equity spot market fell by around 22% to Rs. 36,540 crore in calendar year 2006. Net purchases by mutual funds in the equity segment of stock exchanges amounted to Rs. 15,384 crore in calendar year 2006 (Rs. 13,436 crore in calendar year 2005).

Corporate India witnessed strong growth in revenue and profit due to higher domestic demand, improved global competitiveness and the benefit of expansion and modernisation of the past few years. With increasing profit, Indian companies have been increasingly expanding their capacities and have also ventured into multi-billion dollar cross-border acquisitions. There has been a sharp rise in the rate of investment reflecting a high degree of business optimism. Indian companies are becoming globally competitive through strategic and operational initiatives, and are not just banking on low cost labour. Corporates have been permitted to avail External Commercial Borrowing (ECB) of an additional amount of US \$ 250 million with average maturity of more than 10 years under the approval route, over and above the existing limit of US \$ 500 million under the automatic route, during a financial year.

During 2006-07, the real-estate market has been on a bull-run. Both housing sector and commercial property space have been growing at a rapid pace. The information technology, retail, fast-moving consumer goods, telecom, media (multiplexes), and banking and financial services sectors have been active participants. The Special Economic Zones (SEZ) Act 2005 has acted as a catalyst.

On March 30, 2007, credit-deposit ratio of the scheduled commercial banks stood at 74.13%. Aggregate deposits of scheduled commercial banks increased by 23.0% (Rs. 4,85,210 crore) during 2006-07 as against 18.1% (Rs. 3,23,913 crore) in the previous year. Non-food credit extended by the scheduled commercial banks increased by 28.0% (Rs. 4,10,285 crore)

on top of 31.8% (Rs. 3,54,193 crore) in the previous year. Food credit of scheduled commercial banks increased by Rs. 5,830 crore compared to an increase of Rs. 675 crore in the previous year.

RBI has specified new norms for Non-Banking Financial Companies (NBFCs) to bridge the regulatory gaps and thereby creating a level playing field with minimum potential systematic risk in the area of banking and NBFC operations. The major amendments relating to regulation of NBFCs pertain to exposures by banks to NBFCs, capital adequacy ratio for NBFCs and single/group exposure norms for NBFCs.

During the year, RBI permitted banks to undertake Primary Dealership business. RBI, in order to have a calibrated growth in personal loans, capital market lending, residential housing beyond Rs. 20 lakh and commercial real estate loans, increased the provisioning requirement for loans and advances in the standard assets category to 1% and then again to 2% for the year ended March 31, 2007. RBI also increased the risk weight on exposure to commercial real estate from 125% to 150%.

According to RBI, Indian banks having a presence outside India and foreign banks have to migrate to the standardized approach for credit risk and the basic indicator approach for operational risk under BASEL II with effect from March 31, 2008. For all other scheduled commercial banks, the date has been extended to March 31, 2009.

Source: Economic Survey 2006-07, Union Budget 2007-08, RBI and CMIE

## Consolidated Financial Performance

### Overview

The Bank along with its subsidiaries continue to build the businesses with focus on scale with value creation. The group has been investing significantly in building two of its key businesses – retail liabilities and life insurance. As on March 31, 2007, the Group employs around 10,800 people in its various businesses and has a distribution network of branches, franchisees, representative offices and satellite offices across 300 cities and towns in India and offices in New York, London, Dubai, Mauritius and Singapore. The Group services around 26 lakh customer accounts.

Kotak Mahindra Bank completed four years as a scheduled commercial bank in 2006-07. The Bank opened its 100th branch in January 2007. As on March 31, 2007, the Bank has built a network of 105 full fledged branches spread across 69 cities and towns (65 branches as on March 31, 2006). The Bank proposes to have around 200 full-fledged branches by mid next year.

Kotak Mahindra Capital Company and Kotak Securities continued to report good financial performance on the back of strong capital markets and the robust overall economic growth.

The life insurance subsidiary, Kotak Mahindra Old Mutual Life Insurance continued its growth momentum but posted an accounting loss.

Assets under management (AUM) as on March 31, 2007 was over Rs. 22,350 crore comprising assets managed/advised by the group. Of the above AUM, equity assets managed/advised by the group as on March 31,

2007 were over Rs. 11,800 crore. AUM of Kotak Mahindra Mutual Fund (Kotak Mutual) was over Rs. 12,100 crore as on March 31, 2007.

The group continues to have a significant presence in distribution of mutual funds and is among the top three distributors of mutual funds in India.

The stressed assets portfolio acquired from other banks/NBFCs was Rs. 512 crore with principal outstanding of around Rs. 3,300 crore as on March 31, 2007.

India Growth Fund (the private equity fund) manages Rs. 707 crore, from domestic as well as international investors. The Fund continues to be in active investment mode and as at March 31, 2007, had made investments in 10 companies. Kotak India Real Estate Fund 1 manages contributions of Rs. 460 crore from investors and had made investments in 6 companies.

During the year, the international subsidiaries have been converted to direct subsidiaries (51% holding) of the Bank. These companies are mainly engaged in investment advisory and investment management of funds, management of GDR/FCCB issuances, broker and broker dealer activities as well as investments. Kotak Mahindra (UK) Limited is a SEBI registered Foreign Institutional Investor (FII). The international subsidiaries have gained impetus and have now become gainful contributors to the profits of the Group.

On May 31, 2006, the group consummated the buy-out of Goldman Sachs' stake in Kotak Mahindra Capital Company Limited (KMCC) and Kotak Securities Limited (KS). The consideration for the 25% stake in KS was Rs. 123 crore and the consideration for the 25% stake in KMCC was Rs. 210 crore.

During the year, the Trading and Principal Division (including Primary Dealership) of KMCC was de-merged into the Bank with effect from March 20, 2007 upon receiving requisite approvals from the court and the regulatory authorities. As a result of this restructuring, net worth of Rs. 216.76 crore has moved into the Bank.

### Consolidated Financials

The consolidated financial performance of the Bank for the year ended March 31, 2007 is summarised below. In order to facilitate comparison with the current financial year the numbers for 2005-06 in this section are shown excluding the profit made on sale of stake in Hutchison Essar Limited (HEL).

	Rs. crore		
Income and Profit	2006-07	2005-06	Growth
Total income *	4,293.95	2,852.13	51%
Operating profit	931.19	667.47	40%
Consolidated Profit after tax (PAT)	538.24	342.46	57%

\* Brokerage income is considered net of sub-brokerage

Key Financial Indicators – Consolidated	2006-07	2005-06
Net worth after minority interest (Rs. crore)	3,233.01	2,247.11
Earnings per share (diluted) (Rs.)	16.47	11.01
Book value per share (Rs.)	99.12	72.65
Net Interest Margins (NIMs) (%)	5.2%	5.1%
Return on Average Net Worth (%)	19.6%	20.6%
Net NPA % excluding stressed assets portfolio	0.17%	0.21%

Consolidated profit after tax (after minority interest and share of profit in associates) was up 57% to Rs. 538.24 crore for 2006-07 from Rs. 342.46 crore in 2005-06.

For 2006-07 the consolidated earnings per share was Rs. 16.47 (Rs. 11.01 for 2005-06). The consolidated book value per share was Rs. 99.12 as on March 31, 2007 (Rs. 72.65 as on March 31, 2006).

The consolidated total income (brokerage income is considered net of sub-brokerage) was Rs. 4,293.95 crore up 51% during 2006-07. Other income grew 39% from Rs. 1,636.45 crore in 2005-06 to Rs. 2,269.86 crore in 2006-07. Consolidated other income had three main components: Commission, fees, exchange & brokerage, profit on sale of investments and premium on life insurance business. Commission, fees, exchange & brokerage increased by 22% to Rs. 1,055.94 crore in 2006-07 from Rs. 866.99 crore in 2005-06, with key growth drivers being fee income from the stock broking business, asset management/advisory fees and investment banking. Premium income from life insurance business grew by over 55% to Rs. 950.46 crore reflecting significant momentum in the business.

Operating expenses (excluding sub-brokerage netted-off from brokerage income) increased from Rs. 1,665.09 crore in 2005-06 to Rs. 2,385.71 crore in 2006-07, driven primarily by an increase in employee costs by 57% from Rs. 438.45 crore to Rs. 688.08 crore and the policy holders' reserves, surrender expenses and claims, by 37% from Rs. 591.63 crore to Rs. 810.19 crore.

Consolidated advances were up 49% from Rs. 10,419.88 crore as on March 31, 2006 to Rs. 15,573.44 crore as on March 31, 2007. As on March 31, 2007, consolidated net NPAs were 0.17% of net advances (0.21% as on March 31, 2006) excluding stressed assets portfolio. The breakup of the consolidated advances is given below:

Advances	March 31, 2007	March 31, 2006	Growth
Commercial Vehicles & Construction Equipments	2,578.07	1,873.07	38%
Auto Loans	3,610.79	3,063.72	18%
Personal Loans	1,976.29	1,006.95	96%
Home Loans	1,753.32	970.72	81%
Corporate Banking	2,378.49	1,335.68	78%
Stressed Assets Portfolio	512.30	419.19	22%
Others	2,764.18	1,750.55	58%
<b>Total Advances</b>	<b>15,573.44</b>	<b>10,419.88</b>	<b>49%</b>

## Bank and its Key Subsidiaries: Financial and Operating Performance

The Bank along with its subsidiaries, offers wide range of financial products and services to its customers. The key businesses are commercial banking, investment banking, stock broking, car finance, asset management and life insurance.

### Kotak Mahindra Bank (Commercial Banking)

Kotak Mahindra Bank completed four full years of operation as a commercial bank in 2006-07. The Bank is the central platform for customer relationships across the group. The banking business model is directed towards maximising revenue generation from customers by offering a wide range of products and services to address all their banking needs.

The Bank has five broad business segments:

- lending
- retail liabilities
- corporate banking (including small and medium enterprises — SME)
- treasury and investments and
- venture fund management

The profit before tax of the Bank for 2006-07 was Rs. 203.25 crore up 17% as compared to Rs. 173.60 crore in 2005-06. The profit after tax of the Bank was up 20% to Rs. 141.37 crore as compared to Rs. 118.23 crore in 2005-06. This was after considering (a) additional standard provision consequent to the change in RBI guidelines of Rs. 44.81 crore (b) provision on stressed assets portfolio of Rs. 28.04 crore and (c) Impact of revised Accounting Standard 15 on Employee Benefits of Rs. 6.80 crore.

Segment Revenues	2006-07	2005-06	Growth
Lending	916.44	492.80	86%
Corporate Banking	374.19	181.70	106%
Retail liabilities	362.17	201.98	79%
Treasury and investments	408.49	188.41	117%
Venture Fund Management	17.84	17.68	1%
Corporate Centre	—	54.78	—
Inter-segment revenue	(441.39)	(200.63)	—
Un-allocable revenue (net)	0.03	0.23	—
<b>Total Revenues</b>	<b>1,637.76</b>	<b>936.95</b>	<b>75%</b>

Segmental Results	2006-07	2005-06	Growth
Lending	112.41	114.61	-2%
Corporate Banking	101.65	38.66	163%
Retail liabilities	(42.33)	1.78	—
Treasury and investments	23.61	(17.39)	—
Venture Fund Management	7.88	8.64	-9%
Corporate Centre	—	27.06	—
Un-allocable revenue (net)	0.03	0.23	—
<b>Profit before tax</b>	<b>203.25</b>	<b>173.60</b>	<b>17%</b>
<b>Profit after tax</b>	<b>141.37</b>	<b>118.23</b>	<b>20%</b>

The capital adequacy of the Bank as on March 31, 2007 was 13.46% (Previous year 11.27 %). Tier I ratio was 8.81%.

The advances of the bank stood at Rs. 10,924.07 crore. As on March 31, 2007, the net NPAs of the Bank were at 0.18% of net advances excluding stressed assets portfolio (0.20% of net advances excluding stressed assets portfolio as on March 31, 2006). The Net NPAs of the Bank including stressed assets portfolio were at 1.98% (0.24% of net advances excluding stressed assets portfolio as on March 31, 2006).

As on March 31, 2007, the deposits of the Bank increased by 68% to Rs. 11,000.09 crore as compared to Rs. 6,565.92 crore as on March 31, 2006. Excluding the monies held as collection bankers, the deposits of the Bank increased by 56% to Rs. 10,251.41 crore as compared to Rs. 6,555.49 crore as on March 31, 2006.

As on March 31, 2007, total deposits comprised of Rs. 2,108.68 crore of demand deposits (Rs. 758.64 crore as on March 31, 2006), Rs. 887.70 crore of savings deposits (Rs. 489.34 crore as on March 31, 2006) and Rs. 8,003.71 crore of term deposits (Rs. 5,317.95 crore as on March 31, 2006). The Bank had around 3,50,000 deposit accounts as on March 31, 2007 (1,68,200 as on March 31, 2006).

### Lending

The Bank continues to leverage its experience in the field of retail lending business and has shown a robust growth in disbursements and advances in this area. The total advances of the Bank increased by 72% from Rs. 6,348.54 crore in 2005-06 to Rs. 10,924.07 crore in 2006-07. The break up of the advances of the Bank is given below:

Rs. crore

Advances	March 31, 2007	March 31, 2006	Growth
Commercial Vehicles & Construction Equipments	2,578.07	1,873.07	38%
Personal Loans	1,955.34	1,006.95	94%
Home Loans	1,753.32	970.72	81%
Corporate Banking	2,382.54	1,335.83	78%
Others	2,254.80	1,161.97	94%
<b>Total Advances</b>	<b>10,924.07</b>	<b>6,348.54</b>	<b>72%</b>

Retail and commercial advances grew 70% from Rs. 5,012.71 crore in 2005-06 to Rs. 8,541.53 crore in 2006-07. The Bank has witnessed significant traction in some of the new products like home finance, agri-finance and Saral. The Bank has a widespread geographical distribution network to distribute its retail lending products.

Commercial vehicles & construction equipments advances recorded a growth of 38% to Rs. 2,578.07 crore in 2006-07. Margins continue to be under pressure due to the competitive nature of the industry. However, the Bank has maintained operating economies and delinquency levels comparable to among the best in the industry. During the year Commercial vehicles & construction equipments division has moved one step closer to becoming

one stop shop for the needs of transportation industry through launch of unique products to meet their specific requirements. Going forward this will be an area of focus for the division.

Saral loans which are essentially targeted at asset backed lending to customers, where organized credit does not reach easily, expanded its scope during 2006-07 to prime category of customers through business loans with or without asset backed security.

In 2006-07, personal loans grew by 94% to Rs. 1,955.34 crore and the Bank improved its presence across newer geographies. The Bank had launched home loans in 2003, which has grown 81% YoY to Rs. 1,753.32 crore.

With a view to focus on the agricultural sector, the Bank has a full fledged agri business division which has the required expertise and offers a range of project finance and working capital funding to meet the financing requirements of agricultural machinery, horticultural projects, storage warehouses and farmers implementing new farming techniques.

Asset reconstruction business is one of the key focus areas of the Bank, and the Bank has a pre-eminent position in the industry. The Bank purchases stressed assets and portfolios from other banks and financial intermediaries and helps in the resolution of the non performing loans. During the year, the Bank has made significant investments in buying stressed asset portfolios, the economic benefits of which will accrue over the next few years. The Reserve Bank of India published guidelines for sale of NPAs, which further added impetus to the business.

The profit before tax for the lending segment was marginally down by 2% from Rs. 114.61 crore in 2005-06 to Rs. 112.41 crore in 2006-07. The fall in profit can be attributable to the revision in the standard provisioning norms by RBI during the year which requires it to be 2% in respect of personal loans, capital market lending, residential housing beyond Rs. 20 lakh and commercial real estate loans. The Bank made a provision of Rs. 44.81 crore in 2006-07 on account of such additional standard provision.

### Retail Liabilities

As on March 31, 2007, the Bank had 105 full-fledged (including 22 semi urban/rural) branches across 69 towns and cities (65 branches across 43 cities as on March 31, 2006).

The Bank offers a very wide range of products and services targeted at retail customers, delivered through a state of the art technology platform. In addition to branch banking, the convenience banking facilities offered by Kotak Mahindra Bank include telephone banking, internet banking, mobile banking, direct pay services, payment gateway for online shopping, a "Global Debit Card" which allows certain customers free access at any Visa ATM in India or abroad, and "Kotak Visa Money Transfer", which permits the transfer of funds to all Visa debit and credit cards in India. Kotak Direct Pay currently allows transfer of funds to more than 60 companies across the country. Kotak VISA money transfer permits transfer of funds to more than 44 million VISA debit/credit cards across more than 150 locations. As a part of its platform, Kotak Mahindra Bank offers depository services that allow customers to hold equity shares, Government securities, bonds and other securities in electronic or dematerialised

format. Another product offered by Kotak Mahindra Bank is the "Best Compliments Card", a prepaid spending card accepted at over 150,000 merchant establishments in India, at all establishments which accept Visa credit cards.

The Bank provides tailored investment services to individual and institutional clients in various stages and economic cycles. The focus is to attract, retain and deepen customer relationships through enhanced contact mechanisms. In addition to the existing focus on the mass affluent segment, the Bank plans to increase customer acquisition in the middle and lower end of the pyramid through personalised wealth advisory services.

During the year, the Bank launched "Gold Eternity", 24 carat pure gold coins and bars, carrying a 99.99% Assay Certification, signifying the highest level of purity as per international standards.

The retail liabilities segment reported a loss of Rs. 42.33 crore in 2006-07 as compared to a profit before tax of Rs. 1.78 crore in 2005-06. The Bank continues to invest in this segment and expand its branch network with the objective of building a long-term, low cost and stable deposit base.

The Bank proposes to have around 200 full-fledged branches by mid next year.

### Corporate Banking

Corporate banking provides a broad range of financial services to domestic and international corporations, financial institutions, and government entities. The Bank's services include working capital, trade services, transaction banking, money market and foreign exchange services offered to corporates and small and medium enterprises (SMEs).

The Bank offers the entire range of debt and fixed income products with a team of experienced and highly qualified professionals who structure products to suit the dynamic and varied needs of customers across segments. The Bank offers a variety of products from plain vanilla debt issuance to Asset Backed Securities (ABS), Mortgage Backed Securities (MBS), structured products and loan syndication. The Bank's strength lies in its ability to customise instruments/structures, develop innovative products and then deliver these through high level of execution capabilities and a wide distribution network across the country.

The Bank's strategy in this business is to align the resources with the sectors where it can deliver value-added financial advisory solutions to the clients. The focus is on orientation of all organisational silos to customer service through greater cross functional synergies. The Bank has managed to improvise the "solutions approach" to meet varied needs of the clients.

In spite of intense competition, the Bank witnessed a significant growth in corporate bank advances (including SME). The total advances of this segment grew 78% from Rs. 1,335.83 crore as on March 31, 2006 to Rs. 2,382.54 crore as on March 31, 2007. The profit before tax for the Corporate Banking segment was up 163% from Rs. 38.66 crore in 2005-06 to Rs. 101.65 crore in 2006-07.

### Treasury

The financial year 2006-07 was marked by tightening of monetary policy in major advanced economies as well as emerging market economies as many central banks continued monetary tightening to contain inflation and stabilize inflationary expectations.

The surplus liquidity was significantly high at the start of the financial year due to interventions by RBI in the foreign exchange market. Till end-September 2006 the average bids accepted by RBI at its reverse repo auction window amounted to Rs. 45,395 crore whilst in the second half of the year it turned negative by an average amount of Rs. 393 crore. The real squeeze on system liquidity came with the CRR tightening phase and between mid-December 2006 and end-March 2007, acceptance of bids by RBI at its Repo window amounted to Rs. 7,536 crore. Reflecting the developments in the liquidity scenario, spells of volatility was witnessed in the overnight money market rates. While the call money rate edged up along with the upward move in the policy rates of RBI, it had stayed mostly within the upper and lower ends of the interest rate corridor set by RBI in April to November 2006. Coinciding with the CRR hikes and the advance tax outflows in December 2006 and March 2007, call money rates witnessed sharp volatility, often exceeding the repo rate significantly.

Along with a hardening of the G-sec yields in 2006-07, the yield curve also flattened during the financial year. The financial year started with yields on a firming path even as liquidity remained adequate. The market was cautious and grappled with uncertainties of US interest rates and increases in the domestic price of fuel. The increase in the Reverse Repo rate on 9th June 2006 also led to some nervousness and 10-year benchmark bond yield increased to an intra-year peak of 8.40% on July 11, 2006, an increase of 88 bps over end-March 2006. Subsequently the trend reversed and the 10-year benchmark yield softened as the Federal Reserve, Central Bank of United States of America paused in its interest rate cycle. US Government bond yields came down and the softening bias in Govt bond yields was helped by the reduction in the global crude oil prices. The 10-year benchmark bond yield thus fell to 7.38% on November 28, 2006. However, this failed to sustain for long as yields once again started to harden from the second half of December 2006 with RBI tightening money market liquidity via the CRR increases. The 10-year benchmark G-sec yield finished in 2006-07 at 7.97%.

The yield curve flattened during 2006-07, with the spread between 1-10 year G-sec yields narrowing to 42 bps at end-March 2007 from 98 bps at end-March 2006. The yields on the 5-year AAA rated corporate bonds increased in 2006-07, following the higher G-sec yields. However, the rise in yields on the corporate bonds was faster, indicated in the increase in the spread between the two to 142 bps by end-March 2007 compared to 91 bps at end-March 2006.

Bank deposit and lending rates also moved up, especially in the second half of the year. The weighted average discount rate of CDs increased by 215 bps in the year to end the year at 10.77% while the weighted average discount rate on CPs increased from 8.59% in the fortnight ending March 31, 2006 to 10.24% in the fortnight ending March 15, 2007. Interest rates offered by PSU banks on its deposits of 1-3 year maturity were at 7.25-9.50% by

end-March 2007, higher than 5.75-6.75% at end-March 2006. The Benchmark PLRs of PSU banks were in the range of 12.25-12.75% in March 2007, up from 10.25-11.25% in March 2006.

During the year Bank Treasury continued to focus on garnering client flows from derivatives and foreign exchange remittances and such client flows provided stability to treasury income amidst a volatile fixed income and foreign exchange market.

The Bank Treasury continued its endeavour of diversifying revenue sources. Bullion desk and Custodial services commenced operation during the period and contributed towards treasury revenues.

### Venture Fund Management

The Bank has co-sponsored Kotak SEAF India Fund which has been set up as a Trust registered with SEBI as a Venture Capital Fund. India Growth Fund (the Fund) was set up as a unit scheme of Kotak SEAF India Fund. The private equity division has an experienced investment management team with a successful track record in the venture capital industry. India Growth Fund has commitments of Rs. 707 crore, from domestic as well as international investors. The Fund continues to be in an active investment mode and as at March 31, 2007, had made investments in 10 companies. These investments are in high growth sectors of home retail, logistics, home textiles, airline, light engineering, life sciences and software and information technology.

### Kotak Mahindra Capital Company (Investment Banking)

Kotak Mahindra Capital Company (KMCC), post the demerger of the Principal and Trading business segment (including primary dealership) with effect from March 20, 2007, primarily operates as a full service Investment Bank. The demerger of the aforesaid division has resulted in an outflow of Rs. 216.76 crore of networth into the parent company viz. Kotak Mahindra Bank Limited. KMCC has now two main segments of business (a) Advisory and Transactional Services (b) Long Term Investments.

Rs. crore

Segment Income	2006-07	2005-06	Growth
Advisory and Transactional Services	121.09	104.86	15%
Trading and Principal Investments	76.06	155.01	-51%
Long Term Investments	7.43	0.02	—
Add: Unallocated income	0.60	—	—
<b>Total</b>	<b>205.18</b>	<b>259.89</b>	<b>-21%</b>

Rs. crore

Segment Results	2006-07	2005-06	Growth
Advisory and Transactional Services	64.72	56.32	15%
Trading and Principal Investments	21.15	125.81	-83%
Long Term Investments	7.43	0.02	—
Add Unallocated Income	0.60	—	—
Profit before tax	93.90	182.15	-48%
<b>Profit after tax</b>	<b>67.88</b>	<b>162.23</b>	<b>-58%</b>

The year under review saw 85 equity issuances excluding QIPs (previous year 102). KMCC had a market share of 19.7% of the total value of issuances. Notable deals where Kotak Investment Banking played the book runner role were:

- Rs. 997 crore Power Finance Corporation IPO which mobilized Rs. 76,725 crore, the second highest amount ever for any book-built issue in the Indian capital markets
- Rs. 782 crore Indian Bank IPO, the first Book-built IPO of a Public Sector Bank in India
- Rs. 602 crore Sun TV IPO
- Rs. 569 crore Sobha Developers IPO
- Rs. 465 crore Tech Mahindra IPO

There were 25 QIP issues during the year and KMCC topped the list with a 19.7% share by value. The deals in which Kotak Investment Banking was involved as book runner were:

- US \$ 105 million issue of Mahindra Gesco Developers
- US \$ 75 million issue of Kalpataru Power Transmission
- US \$ 34 million issue of Marico

KMCC, through the international subsidiaries of the Bank, also topped the list of GDR issuances by value with a total share of 30.1%.

During the year 2006-07, Kotak Investment Banking acted as:

- Sole investment banking advisor to both the Blackstone Group and Ushodaya Enterprises in the US \$ 275 million financing for Ushodaya, the owner of the Eenadu newspaper and ETV channels. This is the largest ever media financing in the country
- Exclusive advisor to the INX group in the financing for both its entertainment and news media company
- Financial advisors to Mahindra & Mahindra for their acquisition of controlling stake in Punjab Tractors Ltd
- Sole Financial Advisor to Kingston Properties Private Limited for US \$150 mn Private Equity Funding by Morgan Stanley
- Sole Financial Advisor to Divyasree Group for the Rs. 460 crore Private Equity funding by TPG-Axon

- Exclusive financial advisor to IFFCO for the sale of its holding in Godavari Fertilisers and Chemicals to Coromandel Fertilisers Ltd. and Manager to the consequent open offer
- Advisor to Pioneer Global Asset Management, a US \$ 370 billion asset management subsidiary of Unicredit Group of Italy, in a majority joint venture with Bank of Baroda for mutual funds in India
- Financial Advisors to Mahindra & Mahindra Limited for their acquisition of 67.9% stake in JECO Holding AG of Germany, the largest outbound auto component acquisition by an Indian Company
- Sole Financial advisors to Raymond in setting up a transnational joint venture denim company with UCO textiles of Belgium, by contribution of their respective existing denim businesses, creating a company with an estimated enterprise value of Euro 200 million
- Financial advisors to Mahindra & Mahindra for their acquisition of Schoneweiss & Co., GmbH, a leading company in the forgings sector in Germany
- Exclusive Financial advisors to Great Eastern Shipping Limited for de-merger of the Offshore division
- Sole Financial advisor to Mahindra Group on acquisition of the Chakan unit of Amforge

In April 2007, Kotak Investment Banking closed the following transactions where it acted as:

- Exclusive financial advisor to Bombay Stock Exchange Ltd (“BSE”) in its demutualization, involving a private placement of 51% of BSE to strategic investors valued at Rs. 2,050 crore
- Sole Financial Advisor to the approximately Rs. 2,000 crore sale of promoter holding in Anchor Electricals (AEPL) to Matsushita Electric Works, Japan

KMCC is also acting as the advisor to Hutchison Telecom for the US\$ 18.8 billion sale of its Indian operations to Vodafone.

KMCC has a healthy pipeline of mandates in various sectors for both equity offerings and Mergers & Acquisitions which are expected to be closed in 2007-08.

The Trading and Principal Investment business registered a profit after tax of Rs. 21.15 crore for 2006-07 against Rs. 125.81 crore in 2005-06. The principle reason being, in 2005-06, the profits substantially included a one time gain on account of sale of economic interest in Hutchison Essar Limited.

### Kotak Securities

(Stock broking)

Kotak Securities (KS) is India’s leading stock broking company and accounted for 9.0% of total average daily market volumes in 2006-07 (8.5% in 2005-06). In May 2006, Kotak Mahindra Group ownership in KS increased to 100% following the acquisition of 25% stake held by Goldman Sachs (Mauritius) LLC.

Whereas the year 2005-06 was an historic year for the Indian economy, as the benchmark BSE Sensex crossed the 10,000 mark on February 7, 2006,

the year 2006-07, saw the benchmark BSE Sensex crossing the 14,800 mark. Similarly the benchmark Nifty which had touched the year’s high of 3,418 on March 30, 2006 crossed the 4,200 mark in the year 2006-07.

KS clocked average daily volumes of around Rs. 3,720 crore during 2006-07 as compared to around Rs. 2,440 crore during 2005-06.

Rs. crore

Particulars	2006-07	2005-06	Growth
Total Income	833.93	620.73	34%
Profit before Tax	365.12	320.48	14%
Profit after Tax	255.71	215.54	19%

The profit after tax grew by 19% YoY to Rs. 255.71 crore in 2006-07. The growth was achieved by both, increased volumes, as well as, increased market share.

As on March 31, 2007, in the retail segment, KS had around 3,20,000 secondary market customers and serviced them through a network of 813 offices (own and franchised) across 277 cities.

The online trading portal continued to do well. A number of new schemes and products for online customers were launched. The most significant being a flat brokerage product for clients with relatively smaller transaction size. The number of online registered customers as on March 31, 2007 was in excess of 1,15,000. The online volumes continued to grow and crossed the Rs. 1,000 crore mark in the year 2006-07.

In the Portfolio Management Services (PMS), three of the close-ended schemes launched in earlier years matured in 2006-07. KS continues to focus on increasing product offerings and improving service standards. The total discretionary equity Assets under Management (AUM) as on March 31, 2007 was Rs. 2,300 crore.

The buoyant capital markets saw the number of primary market issues increasing over the last year. KS participated in the distribution of 90 public offer issues, mobilizing in excess of Rs. 24,600 crore in the retail segment itself.

KS’s institutional equities division has made steady growth during the year. This was achieved through a larger customer base and servicing of global and domestic asset managers. Kotak Institutional Equities strives to provide high quality fundamental equity research and globally compliant execution service to clients. It has a strong research team with wide research coverage of over 130 companies. Kotak Institutional Equities clientele includes Foreign Institutional Investors, Financial Institutions, Banks, Mutual Funds and Insurance companies. Significant focus on Futures & Options segment contributed substantially to the revenue growth and market share.

### Kotak Mahindra Prime Limited

(car finance, other lending)

Kotak Mahindra Prime Limited (KMP) is into car finance, engaged in financing of retail customers of passenger cars and multi-utility vehicles and inventory and term funding to car dealers. The Company finances new and

used cars under retail loan, hire purchase and lease contracts. In addition to car finance, KMP also carries out other lending activities.

During 2006-07, KMP's auto advances were Rs. 3,611 crore recording an increase of 18% as compared to 2005-06.

The year 2006-07 witnessed volatile interest rate scenario and increased interest rates on car and other loans. The pressure continued on maintaining the margins in the retail car finance business. KMP continued to focus on control over cost and credit losses, while maintaining its positioning in the car finance market. KMP also maintained its good relationships across car manufacturers, dealers and channel partners in the country.

Rs. crore

Particulars	2006-07	2005-06	Growth
Total Income	443.63	303.20	46%
Profit before royalty and tax	84.25	54.62	54%
Profit before tax	84.25	31.11	171%
Profit after tax	57.34	20.88	175%

The passenger car market in India saw a growth of 21% for the year 2006-07 as compared to a growth of 6% for 2005-06. Total unit sales of cars and MUV's crossed 13.5 lakh units in the year 2006-07. The car market has grown at a rapid pace due to robust economic growth, launch of new and improved models and stable automotive prices. Indian economy in the current financial year is expected to maintain the growth momentum.

KMP has carved out a niche for itself in the car-financing segment focusing on distribution and relationship management across manufacturers, dealers, channel partners and customers. Fee based income is an important initiative of KMP. Dedicated infrastructure is in place to give a further impetus to the growth of fee based income with a twin objective of offering value added services to customers and leveraging the large existing customer database to generate further fee based income.

Customer knowledge, easy accessibility through its wide network of branches and a firm commitment to deliver superior customer service are key drivers for KMP's performance.

KMP has entered the debt capital market segment and carried out various securitisation transactions during 2006-07 and the same are structured to suit the varied needs of the customers. KMP has during the year also ventured into business of retail personal loans, overdraft against securities and other retail lending.

**Kotak Mahindra Asset Management Company Limited**  
**Kotak Mahindra Trustee Company Limited**  
(Mutual Fund)

Kotak Mahindra Asset Management Company Limited (KMAMC) and Kotak Mahindra Trustee Company Limited (KMTC) are wholly owned subsidiaries of Kotak Mahindra Bank. KMAMC is the asset manager of Kotak Mahindra Mutual Fund (KMMF) and KMTC is the trustee company.

Indian mutual funds industry is evolving, in terms of breadth and depth. It is broadening in terms of total number of investors it is catering to and deepening in terms of its product offering and investment and distribution practices.

The following is the list of policy level changes effected during 2006-07 that had an influence on the mutual funds industry:

- Introduction of Gold Exchange traded fund
- Introduction of Dividend Distribution procedures to rationalize the process and to bring in uniformity into the practice of declaring and disbursing dividends
- Rationalization of the initial issue expenses wherein they will be permitted for closed-ended schemes only. Also, the Open-ended schemes are to meet their sales, marketing and distribution related expenses from the entry load.
- Total limit for investing in foreign equity is increased from US \$ 2 billion to US \$ 3 billion.
- Introduction of Capital Protection Oriented Schemes as well as revision in the fees payable by the mutual funds for filing offer document with SEBI

AUM as on March 31, 2007 was Rs. 12,125 crore, as compared to Rs. 10,408 crore as of March 31, 2006. The number of folios as on March 31, 2007 was more than 5,36,000 as compared to over 4,00,000 as on March 31, 2006.

The year saw the launch of several new schemes and facilities, increased distribution reach and market expansion. During 2006-07, the mainstream debt schemes of the Fund continued their commendable performance. KMAMC announced the tie up with T. Rowe Price to launch a fund for resident Indians to invest in a global fund - T. Rowe Price Funds SICAV – Global Emerging Markets Equity Fund.

Rs. crore

KMAMC	2006-07	2005-06	Growth
Total Income	54.43	39.31	38%
Profit before tax	10.60	7.83	35%
Profit after tax	6.83	5.06	35%

Rs. crore

KMTC	2006-07	2005-06	Growth
Total Income	7.35	4.14	78%
Profit before tax	6.74	3.77	79%
Profit after tax	4.64	2.57	81%

The two key growth drivers would be to increase visibility further in metro and non-metro regions and focus on geographic expansion. New product offerings, value added service initiatives and continued focus on fund performance would also hold key to growth.

## Kotak Mahindra Old Mutual Life Insurance (Life Insurance)

Kotak Mahindra Old Mutual Life Insurance (Kotak Life) is 74: 26 joint venture of the Bank with Old Mutual plc.

The life insurance industry's growth is related to demographics, purchasing power, economy growth rate, share of savings and government support through tax and fiscal sops. All these factors were favourable to the industry in the year 2006-07. In the coming years, India is likely to have a growing middle and affluent class with a burgeoning service sector contributing significantly to the growth of life insurance industry.

Introduction of new products and focus on service delivery were primary drivers for the growth of the private life insurers during 2006-07. Consumer confidence in the private sector has substantially improved over the years, and going by the current trends, it is expected that the private sector will improve upon the perceived value to the consumer.

Kotak Life offers life insurance, deferred annuity and employee benefit products to individuals and groups. The business is distributed through three distribution channels viz. Tied Agency, Alternate Channels and Group Insurance. The business is value-driven with a focus on long-term shareholder value and an aspiration to meet policyholder expectations.

The premium income for the year grew to Rs. 971.51 crore (previous year Rs. 621.85 crore). During the year, Kotak Life wrote over 1,65,200 policies (previous year 96,750 policies) of adjusted first year annualised premium (single premium weighted at 1/10th) of Rs. 572 crore (previous year Rs. 367 crore), representing a sum assured of Rs. 20,163 crore (previous year Rs. 8,631 crore). Riders are not included in the sum assured.

As at March 31, 2007, Kotak Life Insurance had around 24,500 active life advisors who are continuously being trained to facilitate them to advise customers in a proper manner. The philosophy of Kotak Life to focus on 'Quality' life advisors has started yielding results.

Currently, Kotak Life operates from 74 branches in 49 cities with a primary focus on the middle class and affluent population. During the year 29 new branches were opened and this expansion was in second tier cities which offer good opportunity and also provide a window to reach to rural areas. A survey conducted by AC Nielsen – ORG MARG in September 2006 in top 8 towns placed Kotak Life at the top 6 brands among the life insurance brands recalled.

Rs. crore

	2006-07	2005-06	Growth
Premium income	971.51	621.85	56%
Deficit	58.35	43.24	—

During 2006-07, Kotak Life introduced two products. In unit linked segment Kotak Life introduced Kotak Head Start Plan; a product designed to offer protection to individual by securing the future of his child and it met with good success. In the participating segment Kotak Life introduced Sukhi Jeevan, meant for the semi-urban and rural segments. The product was received well and will be an important part of Kotak Life's expansion goals in the coming years.

## International Subsidiaries

The Bank has overseas subsidiaries with offices in Mauritius, London, Dubai and New York. Kotak Mahindra (UK) Limited received authorisation from the Monetary Authority of Singapore under the CMS license to set up a branch in Singapore. The branch commenced operations in March 2007 and would essentially be a marketing office.

The overseas subsidiaries are mainly engaged in investment advisory and investment management of funds, management of GDR/FCCB issuances, broker and broker dealer activities as well as investments.

During the year, the Bank infused US \$ 3.01 million into the hitherto subsidiaries of KMCC, thereby making them the Tier I subsidiaries (51% holding) of the Bank.

The assets under management through international operations increased from US \$ 1.1 billion as on March 31, 2006 to US \$ 1.4 billion as on March 31, 2007 translating to an increase of 26%. A significant achievement during the year was the investment management mandate of Indian Equities Fund Limited, an Australian Stock Exchange listed fund, which raised approximately AUD 75 million from Australian investors. KMUK also acted as lead manager to GDR issuance by 2 companies.

To give further boost to its asset management business, the fund management team, which is based out of Dubai, shall be strengthened during 2007-08. During the forthcoming year, the international business intends to launch a number of niche asset management products, which shall increase the presence and penetration of the Group in the international markets.

## Kotak Mahindra Group - Awards and Recognition

- Bank adjudged the 10th Best Employer in India by Hewitt Best Employer Survey
- Bank awarded "IT Team of the Year" - Annual Banking Technology Awards 2006, IBA
- Most Popular Investor Relation Website for the Asia/Pacific Region – IR Global Ranking 2007
- Winner in 16 categories in Annual Private Banking Survey Poll for 2007 for India - Euromoney
- Kotak Investment Bank ranked # 4 for entire Asia (ex Japan) M&A deals by value -MergerMarket
- Kotak Investment Bank topped the League table as Book runners for Global Depository Receipts (GDRs) and Qualified Institutional Placements (QIPs) for the financial year 2006-07 in terms of value of deals - Prime Database
- Best Domestic Investment Bank and the Best Equity House – Asset Triple A Country Awards
- KS topped the Brokers Poll as the Best Local Broker: 2006 – Asia Money
- KS adjudged the Most Customer Responsive Company for 2006 – Avaya Global Connect
- Winner in 33 categories in the Private Banking Poll 2006 – Asiamoney

- KMP: Best Passenger Vehicle Finance Company in India 2006 – Frost & Sullivan
- KMP: Voice of Customers 2006 Best Auto Finance Company in India – Frost & Sullivan
- Best Bond Fund House 2006 - Lipper
- “Best Fund over Five years in the Bond Indian Rupee General Category” for “Kotak Bond Regular Plan-Growth” - Lipper Fund Awards India 2007
- “Best Fund group over three year” in the Bond category - Lipper Fund Awards India 2007
- Gold Award for ‘Best Performance’ in the category of ‘Open Ended Debt - Short Term’ for one-year period ending December 31, 2006 for “Kotak Flexi Debt Fund” - ICRA - MFR 1
- Gold Award for ‘Best Performance’ in the category of ‘Open Ended Debt - Short Term’ for three-year period ending December 31, 2006 for “Kotak Bond Short Term Plan” - ICRA - MFR 1
- Kotak Mutual Fund was also adjudged the Best Mutual Fund and received “NDTV Profit Business Leadership Award” in the Mutual Fund category for 2006 - NDTV

### Technology

2006-07 witnessed a continued focus on innovation in harnessing technologies to provide business the competitive edge. In addition, it developed a focus on achieving improved customer satisfaction and cost synergies through a strategy that leverages common systems across the Group.

Special attention was paid towards providing customers improved access to information and online transactions. The Bank launched a new Internet Platform, which has been benchmarked to have the fastest response time amongst our major competitors according to a leading Independent Internet monitoring Agency. Kotak Life introduced MyKotaklife.com which increased productivity for agents and sales. Kotak Securities enhanced their cutting edge trading portal to provide an improved look and feel, and also to provide new offerings for their retail customers.

Innovation continued to be coupled with productivity and quality, as evidenced by the Bank’s technology team winning the prestigious “IT Team of the Year” award at the annual Banking Technology Awards 2006 organized by the Indian Banking Association.

In addition, this year saw the commencement of a strategy of integrated technology platforms, which will provide synergies across the Kotak Group of Companies. Human Resource Management, General Ledger, Anti Money Laundering and CRM were identified as potential areas in which common systems could be leveraged. Benefits from common systems for Human Resources and General Ledger have already started to accrue from the common systems implemented in these areas. Common systems for Anti Money Laundering and CRM systems have been initiated.

Synergies in technology management were also achieved on the infrastructure side. Reverse auctioning was commenced for purchasing IT

products and significant steps taken to enjoy substantial benefits through improved purchasing power by leveraging the combined purchases for the Group. Group level strategic vendor management also ensured benefits for disaster recovery and email infrastructure planning and procurement. A data center and networks consolidation initiative has provided improved control as well as scalability.

### Risk Management

The diversified business activities require the Bank to identify, measure, aggregate and manage risks effectively and to allocate capital among its businesses appropriately. The risk management framework lays emphasis on the group’s risk philosophy, proper organizational structure, risk and reward balance and is supported by dedicated monitoring and risk measuring mechanism.

Risk Control systems are being enhanced with a view to enable business gain and maintain competitive advantage while growing assets profitably. Consumer Banking continues to take initiatives to further improve its risk management capability.

### Basic Principles and Risk and Capital Management

The Board is involved in defining risk appetite and capital at risk for the Bank, at an integrated level, covering all activities of the Bank. Development of the risk strategy and risk appetite is an ongoing process and is based on past experience and future plans. The risk strategy is consistent with the Board’s overall risk tolerance, management’s expertise in each business unit and the total financial amount that the Bank is prepared to place at risk of loss (Capital at risk).

The Management Committee provides overall risk management supervision for the consolidated group as a whole. Various risk committees, namely Asset Liability Committee (ALCO), Credit Committee, First Tier Audit Committee, Risk Management Committee, Information Security Committee etc, review specific risk areas and supervise the activities of enterprise wide risk management.

### Categories of Risk

The most important risks are specific banking risks and reputational risk as well as risk arising from the general business environment.

### Specific Banking Risks

In consonance with the guidelines of Reserve Bank of India with regards to BASEL II, the risk management processes of the Bank distinguish among four kinds of banking risk: credit, market, liquidity and operational risk.

### Risk Management Tools

The Bank uses a comprehensive range of quantitative tools and metrics for monitoring and managing risks. Some of these tools are common to a number of risk categories whereas the others are tailored to address the particular features of specific risk categories.

Both with a view to bringing in risk sensitivity through policies and to duly meet the regulatory requirements, the Bank continually assesses the appropriateness and the reliability of the quantitative tools and metrics in the light of the changing risk environment

### Credit Risk

Credit risk arises from all transactions that give rise to actual, contingent or potential claims against any counterparty, borrower or obligor. The Bank's credit exposure is primarily categorized into retail and wholesale borrowers. Retail exposure is mostly term loans and asset backed other than personal loans. Wholesale borrowers are internally categorized into emerging corporate, corporate and financial institutional group. While retail credit lending is largely based on predefined parameters and is mostly decentralized, credit appraisal is undertaken by an independent dedicated credit risk team for wholesale exposure.

### Credit Risk Management Tool

During the year the Bank has put in place an internal credit rating model for the comprehensive risk assessment of the wholesale banking credit exposures. Each obligation is evaluated on two dimensions to assign obligor and facility rating. The rating tool rates Large Corporates, SMEs, Brokers, Traders and Services separately. The parameters in each risk entity (viz. business risk, industry risk, management risk and financial risk) to evaluate ratings and appropriate weight-age to these parameters have been decided based on past experience and after assessing the rating methodology. The final output of the model helps the bank to assess the expected probable loss number attached to each borrower after duly considering the securities provided to mitigate the risk. The internal credit rating system would facilitate migrating the Bank to be compliant under the internal rating based approaches of Basel II Accord in due course. The rating tool grades obligors into 18 categories and each rating category has been assigned a Probability of Default (PD) number. The facility extended by the bank to the borrower is also rated on a comprehensive scale of 30 categories of ratings. Such a facility rating provides the Loss Given Default (LGD) number to each facility rating category. The combination of Obligor and Facility Rating provides Combined Rating which is divided into 18 categories.

Internal rating is assigned to each obligor based on quantitative and qualitative factors and forms an important element of credit lending decision. These ratings are reviewed at least annually.

Independent credit appraisal, monitoring, administration, policy and credit risk measurement units are in place encompassing the entire gamut of credit risk management.

### Credit Risk Management Principles

The Bank measures and manages its credit risk based on the following principles

- The extension/renewal of any Credit Facility to a particular borrower requires Credit Approval at the appropriate authority level. The Rating Tool, which is already in place, helps the authorities in such decision

- The approval of all the limits to the counterparties should be in line with the Corporate Credit Policy and Collateral Risk Management Policy of the bank. Such approval should generally be within the Bank's portfolio guidelines and credit strategies
- There will be a regular review of the credit worthiness of the borrowers not only using the rating tool of the bank but also by its Credit Risk Management team

### Market Risk

Market risk arises from the uncertainty concerning changes in market prices and rates viz interest rates, equity prices, foreign exchange rates, the correlations among them and their levels of volatility.

Market risk management framework is laid down in the investment and ALM policy of the bank. The bank runs exposure on interest rates, equity, foreign exchange and a combination of them through derivatives. Exposure is managed through a set of risk limits such as open position, PVO1, gap limits, cash value etc. These limits are monitored on daily basis by the independent mid-office cell and are reviewed based on market conditions on frequent basis by ALCO.

In addition to the above, Bank computes value at risk (VAR) for the aforesaid risk on an individual basis and on aggregated basis after considering correlation effect. Value at risk is reported on a daily basis and back testing/ stress testing is undertaken to confirm the validity of the measurement models.

Interest rate risk of the balance sheet is managed through gap analysis, especially duration gap of the assets and liabilities.

### Liquidity Risk

Liquidity risk is the risk arising from the potential inability of the Bank to meet all payment obligations when they become due. Liquidity risk is managed through setting limits on the negative gap for maturity bucket. As part of liquidity risk management the bank initiated behaviour analysis of its CASA and term deposits to analyse the impact of inbuilt option in these products.

### Operational Risk

Operational risk is the potential for incurring losses due to failure of employees, technology, system or a process and disasters, projects, external factors, frauds etc, including legal and regulatory risk. The bank seeks to ensure that key operational risk are managed in a timely and effective manner through a framework of policies, procedures and tools to identify, assess, monitor, control and report such risk. The group internal audit team and the compliance department have set a sound platform for operational risk management, along with the operational risk management unit. Unusual event reporting and creation of loss database have been institutionalized as a stepping stone towards measurement of operational risk.

### Basel II

The Bank has made considerable progress in capturing data and implementing systems with regards to computing capital adequacy as

per the standardized approach of Basel II for credit risk. Efforts are on to automate the process of capital computation as per Basel II and application system is being implemented to that effect. As on March 31, 2007 the estimated capital adequacy ratio as per the standardized approach is 13.62% as compared to existing 13.46%.

The revised framework of capital adequacy norms is applicable to Indian banks having operational presence outside India and foreign banks with effect from March 31, 2008 and other scheduled commercial banks have been encouraged to migrate with effect from March 31, 2008, but not later than March 31, 2009. A multidisciplinary group having members from various department of the banks have been formed to ensure setting process and develop infrastructure to comply with the requirements of Basel II.

In addition to the regular monitoring and oversight, in the coming years, the focus of risk function would be to develop sophisticated measurement tools to statistically quantify risk in the lending business and operations.

### Compliance

The group has in place an independent and comprehensive compliance structure to address compliance and reputation risk on a group wide basis. The compliance function is headed by a senior resource in all group companies. The Group Head Compliance reports to the Board of Directors of the Bank. The Compliance Department oversees adherence to all regulatory prescriptions both domestic and international. The department is also responsible for ensuring adherence to Know Your Customer (KYC) and Anti Money Laundering (AML) standards. The senior compliance resource in each of the group companies is also designated as the Principal Officer under the Prevention of Money Laundering Act 2002. The Bank and key subsidiaries are implementing a sophisticated AML application.

Dissemination of regulatory information is done on an online basis by using knowledge management tools. The department also brings out a quarterly compliance newsletter to update employees on regulatory developments. The department is also responsible for ensuring adherence to standards and codes by Reserve Bank of India (RBI), Banking Codes and Standards Board of India (BCSBI), Indian Banks Association (IBA), Foreign Exchange Dealers' Association of India (FEDAI), Fixed Income Money Market and Derivatives Association (FIMMDA), Securities and Exchange Board of India (SEBI), Association of Mutual Funds in India (AMFI), Insurance Regulatory and Development Authority (IRDA), and international regulators/SRO's.

The Bank and its companies have adequate compliance monitoring and reporting systems in place. They have also adopted a 'Whistle Blower Policy' encouraging employees to report any instances of irregularity to senior management. Training on compliance matters is imparted to employees on an ongoing basis. The group has hired a reputed consulting firm to benchmark the compliance processes and practices with the best in the world.

### Internal Controls

The Bank's internal audit department undertakes a comprehensive audit of all branches and businesses under a risk-based internal audit model recommended by the Reserve Bank of India and approved by the Audit Committee of the Board of Directors. An annual risk-based internal audit

plan is drawn up on the basis of risk profiling of Bank's branches and businesses/departments which is approved by the Audit Committee. When required, the internal audit department seeks assistance from external firms.

After assessing the overall risk of a branch or business/department, the Bank takes measures to minimize such risk. Senior officers also assess and evaluate the mitigating measures taken by the branch during their visits. Higher risk areas and branches are targeted for more frequent audits.

The Bank has a process of concurrent audit of critical functions using external consulting/accounting firm(s). Concurrent audit is also carried out for the Bank's treasury operations, in particular for sovereign and corporate debt investments and foreign exchange operations. This has been undertaken to ensure the existence of and adherence to internal and regulatory controls.

The subsidiaries of the Bank, where applicable, are also subjected to internal audit, either by internal auditors or by external auditors. All auditors report to the respective Audit Committees. The scope of all companies is approved by the respective Audit Committees. All audit reports are placed before the Audit Committee of the respective companies and key/significant issues communicated to the Bank (the holding company). Mitigating measures are taken where risk is more than acceptable levels.

### Human Resources

As on March 31, 2007, the Bank along with its subsidiaries employed more than 10,800 employees at various locations in India and abroad, an addition of around 4,100 employees over 2006-07. The Bank was adjudged the 10th Best Employer in India by Hewitt Best Employer Survey.

The Bank and its subsidiaries have in place policies relating to employee benefits, service conditions, welfare and training. The Group continues to focus on training and development of its employees on a continuing basis by deputing to reputed training institutions and by holding workshops on various areas including Regulatory Compliance, Risk Management, Customer Care and Communication, Trade Finance, Foreign Exchange Rules and Treasury along with the soft skill programs. With a healthy and dynamic work environment, the Bank and its subsidiaries have created a talent pool which seeks to deliver the best quality service to its customers and associates.

### Opportunities and Threats

#### Opportunities

- Scalability through increased brand awareness, market penetration and service offerings across all categories of financial services
- Increase in customer's wallet share
- Leveraging the latest technology for providing quality and client centric services
- Growth in economy would lead to higher demand for credit
- Burgeoning middle class - consumerist with high earnings

#### Threats

- Increasing interest rate scenario
- Rising inflation

- Execution risk
- Competition from local and multinational players
- Slowdown in global liquidity flows

### Outlook

Stability and confidence was witnessed in the Indian financial markets in 2006-07. The robust performance of the banking industry in 2006-07 indicates a further acceleration of the Indian economy. Kotak Mahindra Group's results for the financial year demonstrate the strong fundamental growth in the India story. However, the economy inhibits the concerns over the impact of inflation, the weakness of the US \$ and rising crude oil prices.

The Group believes that the present economic scenario offers immense opportunities for it to grow in scale and reach coupled with value creation. The group is confident that with its integrated business model it shall be able to take advantage of the significant growth opportunities in the coming years.

### Safe Harbour

This document contains certain forward-looking statements based on current expectations of Kotak Mahindra management. Actual results

may vary significantly from the forward-looking statements contained in this document due to various risks and uncertainties. These risks and uncertainties include the effect of economic and political conditions in India and outside India, volatility in interest rates and in the securities market, new regulations and Government policies that may impact the businesses of Kotak Mahindra Group as well as its ability to implement the strategy. Kotak Mahindra does not undertake to update these statements.

This document does not constitute an offer or recommendation to buy or sell any securities of Kotak Mahindra Bank or any of its subsidiaries and associate companies. This document also does not constitute an offer or recommendation to buy or sell any financial products offered by Kotak Mahindra, including but not limited to units of its mutual fund and life insurance policies.

All investments in mutual funds and securities are subject to market risks and the NAV of the schemes may go up or down depending upon the factors and forces affecting the securities market. The performance of the sponsor, Kotak Mahindra Bank Limited, has no bearing on the expected performance of Kotak Mahindra Mutual Fund or any schemes thereunder.

Figures for the previous year have been regrouped wherever necessary to conform to current year's presentation.