SONATA FINANCE®

CREDIT LOSS ESTIMATION POLICY

Version	Date of Approval / Reviewal
V.1	26.06.2020

1. Preamble

The Board of Directors **(the "Board")** of **Sonata Finance Pvt. Ltd. (the "Company" or "Sonata"),** has adopted the following Credit Loss Estimation Policy for impairment of the financial instruments using the expected credit loss (ECL) approach as per the requirements of AS-19. The policy has been framed in accordance of the notification of the Ministry of Corporate Affairs (MCA) dated 18th January 2016, requiring the company to change from Indian Generally Accepted Accounting Principal (IGAAP) to Indian Accounting Standard (Ind AS) effective from March-2020.

2. Purpose

The purpose of this policy is to provide a model for calculation of the ECL for the credit impairment of its financial instruments. The implementation of the IND-AS as per the aforesaid circular of MCA requires changes in the methodology of calculating the credit impairment apart from the other changes in the accounting of any entity. Under IGAP, company was following fix percentage-based model directed by RBI through its master directions from time to time, however with the introduction of IND-AS, it will change to Expected Credit Loss (ECL) based model. ECL based credit impairment model is considered pragmatic and include many factors which make model widely accepted. This policy describes the basis of ECL model and its key consideration while calculating the credit impairment for the company.

3. Scope of the Policy

The ECL is calculated and accounted for all loan portfolio including own, direct assignment, securitisation and business correspondence.

4. Credit Loss Estimation Model

(a) Overview

ECL involves an estimation of probability-weighted loss on financial instruments over their life, considering reasonable and supportable information about past events, current conditions, and forecasts of future economic conditions which could impact the credit quality of the Company's loans and advances. In this process, management applies a significant degree of judgement in respect of following matters:

I. Defining thresholds for significant increase in credit risk and default.
II. Grouping of the loan portfolio under homogenous pools in order to determine probability of default on a collective basis.

III. Determining effect of less frequent past events on future probability of default.
IV. Estimation of management overlay for macroeconomic factors which could impact the credit quality of the loans

(b) Calculation of ECL:

The Company calculates ECLs based on a probability-weighted scenarios and historical data to measure the expected cash shortfalls. A cash shortfall is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive. ECL consists of three key components: Probability of Default (PD), Exposure at Default (EAD) and Loss given default (LGD). ECL is calculated by multiplying them.

(i) *Probability of Default (PD)*

PD describes the probability of a loan to eventually falling in default (>90 days past due) category. To calculate the PD loans are classified in three stages based on risk profile of the individual loans. PD %age is calculated for each loan account separately and is determined by using available historical observations. PD for stage 1: is derived as %age of all loans in stage 1 moving into stage 3 in 12-months' time. PD for stage 2: is derived as %age of all loans in stage 2 moving into stage 3 in the maximum lifetime of the loans under observation. PD for stage 3: is derived as 100% considering that the default occurs as soon as the loan becomes overdue for 90 days which matches the definition of stage 3.

(ii) *Exposure at default (EAD)*

Exposure at default (EAD) is the sum of outstanding principal and the interest amount accrued but not received on each loan as at reporting date.

(iii) *Loss given default (LGD)*

LGD is the opposite of recovery rate of stage 3 loans. LGD = 1 – (Recovery rate of NPA loans) LGD is calculated based on historical (past 5 years) observations of NPA loans.

5. Definition of default and stage assessment

For the measurement of ECL, Ind AS 109 distinguishes between three impairment stages. All loans need to be allocated to one of these stages, depending on the credit risk since initial recognition (i.e. disbursement date):

Stage 1: includes loans for which the credit risk at the reporting date is in line with the credit risk at the initial recognition (i.e. disbursement date).

Stage 2: includes loans for which the credit risk at reporting date is significantly higher than at the risk at the initial recognition (Significant Increase in Credit Risk).

Stage 3: includes default loans. A loan is considered default if the obligor is past due more than 90 days on any material credit obligation to the company.

Unlike banks which have more of monthly repayments, the Company offers products with weekly and fortnightly repayment frequency, whereby 15 and above Days past due ('DPD') means already 1-2 missed instalments from the borrower, and accordingly, the Company has identified the following stage classification to be the most appropriate for its Loans:

Stage 1: 0 to 30 DPD

Stage 2: 31 to 90 DPD

Stage 3: above 90 DPD (Default)

The policy will be reviewed every year and relevant modification shall be considered based on change in internal or external environment of the business. In case of a conflict, the Government direction on this matter would supersede the policy.