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## **General Risk Management Policy Of**

**SONATA FINANCE PRIVATE LIMITED  
("SFPL")**

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## **CHAPTER 1: PURPOSE AND SCOPE OF THE POLICY**

The purpose of Risk Management Framework is to establish basic principles and general framework for the control and management of risks which may exist or arise in Sonata Finance Private Limited (hereinafter referred to as SFPL). On specific risks faced by Sonata, Specific Risk Sub-Policies have been developed which together form the Risk Management Framework.

The underlying premise of SFPL risk management is to maximise stakeholders' value. While SFPL faces uncertainties and risks, the challenge for the SFPL board and management is to determine, as to what extent uncertainty is acceptable in order to strive to grow stakeholder value. Risk Management is essential as it is required for long-term sustainability of SFPL. More specifically, the objectives of risk management at SFPL are:

- Enhance shareholders value by minimizing losses and maximizing opportunities;
- Increase knowledge and understanding of exposure to risk;
- A systematic, well-informed and thorough method of decision-making;
- Increase preparedness and reduce uncertainty;
- Minimize disruptions and impact caused;
- Better utilization of resources and capital;
- Strengthen culture of continuous improvement;
- Retain the risk profile of SFPL within the approved risk appetite;
- Ensure that risks are correlated with the profitability targets;
- Risks are accurately and timely reflected in SFPL's risk reports.

SFPL is aware that the key management responsibility is to provide reasonable assurance that SFPL's business is being managed sustainably. Rather than focusing on current or historical financial performance, the management of SFPL focuses on its ability to identify and manage future risks; this is viewed as being the best predictor of long-term success and sustainability. SFPL management has a firm commitment that its products and processes comply with laws and regulations, and are aligned to the best practices of risk management. Increased focus of SFPL on risk management reflects a fundamental shift to better anticipate and manage risks, rather than just react to them as and when they occur. This approach emphasises the importance of "self-supervision" and a pro-active approach to risk management by board members and the management team of SFPL.

Over the last few years, the microfinance industry has been moving towards the implementation of risk-based and prudential management, as encapsulated in Basel II guidelines and agreement. For SFPL, proactive risk management is a means to achieve desired goals. As SFPL continues to grow and expand rapidly, serving more customers and attracting more mainstream investment capital and funds, it plans to strengthen its capacity to identify and anticipate potential risks to avoid unexpected losses and surprises. A comprehensive approach to risk management reduces the risk of loss, builds credibility in the marketplace, and creates new opportunities for growth.

The key to fulfilling the responsibility of providing reasonable assurance to stakeholders that the SFPL's business is adequately controlled, is the development of a comprehensive system of management controls, accounting and internal controls, security procedures, and other risk controls.

## Risk Management principles

There are specific core principles with regard to risk management. To suit the context of SFPL and its operations, SFPL has adopted risk management principles as defined by the International Standards Organization (ISO). The risk management principles for SFPL should:

1. Create value through continuous review of its process and systems
2. Is an integral part of the organizational processes i.e. becoming integral part of governance framework and becomes part of its planning at both operational and strategic level.
3. Factor into the overall decision-making processes and help take informed decisions, identify priorities and select the most appropriate action
4. Explicitly address uncertainty by identifying risks and implementing controls to maximise gain while minimising chances of loss
5. Is systematic, structured and timely so that risk management is consistent across SFPL to ensure efficiency, consistency and reliability of results
6. Is based on the best available information relevant to an activity
7. Is based on the risk management framework, factors in the risk profile, and take into consideration internal and external operating environment
8. Take into account human and cultural factors while achieving SFPL's objectives
9. Is transparent and all-inclusive so that it engages both internal and external stakeholders
10. Is dynamic and adaptable to change to identify new risks and make allowances for those risks that no longer exist
11. Is continuously monitored and improved upon for continual achievement of organisational objectives
12. Is independent from risk taking activities i.e. it is independent from regular day to day operations of SFPL
13. Is embedded in the corporate culture so that everyone take responsibility in managing risks

## Risk Management process

At SFPL, risk management is a systematic process that comprises well-defined steps:

- a) Identification, assessment, and prioritisation and mitigation of inherent risks,
- b) Develop strategies and tactics to manage risks,
- c) Implement policies and assign responsibilities,
- d) Test effectiveness and evaluate risks,
- e) Revise policies and procedures,
- f) Monitor and control risks

When these steps are taken in sequence, they support better decision making and enable greater insights into risks. However, the risk management process does not end with monitoring and controlling risk; it is an on-going function. Further, it is not a linear process, but rather an on-going iterative process. The steps are part of an interactive and dynamic flow of information from the field to the head office (and management) and back to the field. These steps make a continuous feedback loop that consistently questions whether the assumed risk is reasonable and appropriate, or whether it should be reassessed.

*Figure 1* below illustrates the cyclical nature of the risk management process followed by SFPL:

**Figure 1: Risk management feedback loop<sup>1</sup>**



### **1. Identification, assessment, prioritisation and mitigation of risks**

Members of the management including heads of the front-line business/operations(JLG/ IL Head) BC & Sanitation etc heads of back end control functions (IT/MIS, HR, Accounts/Finance and Legal and Secretarial Department) shall bear the primary responsibility to identify risks in functional area (s) for which they are responsible (i.e. for which they are Risk Owners<sup>2</sup>). The front-line business/operations are responsible for assessment and control of credit risk whereas back end control functions are responsible for locating, identifying assessment and control of operational, liquidity and market risk. These risk owners/department heads provide the “first line of defence” in the risk governance framework. These risk owners will inform about new risks pertaining to their work area and the consequences if not managed proactively, to the Chief Risk Officer/Advisor. In addition to the first line of defence, the dedicated Chief Risk Officer/Advisor (second line of defence) plays a key role in identifying, assessing and managing the overall risks faced by the institution. The role of the RM is to establishing internal controls by acting as in-house consultant across all risk dimensions and to continuously identify, assess and prioritise the risk independent of the Risk Owners. Besides reporting to the BRMC (Board Risk Management Committee) on Risk Management, he will also apprise them of the new risks identified, their severity and thus priority level. Chief Risk Officer/Advisor, who is not a direct part of the operational command chain, will play a critical role at taking operational exposures by evaluating policies and procedures across different functions from the perspective of risk management. For each new risk area, the BRMC will determine the potential negative impact if the risk is not actively managed. Further, the BRMC will determine the degree of risk that SFPL should tolerate and conduct assessments of potential impact from the identified risk, should a risk event actually materialise.

<sup>1</sup>The diagram and its explanation is adapted from: A Risk Management Framework for MFIs by J. Carpenter and L. Pikholz, ShoreBank Advisory Services, 2000

<sup>2</sup> Risk Owner is defined as the person responsible for managing a particular risk.

## **2. Develop strategies and tactics to manage risks**

The Board determines the risk appetite as an integral part of choosing a business strategy for SFPL. The business strategy needs to be developed and continuously brought in line with the risk appetite. Risk appetite statement of SFPL indicates the maximum risk the institution is willing to take. The Board takes care of regulatory limits while determining the risk appetite including capital adequacy norms. The risk appetite statement in SFPL is reassessed regularly-at least once a year-and more often if required-in view of changes in the business environment and as measures of risks. The Board relies on the risk assessment system to identify different types of risk and obtain estimates of their levels. The Board uses quantitative as well as qualitative descriptions of risks.

The Board approves policies for measurement and on-going assessment of risks and monitors SFPL's adherence to them. The management team identifies key indicators and ratios that need to be tracked and analysed regularly to assess SFPL's exposure to risk in each area. The Board sets the acceptable range for each indicator. The Board also determines the frequency with which each indicator should be monitored and analysed, and lays down the responsibility for tracking. The Board will adopt one or more of the following strategies to manage exposure to risk:

<b>Risk Avoidance</b>	<b>Risk Transfer</b>
SFPL may choose to avoid risks which have high probability, are beyond its control and can have devastating effect on its functioning	SFPL may choose to transfer such risks which have low frequency but can be potentially devastating; examples of tools used for risk transfer are insurance and/or Hedging
<b>Risk Acceptance</b>	<b>Risk Control</b>
If the probability of occurrence and the impact of a particular risk are minor and manageable relative to the cost of controlling it, SFPL may choose to accept such a risk	If the likelihood of a risk is high and the impact of the risk is low to medium and the costs to manage it in house is also cost effective, SFPL may try to control such risks (e.g. risks associated with taking and administering savings services)

Department heads with support from the Chief Risk Officer/Advisor will develop sound procedures and operational guidelines to mitigate each risk within their work area to the level defined by BRMC. Operations and field staff may be consulted on the suggested policies and procedures to ensure their feasibility and cost-effectiveness. The Chief Risk Officer/Advisor will support the management team in development of strategies and tactics to manage risks.

## **3. Implement policies and assign responsibilities**

Once suitable control measures are in place line managers will oversee implementation of controls and monitor risks over time. Every staff is responsible for managing and monitoring the identified risk(s) that fall into his/her work area. The Chief Risk Officer/Advisor will support the management in development of cost-effective controls to manage risks and also in the implementation of policies.

## **4. Test effectiveness and evaluate results**

The Board of SFPL through the BRMC will regularly review the operating results to assess whether the current policies and procedures produce the desired outcome(s) and at the same time adequately manage risks. Some indicators will require weekly or monthly monitoring, while others will require less frequent monitoring. Where results may suggest a need for some changes to policies and procedures and possibly identify new risk exposures, the department heads of SFPL will suggest new risk control measures. These measures have to be approved by BRMC to come into effect, however, policy level changes will be approved by the Board of SFPL. After the new controls are implemented, Chief Risk Officer/Advisor will test their effectiveness, evaluate the results and report to BRMC.

It is the responsibility of the department heads of SFPL to determine line staff to be held accountable for implementing changes and monitoring various risks through key indicators. They must also ensure that BRMC receives relevant and useful information in the prescribed format (s) and within timelines.

Department heads, in co-ordination with the Chief Risk Officer/Advisor, regularly check the operating results to assess to what extent:

- Risks are being identified and anticipated sufficiently
- Risk management strategies are indeed minimising risks, as desired
- Operational systems are working appropriately and are having the intended outcomes
- Risks are being managed in the most efficient and cost-effective manner

Internal Audit's role in Risk Management is to assess the effectiveness with which the controls are addressed. Internal audit department will serve as the control of controls under a direct mandate from the Board. The scope of internal audit specifically also extends to activities of the MD Managing Director and to verify the effectiveness of the risk management framework.

It is important to note that risk identification and assessment is both the responsibility of the 'risk owner' or the business function(s). Simultaneously, it is also a function of the RM to identify the risk independent of the risk owners. Based on risk management progress reports and internal audit findings, the BRMC will review risk management policies for necessary adjustments.

## 5. Revise policies and procedures

Based on the summary risk reporting and internal audit findings, BRMC with the assistance of Risk Management reviews risk policies for necessary adjustments. While only significant findings are reported to the BRMC, directors should ensure that necessary revisions are quickly made to systems, policies and procedures, as well as to operational workflow to minimize potential loss. The report may make specific recommendations on how to strengthen risk management areas. BRMC is responsible for designing specific changes, and in doing so, should seek inputs from the internal audit team and operations team including field staff. This ensures that the suggested operational changes are appropriate and will not result in unforeseen, negative consequences to SFPL or its clients. After the new controls are implemented, its effectiveness must be evaluated for any further improvements that can be brought about. The Chief Risk Officer/Advisor who helps in reporting summary findings to BRMC also suggests possible changes in policies and procedures.

In a nutshell, the risk management feedback loop is an interactive and continuous process to ensure that the management is in-tune with the actual events and that SFPL responds in a timely manner to any changes in its internal or external business environment. Even if an evaluation finds that SFPL is adequately controlling its risks, the risk management process does not end; it continues with regular, on-going evaluations. Each successive evaluation not only tests the effectiveness of new controls but also includes a review of previously tested controls.

### Risk types managed under the policy

As a microfinance institution, SFPL faces different types of risks. The general risk management policy covers five broad categories of risks:

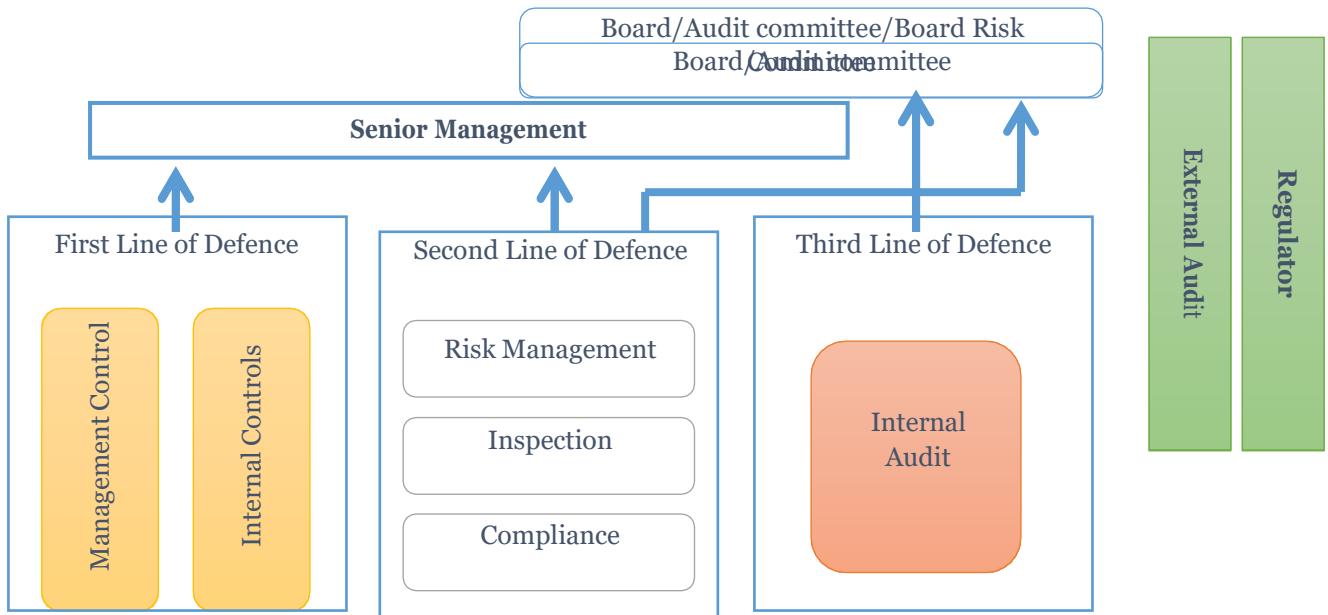
Operational Risk – these include risks related to areas like Information Technology, Human Resources, Administration and Information and Communication, and Legal
Credit Risk – these include risks related to the Lending activity
Market Risks – these include risks related to Foreign Exchange and Interest Rate
Liquidity Risk- including Funding risk
Foreign Exchange Risk –SFPL is exposed to funds in foreign currency and the likelihood of raising foreign currency loans in future also.

SFPL identifies all of the above-mentioned risk categories to be material risk.

## CHAPTER 2: RISK MANAGEMENT GOVERNANCE

The risk governance model of SFPL is adapted from three lines of defence model as suggested by Bank for International Settlement. Figure 3, describes the risk governance model for SFPL in detail.

**Figure 2: Three lines of Defense for Risk Governance at SFPL**



At the organisation level, the Board of SFPL is responsible for overall risk management and it does so through an internal body called BRMC. The Board defines the overall risk appetite of SFPL by setting limits and standards. Specific Charter/Terms of Reference of BRMC is attached as Annexure I of this policy document. In the context of SFPL, the three lines of defence<sup>3</sup> are explained as below:

**First line of defense** - As the first line of defense, department heads (including frontline business and control functions) own and manage risks. They also are responsible for implementing corrective actions to address process and control deficiencies. These department heads are responsible for maintaining effective internal controls and for executing risk and control procedures on a day-to-day basis. The first line of defense identifies, assesses, controls, and mitigates risks, guiding the development and implementation of internal policies and procedures and ensuring that activities are consistent with goals and objectives. Through a cascading responsibility structure, the heads of different departments design and implement detailed procedures that serve as controls and supervise execution of those procedures by other staff. There should be adequate managerial and supervisory controls in place to ensure compliance and to highlight control breakdown, inadequate processes, and unexpected events. The first line of defense provides management with the assurance that robust internal controls are in place and being executed to avoid loss to the organisation.

<sup>3</sup> Adapted from BIS, <http://www.bis.org/publ/bcbs292.pdf>

**Second line of defense** – This line of defense provides assurance through oversight that internal controls are being properly designed and enforced for effective risk management. The oversight is guaranteed through inspection of whether the internal controls are effectively being implemented and there is compliance to risk management policies, procedures, and regulatory requirement. Risk management function facilitates and monitors the implementation of effective risk management practices by the operational management and assists Department Heads in defining target risk exposure and reporting risk-related information throughout the organisation. Risk Management function ensures completeness/accuracy of risk assessment, reporting, and adequacy of mitigation plan. Risk management function also defines and reviews risk policies and thresholds and provides guidance and directions for implementing the policies and for monitoring their proper execution.

**Third line of defense** – This represents internal audit that offers independent challenge to organisational operations and oversight function and lends additional assurance to risk management at SFPL. Besides internal audit, external audit and compliance to regulation forms an additional line of defense in risk management for SFPL.

### **Ownership review and approvals**

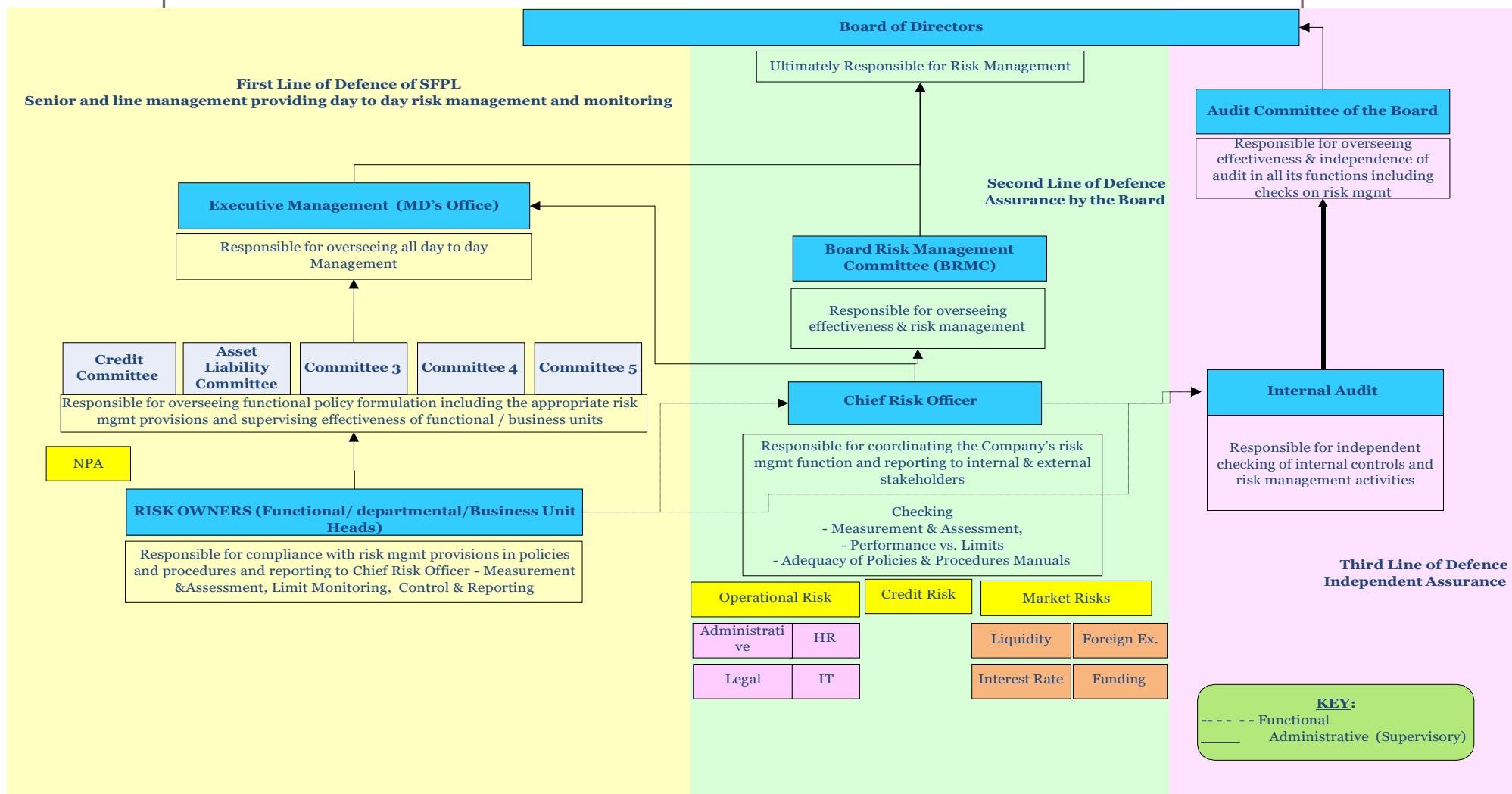
The Board of SFPL is responsible for all aspects of the organisation. The Board is ultimately responsible for management of risk, regardless of the source of risk, by framing an appropriate Risk Management Policy and delegating the responsibility to manage risk to the Board Risk Management Committee ("BRMC").

The main role of BRMC is to ensure that risk management framework in terms of policies, procedures, reports and staff add up to adequate management of risk at SFPL and that the risk profile of SFPL remains within laid down ceilings.

BRMC is also responsible for periodic review of risk management policies and their approval while guiding the management of SFPL on the overall aspects of risk management. The review of policy, typically, will be done on annual basis and will be facilitated by the Chief Risk Officer/Advisor. Any change in policy will be approved by the Board and change in indicators or limits have to be approved by the BRMC for it to come into force.

The risk governance structure of SFPL is further explained on the basis of three lines of defense theory as per Figure 3

**Figure 3: SFPL's Risk Management Structure**



Source:Mfin

In light of the three lines of defense, day-to-day management and monitoring of risks takes place by respective department. The Chief Risk Officer/Advisor who reports back on risks to BRMC further supports this function. RM also inspects and checks compliance of risk management actions, by respective departments, are in line with organisation risk management policies.

BRMC, with support from the Chief Risk Officer/Advisor, provide assurance to stakeholders through its oversight of risk management and by ensuring compliance to organisational risk management policies. Further, it also helps in defining and developing risk management policies and processes and defines SFPL's risk appetite/profile.

Additional assurance to compliance is provided through internal and external audit of SFPL. BRMC, as a committee of the Board, has access to all audit reports for cross comparison and for trend analysis.

Individual business functions of SFPL are responsible for monitoring different types of risk and share the monitoring reports with the Chief Risk Officer/Advisor. The following table defines which business unit/support unit monitors and manages risk at SFPL.

**Table 1: Business Functions monitoring risks**

Risk Type	Credit Risk		Market & Liquidity Risks				Operational Risks			
Risk	Credit Risk	Liquidity <sup>4</sup>	Foreign Exchange	Interest Rate	Funding	IT	HR	Administration	Legal	
Department responsible for monitoring and managing risks	Operations	Finance	Finance	Finance	Finance	IT	HR	Administration	Legal	

Specific departments monitor and implement risk management policies and procedures defined by BRMC on a day to day basis. Risk Management function is supplemented by related control functions like compliance, legal, financial control, treasury and internal audit departments, and audit committee of the board. Based on independent risk assessment, the Chief Risk Officer/Advisor prepares a consolidated report and sends it to BRMC.

## Role of Board

The role of the board in risk management is the following

1. The board will approve and oversee implementation of the Risk Management framework of SFPL and approve risk management policies
2. Define risk appetite statement (RAS) for the institution
3. Ensure that resources allocated for risk management are adequate given the size, nature and volume of SFPL's business
4. Approve SFPL's contingency and business continuity plans
5. Require comprehensive and independent internal audit by well trained, competent auditors, who are independent of the risk management function, and who are responsible for periodically validating adherence to internal controls
6. Ensure that risk report is part of Annual report

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<sup>4</sup> Liquidity risk is a material risk which has been dealt with in detail in the Liquidity Risk Section

## **Role of Board Risk Management Committee**

The role of BRMC with respect to risk management at SFPL is :

1. To assist the Board in setting risk strategy policies in liaison with management and in discharge of its duties relating to corporate accountability and associated risk in terms of management assurance and reporting.
2. To review and assess the quality, integrity and effectiveness of the risk management systems and ensure that the risk policies and strategies are effectively managed;
3. To review and assess the nature, role, responsibility and authority of the risk management function within the Company and outline the scope of risk management work
4. To review processes and procedures to ensure the effectiveness of internal systems of control so that decision-making capability and accuracy of reporting and financial results are always maintained at an optimal level;
5. To monitor external developments relating to the practice of corporate accountability and the reporting of specifically associated risk, including emerging and prospective impacts;
6. To provide an independent and objective oversight and view of the information presented by management on corporate accountability and specifically associated risk, also taking account of reports by the Audit Committee to the Board on all categories of identified risks
7. To review the risk bearing capacity of the Company in light of its reserves, insurance coverage, guarantee funds or other such financial structures.
8. The Chairman of the RMC shall report to the Board of Directors regularly on the deliberations of the Committee.
9. To carry out any other function as may be specified from time to time as per the regulatory amendments/ requirements.

## **Role of Management Oversight (the Risk Owners)**

Management that comprises of Departmental/ Functional Heads, has the collective responsibility of implementing the business strategies approved by SFPL's Board of Directors and developing policies and procedures for effective management of risks. The management team at SFPL shall ensure the following:

- 1) Develop written procedures including responsibilities of the various functions for executing internal controls
- 2) Ensure compliance with internal exposure limits, prudential limits and regulatory requirements
- 3) Ensure that risk management policies, procedures, indicators and thresholds are communicated throughout SFPL and implemented, monitored and revised periodically to address changes in environment and/or operating procedures
- 4) Ensuring SFPL has robust management information systems for risk reporting
- 5) Adequate research is undertaken, and a systematic product development and pilot testing procedure followed, for any new product(s) or activities to ensure risks are appropriately identified and managed.

## **Role of Chief Risk Officer/Advisor**

- 1) Identification, assessment and prioritisation of risk independently as well as in co-ordination with department heads in RAS workshop
- 2) Development and update the SFPL's Risk Management policies and procedures. Though final approval on the policies will be by the Board and final approval on the procedures will be by BRMC.
- 3) Ensure compliance with the rules/ processes set in the risk manual and independent reporting in case of any deviation to the BRMC
- 4) Independent reporting to BRMC of the risk reports as per the defined frequency
- 5) Ensure that SFPL has clear, comprehensive and well documented policies and procedural guidelines relating to risk management and the relevant staff fully understand those policies
- 6) Coordinate risk management training programmes for SFPL staff

- 7) Monitoring positions against approved risk tolerance limits and initiate responses in case of warnings
- 8) Initiate specific risk reviews as requested by the BRMC
- 9) Identification of stress situations and preparation of contingency plans
- 10) Oversee risk analysis for new product development
- 11) Annually update the RAS of SFPL
- 12) Prepare annual risk plans and budgets
- 13) Collate and scrutinise functional line risk reports and submit the appropriate periodic(quarterly) reports to BRMC
- 14) Advise Risk Owners on all matters pertaining to Risk Management

### **Role of Internal Audit**

The Internal audit unit and the internal audit committee of the Board will be responsible for the following:

- 1) Review adherence to Board's policies and procedures
- 2) Provide assurance regarding control systems and risk management process
- 3) Evaluate risk management measures for their appropriateness in relation to exposures
- 4) Test all aspects of risk activities and positions
- 5) Ensure effective management controls over positions, thresholds and actions when thresholds are exceeded. The Chair of Audit committee of the Board shall also be a member of the Risk Committee of the Board

### **Role of Financial Advisory and Asset and Liability Management Committee**

- 1) To review and monitor Company's borrowings from existing or new lenders, including External Commercial Borrowings transactions.
- 2) To review and approve the Company's Business Correspondent, securitization and direct assignment transactions.
- 3) To explore the options available from banks & financial institutions for borrowing, compare the earnings, approve the borrowings after considering the market scenario and other terms and conditions of the borrowings.
- 4) To negotiate the terms and condition of lending with lenders and finally approve the same.
- 5) To continuously review the fund requirement of Company on monthly and quarterly basis in accordance with the ongoing business plan (projections etc).
- 6) To review the cash management and optimum utilisation of the funds available to the company at frequent intervals
- 7) To review the interest rate charge by the Company on quarterly basis in order to comply with the directions of Reserve Bank of India
- 8) To review the fund position of the Company and to analyse the ALM returns before submitting to the Regulatory authorities.
- 9) To consider and approve the opening of Bank account of the Company, delegation and alteration of the authorized signatories and closing of bank accounts.
- 10) To report to the Board of directors on quarterly basis.

## **CHAPTER 3: RISK APPETITE**

SFPL recognises the need to define risk appetite so that it serves as a guide for managing risks. Risk appetite is defined as the amount / quantum and type of risk that SFPL regards as appropriate and acceptable in pursuit of strategy.

The board regularly reviews and sets this in the form of risk appetite statements / threshold limits, which it sets in the context of SFPL strategy and the requirements of various stakeholders, including the regulatory framework inwhich it operates. The risk appetite statements provide the benchmark against which SFPL's risk profile is reported, monitored and managed by the board and relevant committees. Risk appetite also forms the basis for the calibration and setting of delegated authorities and financial limits for all aspects of market, credit, liquidity and operational risk. The risk appetite statements address both quantitative and qualitative aspects of risk taking.

### **Qualitative risk appetite statements**

- 1.** SFPL will ensure full compliance with regulatory requirements
- 2.** SFPL will ensure compliance to the organisation's vision, mission and organisational objectives and avoid situations/actions that could have negative impact on its reputation and brand
- 3.** SFPL will ensure compliance with operational risks in the execution of business plan
- 4.** SFPL will implement effective lending operating policies, and procedures, with appropriate internal controls
- 5.** SFPL will ensure development and adherence to Board approved concentration limits, and credit risk indicators
- 6.** SFPL will ensure that annual or multi-year business plans and business objectives, such as loan portfolio growth, are to be consistent with the credit risk management policy including risk strategy and risk appetite;
- 7.** SFPL will only participate in lending using Grameen and individual lending methodology, where SFPL has developed an appropriate level of knowledge and skills to assess and monitor the particular risk;
- 8.** SFPL's management team and risk head will review and approve material credit risk embedded in new products, and may implement product concentration limits, monitoring and reporting;

### **Quantitative risk appetite statements**

- 9.** SFPL will maintain minimum credit rating level of BBB<sup>5</sup> or its equivalent rating.
- 10.** SFPL will maintain minimum regulatory capital at **15%** of Risk Weighted Assets
- 11.** SFPL will maintain minimum tolerance for market, credit and operational losses<sup>6</sup>
- 12.** Minimum excess liquidity resources to meet peak stressed liquidity requirements without the need to liquidate assets or raise capital<sup>7</sup>.

Risk appetite indicators are monitored by the BRMC by way of a risk dashboard. Consequently, they have to be concise, very well understood by the Board and should capture all material risks. For list of complete risk indicators and limits for each risk category, please refer to subsequent sections of the document.

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<sup>5</sup> Based on the ICRA rating

<sup>6</sup> Please refer Chapter 4 on Credit Risk for quantitative indicators and their limits

<sup>7</sup> Refer chapter 4 for details

## CHAPTER 4: CREDIT RISK

### Introduction and Scope

Credit risk is the most important risk category for SFPL. Credit risk for SFPL refers to the possibility of its borrowers or another contractual counterparty not being able to honour their loan obligations. It includes risk arising from borrower's late repayment or non-repayment of the loan obligations. In case of SFPL, apart from borrowers, contractual counterparty may also be banks where SFPL subscribes to fixed deposits to access funds for on-lending purpose (especially under business correspondent model). Such defaults lead to loss of income for the microfinance institutions as they fail to collect interest and outright losses in case the principal amount given as a loan is not repaid. SFPL needs to identify and manage credit risk arising out of individual transactions as well as losses of a significant portion of the loan portfolio.

This signifies the need for a sound and effective and credit risk management policy for long-term sustainability of SFPL. Credit risk management policy is the responsibility of Chief Risk Officer/Advisor, JLG Lending Head and Individual Lending Head, prepared with stakeholder inputs and recommended by the Chief Risk Officer/Advisor for approval by the Board of Directors. The credit risk management policy requires sound practices for the management of credit risk and applies to all lending and related activities that may lead to credit risk.

SFPL's credit risk management process is designed to cover the entire credit cycle starting from the origination of the credit in the books to the point the credit is paid off and cleared from the books, providing for sound practices in:

- Client selection
- Credit processing/appraisal,
- Credit approval/sanction
- Credit documentation
- Credit administration
- Disbursement
- Monitoring and control of individual credits
- Monitoring the overall credit portfolio
- Credit classification and
- Problem credit management and recovery

Most of the elements of credit risk policy are related to policies and procedures mentioned in the operations manual. It is necessary that the team responsible for making changes in the credit risk management policy must closely work with the team responsible for tracking and managing operational policies and procedures.

### Credit Risk Philosophy

The Board of Directors has the responsibility to establish an appropriate credit risk philosophy, including credit strategy and risk appetite. The senior management of SFPL has the responsibility to implement the philosophy, strategy, and appetite, including establishing an appropriate credit risk culture, throughout the organisation.

The Board of SFPL has approved a balanced risk philosophy, which enables the organisation to earn profits while operating within regulatory limits. This will allow SFPL to emerge as a sustainable financial service provider while minimising financial and reputational risk. This philosophy is to be applied on an enterprise wide basis.

## **Regulatory Requirements**

SFPL must incorporate regulatory and legal requirements, including:

- The Companies Act, 2013
- Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016 as amended from time to time
- RBI (Regulatory Framework for Microfinance Loans) Directions, 2022

## **Loan Products and Features**

SFPL offers basic loans for income generation activity in the area of agriculture, commerce, small-scale production or services. Clients can borrow for their consumption needs such as food, medicine or child education after a certain time of consistent repayment of income generation loan. In partnership with insurance company's SFPL provides life insurance, term plan, products to its borrowers and their spouse.

### **Joint Liability Group (JLG) Loan**

SFPL provides JLG loans to poor women with weekly, fortnightly and monthly repayment options. The amount of loan for each client is evaluated separately and disbursed to individual borrower.

The actual amount of loan for each prospective borrower is determined after careful and thorough assessment of the loan application and borrower's repayment capacity.

Interest on the JLG Loan will be charged as per the company's Loan and Interest Rate Policy. **Additional 1%** of gross Loan Amount will be charged as upfront processing fee (other taxes shall be charged as per the guidelines issued by the Government from time to time at the time of loan disbursement).

#### **Subsequent Loan Criteria:**

For subsequent loan cycles, the individual borrowers performance in previous loan cycle is the major consideration. For the next higher loan, minimum record of accomplishment of 30 weeks with SFPL is required. SFPL follows strict evaluation criteria to assess subsequent cycle loans.

#### **Terms and Conditions:**

- ✓ Total repayment burden of all the loans taken by the household will be within the 50% of the household income.
- ✓ The repayment will be made over equal weekly/fortnightly/monthly payments as chosen by the borrower.
- ✓ These loan repayments have a moratorium equal to one week / fortnight/ month as the case may be.
- ✓ A loan repayment instalment includes a portion of outstanding loan principal, plus the interest generated by the amount owed and will be deposited in SFPL branch account as per the repayment schedule and a receipt for the same will be handed over in centre meetings.

### **Individual Loan (IL)**

SFPL also offers individual loans to existing customers as a graduation product. The following are some of the product features of Individual Loan offered by SFPL:

- ✓ The maximum amount of loan under this product is Rs.1,00,000
- ✓ The individual loan is given for 24 months for the purpose of income generation or as a working capital loan (only for financing existing business).
- ✓ Repayment frequency is monthly
- ✓ Interest on Individual loan will be charged as per the RBI pricing guidelines.

### **Utility Loan:**

Utility loan is kind of aspirational loan product for the customers which help to improve and dignify the life style of the women borrowers. Product such as Refrigerator, LED TV, Washing Machine and Mobile are offered under the Utility Loan products.

Key feature of Utility Loan are:

1. This loan is offered only to Existing good customer of Sonata Finance, customers with any default on EMI in previous loans are not entertained under the utility loan products.
2. Interest rates of the product should always be in compliance with the RBI pricing guidelines and the company's Loan and Interest rate policy, further an additional 1% Processing fees, along with other taxes shall be charged as per the guidelines issued by the RBI from time to time
3. Loan Size, tenor is:

<b>Min Loan</b>	<b>Max Loan</b>
Rs.10,000	Rs.20,000

<b>Min Tenor</b>	<b>Max Tenor</b>
9 Months	24 Months

### **Sanitation Loan:**

In order to help women to live life of dignity and to support government of India initiative Swachh Bharat Abhiyan, SFPL has decided to start Sanitation loan which is primarily given to help build toilets where there is a genuine need.

#### **Criteria of Sanitation Loan:**

1. Sanitation loan is given to existing customer of Sonata, (no new customer is entertained)
2. On the basis of verification of sites where toilet is to be built.
3. Interest charged on Sanitation loan is kept in line with RBI pricing guidelines. Further 1% Processing fees along with other taxes shall be charged as per the guidelines issued by the RBI from time to time
4. Sanitation loan is given under weekly, fortnightly and monthly mode of repayment.
5. Tenor and Loan Amount:

<b>Min Tenor</b>	<b>Max Tenor</b>
20 Months	24 Months

<b>Min Loan</b>	<b>Max Loan</b>
Rs.15,000	Rs.35,000

## Risk Identification and Measurement

### Individual Transactions

The foundation for effective credit risk management is the identification of existing and potential risks in SFPL's credit products and credit activities. This creates the need for development and implementation of clearly defined policies, formally established in writing, which set out the credit risk philosophy of SFPL and the parameters under which credit risk is to be controlled.

### Lending Policies and Procedures

#### Selection of Villages

SFPL targets a village that has sufficient number of poor households to make a full centre of poor women (at least 20 members). SFPL considers following parameters before starting microfinance operations in a particular geography:

- ✓ BPL Population
- ✓ Cash Flow & Viability
- ✓ Political/Religious influence
- ✓ Presence of Competitors
- ✓ Previous repayment history
- ✓ Accessibility/Approach
- ✓ Other Vulnerability

#### Group Formation

SFPL follows a very systematic and exhaustive approach to group formation. The Business Relationship Officer (BRO) of SFPL hold a meeting in a village to explain the objectives and methodologies of microcredit program. The size of group at such meetings is generally between 10-20 persons. BRO visits the house of each person interested to avail loans and conducts following four stages:

- ✓ Village Profile & House Hold "HH" Survey
- ✓ Introductory Meeting
- ✓ (Continuous) Group Training

BRO checks whether the members satisfy the following criteria for group formation:

- ✓ SFPL provides services only to women, aged between 18 to 55 years.
- ✓ Members are required to form their own Joint Liability Group (JLG) of at least 10 members (for the first loan cycle).
- ✓ Later addition of members can be done in multiples of one i.e. any number of women may be added. However, the maximum centre size must not exceed 20.

- ✓ A centre cannot have more than 30% of members staying in rented accommodation. If more members are staying in rented accommodation, then they should have been staying at the same location for at least three years.
- ✓ All members need to be from the same social and economic status and background
- ✓ The annual family household income of the members' must be less than Rs. Rs. 3,00,000
- ✓ The distance of members' houses from the proposed centre must not be more than 100m in urban and 300m in rural areas.
- ✓ All the members of the group need to take responsibility and liability of all other members of the centre. Joint responsibility exists at centre level.
- ✓ Eligibility for the repeat loans would depend on good credit discipline in the earlier loan cycles as well as attendance rate at group meetings.

### *Continuous Group Training (CGT)*

Every group undergoes group training in SFPL before loan application stage. The purpose of this training is to create a culture of credit discipline and to ensure that all members have good understanding of the credit products. The objective and the rules and regulations of the credit program are explained to group members. It is also necessary that rights and obligations of members need to be understood and accepted. SFPL provides all these inputs in short training sessions spanning over a period of 3 to 4 continuous days.

There are several principles that should be kept in mind when conducting CGT:

- There should be a minimum number of training hours undertaken by all members and if further training is necessary, it should be provided.
- An attendance register should be maintained to monitor attendance of members during training sessions.
- If members arrive late or are absent in the CGT, training should be postponed until the next day.
- Although all training sessions should be conducted within the village, the specific location and time of training sessions should be chosen by group members.

Continuous Group Training should be conducted by Business Relationship Officer in a village of potential members. On the 2nd day and last day of the Continuous Group Training, the supervisor should attend the training session. This serves two purposes: it ensures that members are given the signal about their training and its results. Trainee groups should not sit for the Group Recognition Test until the Supervisor is satisfied that they are ready to appear for the test. SFPL has a well-defined content (day wise) for the training program. Detailed guidelines for conducting CGTs are mentioned in the operations manual.

### *Group Recognition Test (GRT)*

When the group completes its CGT, it goes through a final check, which is known as GRT. GRT is done to ensure that all group members meet the eligibility criteria of SFPL. The following are vital objectives of the GRT process:

- ✓ Verify the state of poverty - Very Poor, Poor and Not Poor (the Not poor category must be excluded) of the potential client
- ✓ Ensure that the potential member's husband is aware of her participating in the credit programme of SFPL
- ✓ Determine if the potential members satisfy the requirements for forming the group and ask them questions to check that they know and trust each other
- ✓ Determine the knowledge by checking the understanding and their agreement with the objectives and the important rules of the micro credit programme; testing them verbally (each member must be approved before the group is approved by the supervisor doing the GRT).

- ✓ Verify attendance at each one of the four meetings and the commitment of each applicant to attend all the weekly/fortnightly/monthly centre meetings.

GRT can be carried out only by an authorized officer of the rank of BM or higher. They are to be carried out at times and in places acceptable to the prospective clients. Generally, two or three possible groups at a minimum in a single session must be tested in order to make use of the time of the supervisors.

Results of the GRT must be announced verbally by the senior officer conducting it, immediately after the GRT is completed. There has to be no delay in announcing GRT results. Reasons should be given in case of a failure of a potential group, and they should be encouraged to attend repeat CGT sessions.

SFPL has strict group evaluation criteria. If members of any group obtain poor or very poor grade or if any member's house is not within the desired limit, the assessor may disapprove the group. In addition, the assessor has the authority to order retraining of the group, if

- ✓ If four or more members in a group obtain poor grades.
- ✓ If any member arrives late at a centre.
- ✓ If any member withdraws from training and as a result, required number of members became less than 10(in case of new centre) or 5 (in case of existing centre).

#### *Loan Application and Approval*

Loan applications for all members are filled at the time of GRT (after the group passes GRT). Loan applications are first evaluated by BRO's and then by the BM. Together, they decide the loan amount for individual members. Loan approval power is defined based on the lending methodology – Individual and group lending methodology. Following table summarizes the loan approval power of Branch Manager as well as credit committees formed at various levels:

**Table 4 Loan Approval power**

<b>Approving Authority</b>	<b>Loan Amount</b>
BM	JLG – All the loan under JLG model IL - UP to 35,000
Branch Credit Committee at Branch (Hub In charge, Credit Manager, Branch Manager)	IL - Rs.35,001 to Rs.60,000
Divisional Credit Committee (Divisional Head, Divisional IL In charge, Divisional Accountant)	Rs.60,001- Rs.1,00,000
HO Credit Committee (Chief Financial Advisor, IL Head, one of any other product head)	Rs.1,00,001 – Rs.5,00,000

All loan applications are also subjected to credit bureau checks to avoid multiple lending among borrowers. Credit bureau checks are an integral part of the credit assessment as it helps SFPL in managing the quality of the loan portfolio.

#### *Loan Disbursement and Repayment*

Loan disbursements will be carried out in a manner that makes it convenient for clients to accept disbursements and eliminates the risk of frauds. Loan disbursement is done digitally after completing documentation at the branch offices of SFPL.

Loan repayments are made by borrowers at the branch offices by borrowers. One of the borrowers from each centre (on a rotational basis) deposits the loan instalments at branch office-this practice reduces cash handling risk, to some extent, for the company. As a large number of Sonata's branches are in rural areas, the company uses a mobile based application to update customer's transaction details including disbursements and collection on a real time basis.

SFPL allows borrowers to prepay the loan as per their convenience and SFPL does not charge any prepayment penalty from the customer.

### *Loan Utilization Check (LUC)*

SFPL gives loan to all clients for a specific purpose (income generation activity) after a detailed cash-flow analysis. LUC is a process of checking the usage of the loan amount. LUC is very important because if the client does not use the loan for intended and stated purpose; it may not be able to generate desired cash-flow, which could affect her ability to repay. The LUC process is conducted by BRO as per the guidelines mentioned in the operations manual. BRO conducts LUC for 60% of loans within 10 days of the disbursement.

### *Delinquency Management*

The management of SFPL will establish policies and procedures for loan repayment supporting a robust delinquency management process to reduce potential losses from delinquent loans. Monitoring and reporting of delinquent loans should ensure that loan accounts are classified based on the age of the delinquency. Delinquency ratios and trends will be monitored relative to approved tolerance levels and should be reported to the management team and to the Board Risk Management Committee. In the operations manual, written collection processes and procedures are developed to assist management of delinquent loans.

### ***Role of Chief Risk Officer/ Advisor specific to credit risk***

- Chief Risk Officer/Advisor will ensure that product features offered by SFPL are in line with regulatory requirements and guidelines issued by RBI.
- The Chief Risk Officer/Advisor will ensure that pricing of a loan product is in line with the company's credit pricing policy, as amended from time to time.
- Ensure lending standards are sufficiently prudent to allow SFPL to meet the RAS requirements. In doing so all changes to the Ops Manual have to be vetted by Risk Management as well.
- The Chief Risk Officer/Advisor will assess eligibility conditions specified for borrowers on regular basis. Chief Risk Officer/Advisor will have to closely monitor regulatory and RBI guidelines to ensure that eligibility criteria of SFPL is consistent with regulatory requirement as well as it is appropriately defined considering objectives of risk appetite statement. Chief Risk Officer/Advisor will provide recommendations during monthly management team meetings if there are any changes to be made in the eligibility criteria to ensure effective risk management.
- Chief Risk Officer/Advisor will independently assess CGT and GRT related policies and procedures from the perspective of risk management. If there are any changes required in CGT related policies and procedures or the documentation related to CGT, the same should be highlighted in reports produced by Chief Risk Officer/Advisor and discussed in regular management team meetings.
- ( This line has come in the earlier para)Chief Risk Officer/Advisor will ensure that all clients' records are subjected to credit bureau check before the final decision on loan approval.
- Chief Risk Officer/Advisor will independently assess if loan approval matrix is followed diligently and if it needs any revision

Note: Overall, Chief Risk Officer/Advisor will be responsible to assess effectiveness of lending policies and procedures and give recommendations to improve those policies and procedures from the perspective of risk management.

## **Loan Portfolio**

Loan portfolio across group lending and individual lending is the main asset for SFPL. SFPL has well-established risk identification and measurement systems for individual loans as outlined in the above section. However, it is equally important that overall loan portfolio of the institution is analyzed separately from the perspective of risk management and decision-making. Portfolio credit quality is measured by focusing on following indicators:

### ***Portfolio at Risk***

PAR is one of the most important benchmarks in the industry for tracking portfolio quality. PAR is defined as the total balance outstanding under any loan account with past due for a day or more. PAR highlights the gross amount of the exposure, which is at risk of not being collected (because of past dues, which have begun to emerge on certain loans). SFPL tracks following sub-indicators under PAR with the help of its automated management information system.

PAR statistics are also analyzed in various segmentations at SFPL such as by branch, by loan product, by loan officer, and by region. When PAR is analyzed in segmentations, it is quite helpful in detecting risk and default concentrations in certain parts of the portfolio. It can also explain to some extent the underlying risk factors driving the arrears behavior. (Risk indication as per annexure table 1)

### ***Vintage Analysis***

Vintage analysis is an important arrears-based portfolio statistic that can provide early indications of default trends across the entire portfolio or certain segments of the portfolio by product, region, or business units. It is a visual representation of defaulted balances by time elapsed since loan disbursement. The default rate in this calculation is defined as principle balance of outstanding loans, which are in arrears category of 30 days or more divided by the original amount disbursed under this portfolio. Typically, the portfolio is clustered by month of origination (a vintage) such that each origination month becomes a distinct segment of the portfolio and a separate line in the vintage curve graph. Chief Risk Officer/Advisor at SFPL is responsible for periodic vintage analysis of the portfolio, which is in arrears category of 30 days or more.

#### *Calculation and Data Requirements*

In order to calculate vintage curves, the following essential data elements are required from the MIS are required:

- Loan ID
- Observation Date
- Disbursement Date
- Disbursed Amount
- Outstanding Principal on Observation Date
- Arrears Status on Observation Date (Good/Bad or arrears in days)
- Counter: number of months between Observation Date and Disbursement Date

Vintage analysis tool is embedded into this document. Chief Risk Officer/Advisor of SFPL will need to collect the raw data using MIS and update this tool as per the frequency defined in risk reporting section of this policy.

## **Loan Provisioning**

To cover the losses due to deterioration in loan portfolio quality, SFPL creates a reserve through loan loss provision. SPFL has adopted Indian Accounting Standard (Ind-AS) wef. April 1<sup>st</sup>, 2019 and since then it is following expected credit loss (ECL) model to determine the loan loss provisioning. ECL model is designed in consultation with experts and it is in line with industry practice.

## **Rescheduled Loans**

There may be cases where client is not able to repay her instalment because of some unfortunate events such as accident, death, illness of the household members or loss of productive assets. In cases of death, SFPL help the dependent of the deceased through the insurance cover provided at the time of loan disbursement. In other cases, except the wilful default, clients are motivated to resume attendance in the centre meetings, and a plan for rehabilitation of loan repayment is developed in consultation with the client. The plan could include refinance (disbursement of supplementary loan) or extending the loan tenure or both. Such restructuring can be done only with the approval of the Head Office, for which sufficient evidence mustbe provided. Rescheduled loans are tracked regularly by the Chief Risk Officer/Advisor in the course of monitoring and managing credit risk:

Risk Indicators	Exposure Limits
Rescheduled loans	<=0.03%

SFPL believes that rescheduling of loans is a positive approach from the point of view of the client experiencing financial difficulties. SFPL shall ensure that rescheduled loans are reported separately as a part of the requirements of loan portfolio management.

## **Portfolio Concentration Limits**

Concentration risk is the risk posed to a financial institution by any single or group of exposures that have the potential to produce losses large enough to threaten the ability of the institution to continue operating as a going concern. For example, a microfinance institution may have a concentration of loans in a certain geographic area. If that area experiences an economic downturn, an unexpected volume of defaults might occur, which could result in significant losses or failure of the institution. By the very nature of microfinance, some degree of concentration risk is inherent in the methodology; geographically, within their customer/member base, and by the products they specialise in and offer. The smaller the geographic area served, the more limited the customer base, and the fewer the number of products offered all this adds up to increased concentration risk. Concentration risk can also manifest in asset categories or within asset categories.

Management of SFPL has developed credit concentration limits for Board approval as per Annexure III. Concentration limits include geographic exposure, line of business/product exposure and sector exposure (loan purpose). Concentration reporting will be provided to the management team and to the Board Risk Management Committee on regular intervals.

## **Risk Tolerance Levels**

The management team has developed key credit risk indicators for Board approval, as per Annexure III. Key risks indicators include delinquency indicators, provisioning indicators, rescheduling of loan portfolio and write off. Performance reporting on these indicators will be provided to the management team and to the Board Risk Management Committee on regular intervals.

## Risk Reporting and Monitoring

Quarterly reporting to the Board Risk Management Committee will include quantitative data on key risk indicators and concentration limits relative to stated risk tolerances as well as qualitative information, including corrective action, where appropriate. These reports will include the performance of SFPL on defined indicators vis-à-vis risk tolerance and concentration statistics and benchmarks. SFPL uses the following reports to manage credit risk:

Report Type/Report Content	Frequency	Audience	Responsible Person	Source of Data
Details on Portfolio: <ul style="list-style-type: none"><li>• No of clients</li><li>• No of loans</li><li>• Portfolio outstanding</li><li>• No of branches</li><li>• PAR&gt;0</li><li>• PAR&gt;30</li><li>• PAR&gt;60</li><li>• Vintage analysis using an excel tool (quarterly frequency)</li></ul>	Weekly and Quarterly	<ul style="list-style-type: none"><li>• MD, Group Lending Head, Individual Lending Head, Chief Risk Officer/Advisor (Weekly)</li><li>• Board Risk Management Committee (Monthly)</li></ul>	Chief Risk Officer/Advisor	MIS
Distribution of loans across products, branches, industries/sectors, and other factors which present concentration risk	Monthly and Quarterly	<ul style="list-style-type: none"><li>• MD, Group Lending Head, Individual Lending Head, Chief Risk Officer/Advisor (Monthly)</li><li>• Board Risk Management Committee (Quarterly)</li></ul>	Chief Risk Officer/Advisor and IT Team	MIS and Manual Consolidation
Top 10 lists: Largest new loans Largest cases in PAR 30, PAR60 and PAR90	Monthly and Quarterly	<ul style="list-style-type: none"><li>• MD, Group Lending Head, Individual Lending Head, Chief Risk Officer/Advisor (Monthly)</li><li>• Board Risk Management Committee (Quarterly)</li></ul>	Chief Risk Officer/Advisor	MIS
Compare exposures to defined limits for both concentration and key risk indicators using an excel dashboard	Monthly and Quarterly	<ul style="list-style-type: none"><li>• MD, Group Lending Head, Individual Lending Head, Chief Risk Officer/Advisor (Monthly)</li><li>• Board Risk Management Committee (Quarterly)</li></ul>	Chief Risk Officer/Advisor and IT Team	MIS and Manual Consolidation

<p>Written comments about the progress in business operations.</p> <p>Note: In this report, Chief Risk Officer/Advisor will also highlight issues in existing policies and procedures (if any) surrounding lending operations.</p>	<p>Monthly and Quarterly</p>	<ul style="list-style-type: none"> <li>• MD, Group Lending Head, Individual Lending Head, Chief Risk Officer/Advisor (Monthly)</li> <li>• Board Risk Management Committee (Quarterly)</li> </ul>	<p>Chief Risk Officer/Advisor and Internal Audit Head</p>	<p>Internal audit reports, minutes of monthly meetings</p>
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## Risk Control

SFPL's sustainability lies in establishing adequate procedures to effectively monitor and control the credit function within established guidelines. SFPL strives to develop and implement comprehensive procedures and information systems to effectively monitor and control risks inherent in its credit portfolio.

The Chief Risk Officer/Advisor follows credit risk management guidelines for identifying and reporting on potential problem accounts. The Chief Risk Officer/Advisor works closely with the internal audit team, and the Heads of JLG and Individual Lending and ensures that such accounts are identified for more frequent review, followed up with appropriate corrective action, adversely classified where appropriate and that provisions are made where necessary.

Apart from tracking credit risk indicators, portfolio concentration limits, and credit risk related reports, Chief Risk Officer/Advisor also refers to consolidated as well as branch wise audit reports to monitor compliance issues in branch offices and how those compliance issues may affect the credit risk exposure for SFPL. In addition to internal audit reports, there are monitoring reports submitted by supervisors such as hub manager and divisional manager, and these reports also give an overview of issues taking place at the field level. Using both internal audit reports and monitoring reports as data sources, Chief Risk Officer/Advisor at SFPL identifies issues with existing credit policies and procedures. Chief Risk Officer/Advisor also puts forward his recommendations for strengthening of credit policies and procedures, which are discussed during regular management meetings.

## CHAPTER 5: LIQUIDITY AND INTEREST RATE RISK

### Introduction

#### Definition of Liquidity Risk Management

Liquidity risk is the risk that SFPL may not be able to fund increases in assets (primarily loans) or meet obligations as they fall due, without incurring unacceptable losses. This may be caused by SFPL's inability to liquidate assets or to obtain funding to meet its liquidity needs.

#### Scope of Liquidity Risk Management Policy

The liquidity risk management policy details the asset and liability risks, daily strategy and long-term plans to identify and measure risks, strategies to effectively control risks, report and monitor risks and contingency plan.

### Liquidity Risk Identification and Measurement Tools

Measuring liquidity risk involves matching the maturities of assets and liabilities to see what funding gaps exist and then using that analysis to adjust maturities of assets and liabilities as necessary, plan for refinance needs, and plan for adequate liquidity reserves or cushions in case of emergency. When measuring liquidity risk, assets are potential sources of funds to meet maturing liabilities. Liquidity risk is measured using gap analysis and liquidity ratios, and it is further managed with contingency funding plans. For effective liquidity management both static and dynamic measures need to be applied. Static measures are based on a certain published balance sheet date, it provides a simple, point in time liquidity index, which is based on a static balance sheet condition. The dynamic measures are based on a more detailed breakdown of inflows and outflows based on projected business. In this type of analysis, the respective paths of in- and outflows of assets and liabilities are being considered per time period. Dynamic measures need to be used in addition to static measures for high level planning and for formulating simple operating rules or positioning limits. Static measures can give a quick indication of the overall liquidity position based on a balance sheet date to investors, funders and regulators but dynamic measures give an insight into future liquidity needs given projected business (i.e. funding plan)

#### Static Liquidity Management based on the Balance Sheet

The conventional place to start in measuring liquidity is on the balance sheet, by looking at certain ratios between liquid or illiquid assets and liabilities, and at the contractual maturity structure of the balance sheet in the form of a maturity gap report.

#### Contractual Maturity Gap Report

A contractual maturity gap report highlights the gaps between the contractual inflows and outflows of liquidity for defined time bands. These maturity gaps indicate how much liquidity a financial institution would potentially need to raise in each of these time bands if all outflows occurred at the earliest possible date.<sup>8</sup>

Annexure V shows the format of a contractual maturity gap report. The gap report is simply a stratification of the entire balance sheet into time bands by contractual maturity. This means that the carrying values of individual asset or liability items are classified into the time band during which they will become available or payable contractually. The time intervals are counted forward from the balance sheet date.

Amortizing assets or liabilities must be decomposed into their principal flows with their respective contractual maturity, instead of showing the full amount of the carrying value in the time band when the last principal instalment is paid. The Maturity Gaps at the bottom of figure 1 are simply the sum of all the assets minus the liabilities becoming due during that particular time interval. If period gaps up from left to

<sup>8</sup>As per Basel III regulations

right are added, the cumulative maturity gap is derived. By definition, the total cumulative gap must add up to zero, because total assets should be equal to total liabilities and equity.

### **2.1.2 Balance Sheet Liquidity Ratios**

Some of the key liquidity ratios used to measure liquidity and the institutional threshold limit are given in the Annexure II.

## **2.2 Dynamic Liquidity Management based on Cash Flows**

### **2.2.1 Objectives of Cash Flow Planning**

Cash flow planning is essential for liquidity management as balance sheet ratios can only give a quick sense of the liquidity risk of an institution but assurance that SFPL will always be able to meet its payment obligations can only come from a detailed forecast of expected future business and its attendant cash flows. Ideally, 20% Liquid Assets Ratios (LARs) should be maintained after covering the forecasted net cash flows as a buffer for unexpected flows, sudden stress events and business growth.

Cash flow forecasting tool covers a forward period of twelve months and it is granular. The Treasury Head will plan daily increments for the next month and update the plan based on actual materialized flows at least weekly, preferably daily.

Treasury Head will follow a two- step process while doing cash flow planning:

1. Forecast the net funding requirement to understand how cash will be generated or absorbed by client driven transactions and other operating expenses and revenues.
2. Apply appropriate liquidity management actions i.e. either invest excess cash or procure additional liquidity to cover shortfalls based on or triggered by this forecast.

### **2.2.2 Net Funding Requirements Forecast**

When forecasting the net funding requirements, Treasury Head must first develop detailed projections of loan portfolio balances as it is the most important portion of SFPL's operations. Trend and seasonality elements shall be incorporated into these forecasts to ensure realistic projections. However, for SFPL - specific strategic changes should be prioritized when developing these kinds of forecasts. Once loan estimates are made, other flows such as interest payments, interest on short -term investments, and other cash operating expenses and revenues can be derived.

The focus of this forecast must be on the net liquidity effects of the transactions. Projections of outstanding loan portfolio should be aggregated after having totaled expected new disbursements against planned repayments of old loans. A net increase of the outstanding loan portfolio represents a cash outflow, while a reduction of the outstanding amount leads to a net cash inflow.

A detailed description of forecasting loan demand, including utilizing seasonal patterns, as well as forecasting other cash outflows and inflows can be found in Annexure IV. In addition, the excel model titled **Liquidity Management Tool.xls** includes a comprehensive forecasting model that can be used for this purpose and is linked to Liquidity Ratio Dashboard and other Liquidity tools.

Once all the individual cash flows are estimated, they are then consolidated and the net periodic change in cash and the cumulative cash position, i.e. the net funding requirements are calculated.

After forecasting the net funding requirements, Treasury Head must review the results in detail and analyses whether any liquidity management actions are necessary. In the case outlined above, the Treasury Head must procure additional cash to prevent the predicted negative Liquid Assets and Liquid Assets balances below the limit of 10 % of total assets at any point of time. The projected cash flows from these

activities will in turn be added to the Net Funding Requirements. It is only after this final step that the Liquid Assets balances must strictly be positive and, moreover, must meet the minimum requirements of 10 % of total assets set by management.

### **2.3 Scenario analysis and Liquidity Stress testing**

Liquidity stress testing plays a critical role in assessing the potential impact of a range of low probability and high impact severity circumstances on SFPL's liquidity risk profile.

Liquidity stress test is designed to:

- Capture the impact of exceptional but plausible events, including the change in behaviour of borrowers and the impact on SFPL's balance sheet and Liquidity Report under stress conditions,
- Understand SFPL's liquidity risk profile and potential action plans that could be implemented even if the Disaster Recovery Plan had to be invoked,
- Confirm the adequacy of risk limits and risk appetite, and
- Evaluate strategic risk that may be sensitive to liquidity risk.

The stress tests consist of a country-specific scenario and a SFPL -specific crisis scenario. Each scenario represents a change in the measurement methodologies and assumptions governing the Liquidity Report.

Crisis Type	Causes	Impacts
SFPL-specific	Major earnings or loan losses, deterioration of key financial ratios, reputation issues, management turmoil.	Negative public reports, loss of confidence expressed by key donors and sponsors, increased supervisory oversight, client or staff fraud and salary hike because of increased competition.
India- specific	National economic and political issues, natural disaster, financial turmoil.	Clients' inability to repay loans, negative sentiment about the microfinance industry, political hazards etc.

The results of the scenario are expressed in terms of the residual cash assets over the 90-day stress period after taking account of the scenario outflows and the cash-generating or cash-preserving effects of the mitigating measures included in the scenario.

***A liquidity stress scenario for SFPL is specified as follows:***

- The liquidity crisis starts with a trigger event on a particular balance sheet date and runs for 90 days.
- The stress test is routinely applied at the most recent monthly account closing as well as at certain forward monthly closing dates using forecast balance sheet data as instructed by the Asset Liability Management Committee (ALCO)
- As of the trigger date and for the full 90 day stress period, there will be no additional long-term borrowing, even planned drawdowns under existing and committed facilities will be disallowed or delayed by the lender.
- Undrawn overdraft limits and other short-term funding opportunities in the local market will be cancelled within the first 30 days such that no further short-term funding will be available thereafter.
- Overdraft utilizations outstanding 30 days after the trigger date must be repaid within the remaining 60 days stress period.
- Any available liquidity standby facility made available or guaranteed by shareholders or sponsors of SFPL will be drawn immediately to the full extent.
- Time deposit placements and other available-for-sale investments are sold over the 90 day period to generate maximum cash for meeting outflows.
- The collection ratio on all loan portfolios drops by 15% percentage points within 90 days
- New loan disbursements are limited to previously identified strategic regions and client segments leading to a reduction of the gross loan portfolio of 2% per month.
- Any capital spending is deferred.
- Cash operating expenses are maintained at or slightly below the budgeted level throughout the stress period.
- Bullet repayment of NCD within the first 30 days
- One of the key lenders calls off the loan within the first 60 days

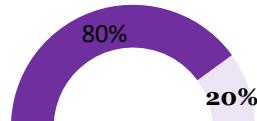
## Funding and Capital Strategy

SFPL ensures at all the times that funding sources are well diversified and reliable; loans have been appropriately approved with designated signing authorities. It preserves sufficient debt service capacity without over leveraging.

The MD informs board about matters related to equity and takes its approval before taking any decision related to equity.

- Equity holding pattern will be monitored so that no single shareholder represents more than 40% of Equity.
- Capital Adequacy Ratio (CAR) consisting of Tier I and Tier II capital maintained will not be less than 15 % of its aggregate risk weighted assets. The total of Tier II Capital at any point of time, shall not exceed 100 % of Tier I Capital.
- Treasury Head is responsible to monitor Debt to Equity Ratio and CAR, and he will report any discrepancies to the MD. MD with support from Head Finance would take action by finding new capital sources via donors or investors and present capital alternatives to the Board in the Board meeting.

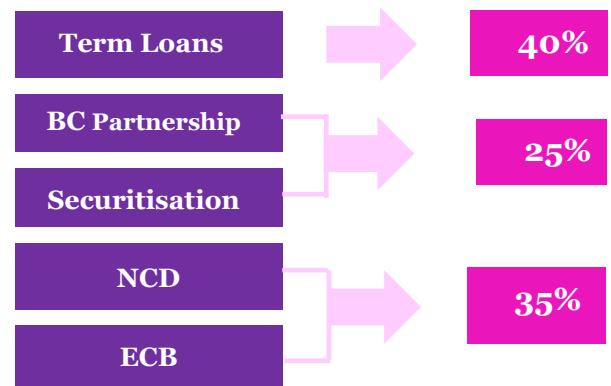
### Debt to Equity Ratio



SFPL ensures that debt funding sources are well diversified. SFPL access following debt funding sources:

- Term Loans- Term loan is accessed from 3 sources; Banks - Public and Private Sector, NBFCs, and development financial institutions like SIDBI and NABARD. SFPL ensures that term loans do not exceed 40% of the total exposure. SFPL will always prefer term loan from private and public sector banks over NBFCs. This will help to reduce average cost of funds. SFPL tries to ensure that no single lender represents more than 15% of liabilities by way of term loans.
- Securitization and Off book exposure- SFPL shall keep securitization and off book exposure within 25%. Off book exposure include Business correspondence (BC) and Direct assignment.
- NCD and ECB- As the NCD and ECB flows has increased in Indian Debt market therefore SFPL shall maintain its exposure in NCD and ECB up to 35% of the total funding exposure.

#### Debt Funding Sources of SFPL with Exposure Limits



Head Finance is responsible to source debt-funding for SFPL. He prepares a debt fund plan and scout for various debt funding sources. Head Finance presents funding alternatives to Financial Advisory and Asset Liability Management Committee and, the committee selects the funding alternatives and approves the funding mandate.

Head Finance and Treasury Head will explore Line of Credit from key lenders(s) of SFPL in addition to existing overdraft facility, to address any temporary liquidity shortfalls.

Treasury Head should perform a spread analysis on debt obligations to assure competitiveness, SFPL's profitability, and leverage. This should be presented to the Financial Advisory and Asset Liability Management Committee, who should set out the strategies to lower cost of funds on regular basis.

The Board of SFPL at all times ensures that all lenders covenants are being complied with. Most of the loan contracts are standardised and do not vary much across the banks. Therefore, covenant tracking tool is not required at this stage as per discussion with SFPL. However, in order to track the covenants Head Finance will create a list of all covenants and allocate the responsibility of monitoring covenants to his team. The Chief Risk Officer/Advisor will collect periodic reports from the Finance Department on key lender covenants and their compliance and submit the report to the Board and the BRMC.

## **Investment Strategy**

SFPL invests excess cash in liquid funds which can be made available by the next day in case a need arises to liquidate them. In investing excess cash, the Treasury Head will have to observe the liquidity objective to ensure SFPL can at all times fulfil its financial obligation.

SFPL invests portion of excess cash in fixed deposits with banks in order to diversify the investment and also manage relationship with banks to avail other banking services such as loan disbursement, payments etc. SFPL keeps major portion of its fixed deposit in public sector bank and small portion in recognized private banks if returns are better.

The Liquidity Management Tool Titled Liquidity Management Planner highlights the net funding requirements before any active liquidity management actions are undertaken. This gives the Treasury Head an opportunity to take corrective actions to ensure that the institution is operating within liquidity limits that have been set.

If Treasury Head updates the financial statements and cash flow forecasts in the tool, the Liquidity Management Planner can be used as a regular planning tool for the Treasury Head. This tool can help to make daily treasury decisions about investing, borrowing and moving cash among various accounts, and immediately simulating the effects of these decisions over the coming months.

## **Cash Management**

SFPL aims to create a liquidity buffer through accurate forecasting of daily cash flow requirements, such that surplus funds can be invested in Liquid Fund with the intent of increasing the interest earned or reducing the idle funds in current accounts.

SFPL has fixed average monthly cash balance in bank account and vault of branch at Rs.25, 000. In order to minimise the cost of liquidity, SFPL has enabled its system to swap daily excess cash in HO central account or get the excess amount deposited in HO central account.

The following process of Cash Flow Forecasting will be adopted by SFPL to streamline the cash management process and reduce idle funds in current accounts.

### **Cash Flow Forecasting**

<b>Cash Flow Forecasting Policy</b>	<b>Monitoring</b>	<b>Implementation and Action</b>
<i>Objective:</i> To project as accurately as possible the cash inflows and outflows on a periodic basis, to ensure sufficient funds for needs.		
1. Detailed daily cash flow forecast – Forecast the SFPL's daily liquidity position on a weekly basis, in addition to monthly projections.	Treasury Head reviews these cash flow projections daily.	Increase liquidity if cash flow forecast indicates a potential liquidity shortfall.
2. Annual funding and liquidity plan— Develop a long-term plan (one to five years) for the SFPL's liquidity needs.	Finance Head, Financial Advisor, Treasury Head, MD and ALCO	Ensure the plan meets the SFPL's growth objectives and repayment liability of the lenders.

### **Interest Rate Risk**

#### **Definition and Scope**

SFPL defines Interest Rate Risk as the current and prospective risk to earnings or capital arising from adverse movements in interest rates. The immediate impact of changes in interest rates is on the Net Interest Income (NII). A long-term impact of changing interest rates is on the net worth since the economic value of assets, liabilities and off-balance sheet positions get affected due to variation in market interest rates. For SFPL, the interest rate risk results from the fact that loan portfolio, provided on a fixed-rate basis, is funded through a floating rate liability/term loan. If interest rates rise, the cost of funds increases more rapidly than the yield on assets/loan portfolio, thereby reducing net income. The exposure to interest rate risk is limited for SFPL as most of the borrowing for SFPL takes place on a fixed rate basis. However, there is still a small funding portfolio which is offered to SFPL on floating rate basis. Therefore, SFPL considers managing interest rate risk critical to the success of overall risk management framework of the institution. Measurement and Monitoring

SFPL uses maturity gap analysis, a widely accepted approach for interest rate risk management. This measurement system helps SFPL assess the effect of interest rate changes in ways that are consistent with the scope of institution's activities.

Gap analysis is conducted by constructing a maturity/re-pricing schedule that distributes interest rate sensitive assets, liabilities and off-balance sheet positions according to their re-pricing buckets (if those are attached with the fixed rate) or time remaining to their next re-pricing (if floating rate is used).

Interest rate sensitive liabilities in each time band are subtracted from the corresponding interest rate sensitive assets to produce a re-pricing "gap" for that time band. This gap can be multiplied by an assumed change in interest rates to yield an approximation of the change in net interest income that would take place from such an interest rate movement. The size of the interest rate movement used in the analysis can be based on a variety of factors, including historical experience, macro-economic conditions, central bank's policy, simulation of potential future interest rate movements, and the judgment of SFPL management.

The embedded tool will be updated by Treasury Head. Chief Risk Officer/Advisor will report SFPL's interest rate risk exposure to the Board on Half Yearly basis. The reporting will also focus on SFPL's current exposure (against defined thresholds) to following risk indicators:

- **Net interest income:** Projected net interest income over the next 12 months may not be reduced by over 10% given a change in interest rates of up to (+/-) 1%

**Gap Limit:** The one-year cumulative Gap may not exceed 10% as a percentage of assets.

## Foreign Exchange Risk

SFPL may face foreign exchange risk if:

1. It receives loans in foreign denominations and has to pay back in the same currency after investing in the portfolio in local currency
2. Holds its investments/deposits in foreign currency

The foreign exchange risk is considered material for SFPL. The guidelines relating to Foreign exchange risk and its management is enclosed herewith as **Annexure – VI**

<sup>9</sup> Foreign Currency risk is not a material risk at this stage for SFPL, however, basic background on this risk is given to be used as and when such a risk emerges. Further, this policy needs to be further developed as required at a later stage.

## Roles and Responsibilities

### 9.1.1 Role of Senior Management

With respect to liquidity risk management, responsibility to different management personnel, individually and as a collective, are assigned as per the table below:

Person/Committee	Responsibilities
Financial Advisory and Asset and Liability Management Committee (FA&ALM)	<p>Provides strategic direction and primary oversight to the treasury function in the area of liquidity risk management. Its responsibilities include:</p> <ul style="list-style-type: none"> <li>• To review and monitor Company's borrowings from existing or new lenders, including External Commercial Borrowings transactions.</li> <li>• To review and approve the Company's Business Correspondent, securitization and direct assignment transactions.</li> <li>• To explore the options available from banks &amp; financial institutions for borrowing, compare the earnings, approve the borrowings after considering the market scenario and other terms and conditions of the borrowings.</li> <li>• To negotiate the terms and condition of lending with lenders and finally approve the same.</li> <li>• To continuously review the fund requirement of Company on monthly and quarterly basis in accordance with the ongoing business plan (projections etc).</li> <li>• To review the cash management and optimum utilisation of the funds available to the company at frequent intervals</li> <li>• To review the interest rate charge by the Company on quarterly basis in order to comply with the directions of Reserve Bank of India</li> <li>• To review the fund position of the Company and to analyse the ALM returns before submitting with the Regulatory authorities.</li> <li>• To consider and approve the opening of Bank account of the Company, delegation and alteration of the authorized signatories and closing of bank accounts.</li> <li>• To report to the Board of directors on quarterly basis.</li> </ul>

Managing Director	<ul style="list-style-type: none"> <li>• Managing Director (“MD”) is the Chairman of FA&amp; ALM Committee</li> <li>• Take Approval from FA&amp; ALM Committee for excesses to Liquidity Risk limits</li> <li>• Active involvement in contingency liquidity risk management (Liquidity Contingency Plan, stress testing and contingency liquid assets management)</li> </ul>
Chief Financial Officer	<ul style="list-style-type: none"> <li>• Chief Financial Officer is a member of FA&amp; ALM Committee.</li> <li>• Acts as the primary liaison with regulators and rating agencies with respect to liquidity management</li> <li>• Supports liquidity risk identification for new products and initiatives</li> <li>• Proposes and reviews various liquidity risk measurement methodologies, providing input on assumptions and reviewing liquidity procedures and policies</li> <li>• Recommends the Contingency Liquidity Plan</li> </ul> <p>Finance functions under his control are responsible for:</p> <ul style="list-style-type: none"> <li>• Preparation of the financial statement at monthly, quarterly, six monthly and annual basis.</li> <li>• Responsible for execution of short-term, tactical liquidity management within approved limits</li> <li>• Responsible for regulatory reporting for liquidity risk</li> <li>• Reporting, monitoring and oversight role for internal liquidity metrics</li> </ul>
Treasury Head	<ul style="list-style-type: none"> <li>• Treasury Head has day-to-day responsibility for liquidity management including, compliance with escalating policy, limit and oversight and reporting to the management team</li> <li>• Develops and implements cash management procedures and internal controls in order to conform with this Liquidity Risk Framework and Policy</li> <li>• Operate liquidity management to, prepares weekly Liquidity Reports and quarterly Stressed Liquidity Reports</li> <li>• Monitors and reports market developments, including Reserve Bank actions, to assess the potential for changes in liquidity management policy</li> </ul>
Internal Auditor	<ul style="list-style-type: none"> <li>• Provides independent assessments of liquidity risk management practices and processes</li> </ul>
IT Head	<ul style="list-style-type: none"> <li>• Provide operational data for liquidity management tools</li> </ul>
Chief Risk Officer/Advisor	<ul style="list-style-type: none"> <li>• Responsible for reviewing SFPL’s internal liquidity stress tests</li> <li>• Re-engineering of SFPL’s internal liquidity stress tests (where required)</li> <li>• Oversight of the stress testing required for regulatory purposes, including documentation of the stress test methodology and presentation to the business, as required</li> <li>• Maintaining the business requirements documentation for the in-house liquidity system</li> <li>• Responsible for any new product within the liquidity stress testing framework Keeping abreast with developments within the microfinance environment specifically within liquidity and regulatory developments and with best practice for liquidity stress testing</li> <li>• Ensuring that liquidity risk methodology is fully documented and reported</li> <li>• Contribute by documenting the Liquidity Risk Framework and providing analysis of the stress test results</li> <li>• Contribute, where necessary, to the liquidity escalation process</li> <li>• Extensive liaison with Treasury, FA&amp; ALM Committee, and Finance head</li> </ul>

## Risk Reporting and Monitoring

SFPL uses the following reports to manage liquidity risk:

<b>Report Content</b>	<b>Type/Report</b>	<b>Frequency</b>	<b>Audience</b>	<b>Responsible Person</b>	<b>Source of Data</b>
• Static balance sheet measures of liquidity	Monthly/Hay early		<ul style="list-style-type: none"> <li>MD, CFO, Treasury Head, Finance Head, Chief Risk Officer/Advisor (Monthly)</li> <li>Board Management Committee (Half yearly)</li> </ul>	Chief Account Controller, and Treasury Head	Accounts/Finance and MIS
Maturity Gap Report	Quarterly/Half Yearly		<ul style="list-style-type: none"> <li>MD, CFO, Treasury Head, Finance Head, Chief Risk Officer/Advisor (Quarterly)</li> <li>Board Management Committee (Half yearly)</li> </ul>	Chief Account controller and Treasury Head	Accounts/Finance and MIS
Gap Analysis-Repricing Schedule (Interest Rate Risk Management)	Quarterly/Half Yearly		<ul style="list-style-type: none"> <li>MD, Group Lending Head, Individual Lending Head, Chief Risk Officer/Advisor (Quarterly)</li> <li>Board Management Committee (Half yearly)</li> </ul>	Chief Account controller and Treasury Head	Accounts/Finance and MIS
Compare exposures to defined limits for both concentrations and key risk indicators using an excel dashboard	Monthly and Half Yearly		<ul style="list-style-type: none"> <li>MD, Group Lending Head, Individual Lending Head, Chief Risk Officer/Advisor (Monthly)</li> <li>Board Management Committee (Half yearly)</li> </ul>	Chief Risk Officer/Advisor,	Accounts/Finance and MIS

## Liquidity Contingency Plan

The Liquidity Contingency Plan (“LCP”) describes the requirements for managing liquidity in situations where it becomes difficult to meet its commitments as they fall due. The LCP also outlines the approaches used to pro-actively

assess the potential impact of a range of low probability-high impact events and uses this information to assess and enhance appropriate action plans for such incidents and to confirm the appropriateness of risk limits.

Therefore, the LCP is an action plan that addresses the funding and liquidity issues arising from liquidity stress testing. The plan includes, but is not limited to, the following:

- Back-up sources of liquidity are clearly set out, including access to funding (overdraft facility, line of credit etc.) from key lenders,
- Arranging cash by liquidating fixed deposits, contingency liquid assets, calling repayments from the branch and raising short term loan.
- Slowing client loan disbursement, etc., are detailed and responsibilities assigned.
- A list of actions and names or roles of individuals responsible.

### **12.1 Elements of Contingency Funding Plan**

<b>Particulars</b>	<b>Action from SFPL</b>
Crisis Preparedness	<ul style="list-style-type: none"> <li>• SFPL will strive to establish confirmed overdraft or credit lines with several lending institutions.</li> <li>• SFPL will establish relationship with NBFCs, private and public sector bank for short term borrowings</li> </ul>
Monitoring and Crisis Detection	<ul style="list-style-type: none"> <li>• The Chief Risk Officer/Advisor should regularly review the economic environment as well as signals from wholesale funders for early signs of a deterioration of confidence that could lead to liquidity stress. Particular attention is paid to reputational events such as publicized loan portfolio problems, major fraud, a lawsuit or other negative press that could escalate into a public concern about the creditworthiness of SFPL. The RM declares watch event or a full crisis, informs the BRMC and triggers the implementation of the liquidity contingency plan.</li> </ul>
Communication with SRO (Self-Regulatory Organisation), investors and lenders	<ul style="list-style-type: none"> <li>• The Managing Director assume exclusive responsibility for communicating with the investors and lenders about the emerging situation at the institution. The issue at hand (loss, fraud, legal problem) is never denied but fully disclosed and put into perspective with the overall size of the operation and the financial resources of the institution. MD along with the management team communicates proactively about the situation and seeks the explicit backing of the major financial institutions and stakeholders about the solvency of Sonata.</li> </ul>
Meet all Wholesale Placement	<ul style="list-style-type: none"> <li>• Even under liquidity stress, Sonata will continue to meet any wholesale settlement obligations without delay.</li> </ul>
Draw available lines of credit	<ul style="list-style-type: none"> <li>• SFPL will try to quickly draw all of overdraft lines of credit, before potential limit reductions and cancellations might take effect.</li> </ul>
Limit discretionary expenditure	<ul style="list-style-type: none"> <li>• Management will implement an immediate capital spending freeze, delay accounts payable settlement for supplier invoices by several weeks on average and consider paying only a partial payroll to employees with executives accepting the largest deferral of salary.</li> </ul>
Customer triage	<ul style="list-style-type: none"> <li>• In order to conserve cash, SFPL will make fresh loan disbursements only to strategically important clients and customer segments according to a previously established client classification. However, utilizations under confirmed lines of credit and previously communicated customer limits must always be honoured. SFPL will never renege on contractual commitments, even under liquidity stress.</li> </ul>

## CHAPTER 6: OPERATIONAL RISK

### Introduction

#### Definition of Operational Risk Management

Operational Risk is defined as the possibility of “losses resulting from inadequate or failed internal processes, people and systems or from external events.<sup>10</sup> This definition includes legal risk, but excludes strategic and reputational risk. Legal risks includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.

**Reputational risk could arise** since SFPL deals with vulnerable, financially inexperienced clients’, with high expectations on social responsibility towards clients. When internal controls and codes of conduct fail, the damage to the reputation of a responsible microfinance provider like SFPL can be substantial. Hence, for the purposes of this operational risk policy, reputational risk has been considered as a part of operational risk.

#### Type of Operational Risk Events Relevant to SFPL

There are several types of operational risk (OR) events which SFPL could face. Any OR incident/must be classified into one of the top-level categories as defined in Basel II norms.

S. N	Operational Risks	Examples
1.	Internal fraud	Intentional misreporting of positions, employee theft, ghost loans to non-existing clients siphoned off by business executives
2.	External fraud	Robbery, forgery, cheque kiting, damage through computer hacking, clients misrepresenting their situation and obtaining a loan that they have no intention of paying back.
3.	Employment practices and workplace safety	Staff compensation claims, violation of employee health and safety rules, discrimination and sexual harassment claims and general liability for damages incurred by staff.
4.	Clients, products and business practices	Misuse of confidential customer information, marketing of unauthorised or inappropriate products, omission or incorrect disclosure of effective rates, abusive collection practices
5.	Damage due to physical activities	Fires, floods, vandalism, earthquakes, terrorism
6.	Business Disruption and System Failures	Hardware and software failure, utility failures, telecommunication problems, massive staff absence due to epidemic or political unrest.
7.	Execution, Delivery and Process Management	Data entry errors, collateral management failures, incomplete legal documentation, unapproved access granted to client accounts and vendor disputes.
8.	IT platform and procedure related risk	Disaster Recovery & business continuity plan failure, AMC deficiency, software upgrade, user credential reset , IS audit compliance etc.

Apart from Basel Level I Event classifications, there are Level II OR classifications as well. These classifications are further explained in a section titled “Operational Risk Incidents Collection/Loss Event Database”.

#### Sources of Operational Risks at SFPL

Operational risk events can occur when there are inadequacies or failures due to:

<sup>10</sup>As defined by the Basel Committee on Banking Supervision, June 2004

## **Internal Factors**

### **A. People**

The management of human resources and employee behaviour can become a major source of operational risk. Poorly trained or overstretched employees may expose SFPL to operational risk (for example, via processing errors). Understanding of the mission and vision of SFPL, confidence in and respect for the institution as well as adherence to policies and strategies are key for effective use of human resources. In addition, the continuous availability of employees, or SFPL's ability to replace them, can influence its ability to recover from interruptions to continuity of its operations. SFPL strives to develop an appropriate risk culture in which employees are aware of operational risks and are encouraged to learn from their mistakes.

### **B. Process and Systems**

SFPL's operations are supported by many different systems and processes, such as IT systems, human resource management systems, credit, market, insurance and liquidity risk management systems and even operational risk management systems.

These systems may have many different components, each of which require the operation of various processes. For example, the credit risk management system of SFPL should and does include processes for the identification, measurement, monitoring and control of credit risk. Complex or poorly designed systems and processes can give rise to operational losses, either because they are unfit for the purpose, or because they malfunction. As a result, SFPL may experience a wide range of problems, including settlement-processing errors, fraud and information security failures. In addition, the increasing automation of systems and SFPL's reliance on IT has the potential to transform risks from minor manual processing errors to major systematic failures.

## **External Factors**

### **A. Disruptive Events**

Such events include fire, flooding, earthquakes, terrorist actions, vandalism, power failures, etc. SFPL should assess the occurrence of such potential risks and design and put in place disaster recovery systems and procedures, with a view to ensuring business continuity. Against the monetary loss derived from such events, SFPL should evaluate potential cost and acquire proper insurance.

### **B. Outsourcing of Services**

SFPL may use services of external parties for performing various tasks. Outsourcing arrangements require careful management if they are to yield benefits. If these arrangements are not managed adequately, the degree of operational risk faced by SFPL may increase as is also the institution's dependency upon the use of consultants/third parties for activities that may be more effectively developed internally.

## **Responsibilities of the Stakeholders**

Below mentioned are necessary organisational arrangements for managing operational risks in SFPL in addition to those defined in Risk Management Governance section:

- The Board Risk Management Committee is the board level counterpart for all risk dimensions including operational risk exposures.
- The "three lines of defense" in operational risk are implemented in SFPL by means of:
  - Dual control and staggered approval authorities within the business units i.e. each business unit is headed by department heads who own and manage risks. Within the same business unit hierarchy, there are other levels of staff who play an important role in managing operational risk exposures. In addition, there are divisional offices and branch offices having specific roles and responsibilities under operational risk management.
  - Each department head is often involved in establishing frequent and often real time controls in their operating units at both head office and branch level. The Chief Risk Officer/Advisor also plays an important role in establishing internal controls by acting as in-house consultant across all risk dimensions. Chief Risk Officer/Advisor, who is not a direct part of the operational command chain, will take a critical role at operational exposures by evaluating policies and procedures across different functions from the perspective of risk management.

- Internal audit department serving as the control of controls under a direct mandate from the Board. The scope of internal audit specifically also extends to activities and reports of the MD and to verifying the effectiveness of the operational risk management framework.

## Risk Identification and Measurement

### Risk Control Self Assessments (RCSA)

The objective of RCSA is to discover vulnerabilities and potential exposures to operational risk in a mostly qualitative, forward looking approach. Where possible, RCSAs also attempt to estimate the frequency and loss severity of the potential exposures that have been identified.

### Scope of RCSA

RCSA goes beyond the credit related processes and covers all organisation areas in SFPL:

1. Operations
2. HR
3. IT/MIS
4. Finance & Accounts
5. Legal/Compliance

### Process

The Chief Risk Officer is responsible for initiating the RCSA process every year and documenting the results. RCSA process involves three stages, namely **risk identification**, **risk assessment**, and **control evaluation**.

### Risk Identification

The Chief Risk Officer conducts structured individual discussions with all functional heads, branch managers from sample branches and area managers to identify key operational risks faced by SFPL.

The following is an indicative agenda for discussions:

- Presentation of previous RCSA findings and risk mitigation strategies
- Assess implementation of risk mitigation strategies (as finalised during the senior management team meetings)
- Identify operational risks and inefficiencies faced in different departments
- Understand existing risk mitigation/control strategies
- Identify gaps in the existing control strategies
- Suggest risk mitigation strategies

### Risk Assessment

After the identification of risk, the Chief Risk Officer/Advisor assesses risks, in consultation with functional heads, of likelihood and impact; the scoring will be done on the basis of his experience as also the discussions with functional heads. The Chief Risk Officer/Advisor will use RCSA excel tool designed specifically for this exercise. After scoring on these two parameters, the Chief Risk Officer/Advisor calculates the total Risk Score for each risk by multiplying frequency score with the score for severity. After scoring, the Chief Risk Officer/Advisor maps all operational risks faced by each functional area to determine the top risks faced by SFPL. The outcome of this exercise is shared with all the functional heads for their feedback and comments.

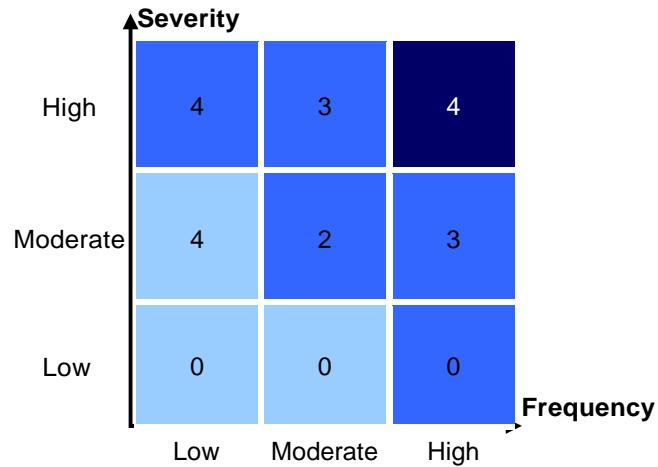
Likelihood/Frequency	Definition	Description
1	Unlikely/Low	The risk is seen as unlikely to occur in the near future (2-3 years). The chances of occurrence of a risk event are less than 0.33 per year (i.e. less than or equal to one event every three years).

2	Likely/Medium	The risk is seen as likely to occur in the near future. The chances of occurrence of a risk event are between 0.33 to 0.66 per year (i.e. more than one event every three years)
3	Certain/High	The risk is expected to occur in the near future. The chances of occurrence of a risk event are greater than 0.66 per year (i.e. equal to one event every three years or more than this).

**Figure 1: GROSS RISK MAPPING (L / M / H)**

Functional Areas	Frequency / Severity of Impact									Total
	L/L	L/M	M/L	L/H	M/M	M/H	H/L	H/M	H/H	
Credit Operations	0	1	0	2	0	1	0	1	3	8
Human Resource Management	0	1	0	1	1	1	0	0	0	4
MIS/IT Risks	0	1	0	1	0	0	0	0	1	3
Accounts	0	1	0	0	1	1	0	2	0	5
<b>Total</b>	<b>0</b>	<b>4</b>	<b>0</b>	<b>4</b>	<b>2</b>	<b>3</b>	<b>0</b>	<b>3</b>	<b>4</b>	<b>20</b>

Impact/Severity	Definition	Description
1	Negligible/Low	The risk will not substantively impact SFPL's operations and will not impede the achievement of business objectives, causing minimal damage to the SFPL's reputation. The impact on SFPL's assets or income from such risk event is less than Rs.1 lakh per year
2	Moderate/Medium	The risk will cause some elements of the business objectives to be delayed or not be achieved, causing potential damage to the SFPL's reputation. The impact on SFPL's assets or income from such risk event is between Rs.1 lakh and Rs.5 lakh per year.
3	Critical/High	The risk will substantively impact SFPL's operations and will cause the business objectives to not be achieved, causing damage to SFPL's reputation. The impact on SFPL's assets or income from such risk event is more than Rs.5 lakh per year.



**Figure 2: Heat Map of Risks**

### Control Evaluation

For each operational risk identified during the RSCA workshop, the Chief Risk Officer/Advisor identifies controls that are in place and can potentially mitigate the risk. This is done on the basis of discussions with the concerned functional heads and details about existing control mechanisms are documented in detail.

After identification of controls, the Chief Risk Officer/Advisor on the basis of discussions with the concerned functional head assesses whether the controls are working as intended and identifies any gaps in control measures. Gaps in control measures are also documented in the RSCA tool. RSCA workshop's participants conduct qualitative assessment of control gaps and proceed to rank residual risk.

### **Residual Risk**

The Chief Risk Officer/Advisor reassesses the identified operational risks, after applying the identified control measures, using the same impact and likelihood scales. After application of the existing control mechanism, the residual levels of risk are rated as High, Medium or Low.

### **Risk Owners**

Each functional head is the risk owner for the identified operational risks related to his functional area or department. For all residual risks in the high or medium categories, the respective risk owners and the Chief Risk Officer/Advisor discuss corrective strategies / risk mitigation strategies (along with the management team) and timelines to address the risks.

### **Monitoring of Control Improvements**

The Chief Risk Officer/Advisor monitors corrective actions taken by the functional heads and analyses if those actions provide the intended results. The Chief Risk Officer/Advisor will also monitor the implementation timeline of the corrective actions.

### **Report Results**

RCSA results are incorporated into quarterly operational risk report. Key findings of RCSA exercise and heat map are shared with Board Risk Management Committee every quarter.

### **Review and Maintenance of Key Risk Indicators**

Effectiveness of key risk indicators and their thresholds levels is done annually. If there are other indicators, which can be measured and recorded and are predictive of risk, the Chief Risk Officer/Advisor may propose the inclusion of these indicators to BRMC for approval. BRMC will discuss and approve threshold levels of different risk indicators on the basis of recommendations made by the management team (functional heads and the MD) and the Chief Risk Officer/Advisor. (Annexure: IV) Following sources of information to identify relevant KRIs for SFPL is normally done.

- Historical internal loss events (Loss event database);
- Risk and Control Self - Assessment (RCSA) results;
- Internal audit findings;
- Regulatory inspection findings; and
- discussions with business functions

The Risk Department will coordinate with different functional heads and ensure that the performance of SFPL is captured on all of these indicators. SFPL's performance on KRIs is shared with the Board every quarter and with the management team (comprising of functional heads, MD, and the Chief Risk Officer/Advisor) during regular meetings at the head office.

### **2.3 Operational Risk Incidents Collection/Loss Event Database**

SFPL will record information pertaining to operational risk incidents in a bid to establish a well-structured database of materialized OR events that have or may eventually lead to an avoidable financial loss or expense. This database will also help in the detection of vulnerabilities and allow SFPL to better target risk management actions that will mitigate operational risk. The Chief Risk Officer/Advisor will be the owner of this database and will be responsible for the integrity and completeness of data. The Chief Risk Officer/Advisor will coordinate with functional heads and the internal audit head to feed data in the tool such that it is updated.

There can be many different types of operational risk events which SFPL can face and all of events will be captured in a loss event database maintained at SFPL. This point is illustrated below in greater detail:

**Losses and near misses:** Some events lead to a financial loss or a gain; other events do not lead to a financial impact. Operational risk events that do not lead to a loss or gain are called "near misses". In other

words, near miss is a risk event where failed or inadequate internal processes, people, system, or external event occurred but it did not result in a direct or indirect impact on the organization. Recording of near miss events gives important information for risk management purposes. Both financial loss events and near gains and misses within SFPL are recorded in the database.

**Open and closed events:** Both open (those cases that are yet to materialize or partially materialized) and closed events (events already materialized) are recorded in the database.

**Reporting threshold:** SFPL has not defined any threshold limit (concerning the loss amount) to be used in reporting risk incidents to a loss event database. BRMC allows the management team to apply a meaningful reporting threshold to avoid recording small losses, while maintaining the benefits of the database.

## 2.4 Operational Risks Faced by SFPL

Operational Risk Category	Operational Risks
<b>People and Business Processes</b>	<ul style="list-style-type: none"> <li>• Staff fraud</li> <li>• Key man risk</li> <li>• High staff turnover</li> <li>• Multiple lending to same client</li> <li>• Low capability of staff</li> <li>• Inadequate functionality – supporting software</li> <li>• High client dropout rate</li> </ul>
<b>IT/Systems</b>	<ul style="list-style-type: none"> <li>• Version archiving system not in place</li> <li>• Inadequate systems for data security</li> <li>• System breakdown</li> <li>• IT infrastructure not aligned to business needs</li> <li>• Inadequate systems and processes for vendor management</li> <li>• IT policy not updated</li> <li>• Insufficient/ untested business continuity processes</li> <li>• Outsourcing risk</li> <li>• Inadequate systems for backup of data</li> </ul>
<b>External Events</b>	<ul style="list-style-type: none"> <li>• Third party provider failure – other</li> <li>• Natural disaster</li> <li>• Power outage</li> <li>• War and social unrest</li> <li>• External theft or fraud</li> <li>• Competition</li> <li>• Regulatory changes</li> </ul>

## Risk Reporting and Monitoring

<b>Report Type/Report Content</b>	<b>Frequency</b>	<b>Audience</b>	<b>Responsible Person</b>	<b>Source of Data</b>
<p>Details on Key Risk Indicators:</p> <ul style="list-style-type: none"> <li>Quantitative data on key risk indicators (tables, time series, targets and benchmarks for selected key risk indicators)</li> </ul>	Monthly and Half Yearly	<ul style="list-style-type: none"> <li>MD, Group Lending Head, Individual Lending Head, Chief Risk Officer/Advisor, IA Head, Legal and Secretarial Head, HR Head (Monthly)</li> <li>Board Risk Management Committee (Half Yearly)</li> </ul>	Chief Risk Officer/Advisor (with the support of functional heads)	MIS, HRIS, Grievance Cell, IA Reports
<p>Loss Event Database Summary:</p> <ul style="list-style-type: none"> <li>Materialised losses per category for the reporting period or time series of materialised losses per category</li> </ul>	Monthly and Quarterly	<ul style="list-style-type: none"> <li>MD, Group Lending Head, Individual Lending Head, Chief Risk Officer/Advisor, IA Head, Legal and Secretarial Head, HR Head (Monthly)</li> <li>Board Risk Management Committee (Quarterly)</li> </ul>	Chief Risk Officer/Advisor	Loss Event Database
<p>RCSA Summary</p> <ul style="list-style-type: none"> <li>Findings from RCSA</li> <li>Heat map</li> </ul>	Monthly and Half Yearly	<ul style="list-style-type: none"> <li>MD, Group Lending Head, Individual Lending Head, Chief Risk Officer/Advisor, IA Head, Legal and Secretarial Head, HR Head (Monthly)</li> <li>Board Risk Management Committee (Half Yearly)</li> </ul>	Chief Risk Officer/Advisor	RCSA Template

Written comments about the progress in business operations. Note: In this report, the Risk Manager/Advisor will highlight noteworthy incidents, give progress updates on high profile cases and offer explanations on outliers and unusual situations	Quarterly	• Board Risk Management Committee (Quarterly)	Chief Risk Officer/Advisor	Internal audit reports, minutes of monthly meetings
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Chief Risk Officer/Advisor will be reporting to the Board Risk Management Committee on a regular interval. These reports will include quantitative data on key risk indicators (tables, time series, targets and benchmarks for selected key risk indicators) and summary from loss event database (this will primarily include materialised losses per category for the reporting period or time series of materialised losses per category). In addition, heat map chart along with findings of latest RCSA exercise will also be shared with the BRMC. Wherever possible, the Chief Risk Officer/Advisor will include industry benchmarks/peer institution benchmarks on KRIs and operational risk losses.

In the reporting pack for BRMC, the Chief Risk Officer/Advisor will highlight noteworthy incidents, give progress updates on high profile cases and offer explanations on outliers and unusual situations.

### **Outsourcing of Operational Processes**

This section contains guidelines with regard to outsourcing arrangements entered into by SFPL (for outsourcing of key operational processes) with a service provider located in India or elsewhere. SFPL will ensure that outsourcing arrangements do not affect its ability to fulfil its obligations towards the clients and major stakeholders like investors, funders and regulators.

SFPL will not engage in outsourcing that will result in its internal control, business conduct or reputation being compromised or weakened. SFPL will not engage with any service provider which is owned or controlled by any director or employee of SFPL or their relatives having the same meaning as mentioned under Section 2(77) and draft rules notified on 09.09.2013 with reference to Section 2(77) (iii) of the Companies Act, 2013.

### **Type of Activities that can be Out-sourced**

SFPL will not outsource core management functions including Internal Audit, Compliance function and decision-making functions like determining compliance with KYC norms, loan approval processes and delinquency management. Outsourced activities may include processing of loan applications, marketing, research, data processing and other back office related activities.

### **The Outsourcing Agreement**

The terms and conditions governing the contract between SFPL and the service provider should be carefully defined in written agreements and vetted by SFPL's legal and secretarial department on their legal effect and enforceability. Every such agreement should address the risks and risk mitigation strategies. The agreement should be sufficiently flexible to allow SFPL to retain an appropriate level of control over outsourcing and the right to intervene with appropriate measures to meet legal and regulatory obligations. Some of the key provisions of the contract that SFPL's legal expert should ensure are as follows:

- i. The contract should clearly define activities which will be outsourced including appropriate service and performance standards;
- ii. SFPL has the ability to access all books, records and information, relevant to the outsourced activity, available with the service provider;
- iii. The contract should provide for continuous monitoring and assessment by SFPL of the service provider so that corrective measure can be taken immediately;
- iv. A termination clause and minimum period to execute a termination provision, if deemed necessary should be included;
- v. Controls to ensure customer data confidentiality and service provider's liability in case of breach of security and leakage of confidential customer related information should be incorporated;
- vi. There must be contingency plans to ensure business continuity;
- vii. The contract should provide for the prior approval/consent by SFPL of the use of subcontractors by the service provider for all or few parts of an outsourced activity;
- viii. The contract should provide SFPL with the right to conduct audit on the service provider whether by its internal or external auditors, or by agents appointed to act on its behalf and to obtain necessary documents such as copies of any audit or review reports and findings made on the service provider in conjunction with the services performed for SFPL;
- ix. Outsourcing agreements should include clauses to allow the Reserve Bank of India or persons authorised by it to access documents, records of transactions, and other necessary information given to store or process from the service provider within a reasonable time.
- x. The outsourcing agreement should also provide that confidentiality of customer's information should be maintained even after the contract expires or gets terminated.
- xi. The outsourcing agreement should provide for the preservation of documents and data by the service provider in accordance with the legal/regulatory obligation of SFPL in this regard.

## **Approval of Outsourcing Contracts**

The head of legal and secretarial department should prepare a note for consideration by the Board for the outsourcing plan. This note will specify rationale, quality and reputation of the vendor, cost implications and potential risks in outsourcing. The Risk department will provide his/her comments on this note. Final approval to outsource a key process will only be done by the Board of SFPL.

## **Outsourcing Due Diligence**

While considering or renewing an outsourcing arrangement, appropriate due diligence should be performed by the concerned department and the Chief Risk Officer/Advisor to assess the capability of the service provider to comply with obligations in the outsourcing agreement. Due diligence should take into consideration qualitative and quantitative, financial, operational and reputational factors. The concerned department and the Chief Risk Officer/Advisor should consider whether the service providers' systems are compatible with SFPL's systems and also whether their standards of performance including in the area of customer service are acceptable to it. SFPL will ensure that there is no undue concentration of outsourcing arrangements with a single service provider. SFPL will also obtain independent reviews and market feedback on the service provider.

Due diligence of the service provider will involve an evaluation of all available information about the service provider, including but not limited to:

1. Past experience and competence to implement and support the proposed activity over the contracted period;
2. Financial soundness and ability to service commitments even under adverse conditions;
3. Business reputation and culture, compliance, complaints and outstanding or potential litigation;
4. Security and internal control, audit coverage, reporting and monitoring environment, business continuity management;

## **Outsourcing Risk Management**

### ***Role of the Board***

The Board of SFPL is responsible for the following:

- i. Approving a framework to evaluate the risks and materiality of all existing and prospective outsourcing arrangements and the policies that apply to such arrangements;
- ii. Lay down appropriate approval authorities for executing outsourcing arrangements depending on risks and materiality.
- iii. Undertaking regular review of outsourcing strategies and arrangements for their continued relevance, and safety and soundness and
- iv. Deciding on business activities of a material nature to be outsourced, and approving such arrangements.

### ***Responsibilities of Functional Heads***

- v. Developing and implementing sound and prudent outsourcing policies and procedures commensurate with the nature, scope and complexity of the outsourcing activity;
- vi. Ensuring that there is independent review and audit for compliance with set policies.

### ***Responsibilities of the Chief Risk Officer/Advisor***

- vii. Evaluating the risks and materiality of all existing and prospective outsourcing, based on the framework approved by the Board;
- viii. Reviewing periodically the effectiveness of outsourcing related policies and procedures;
- ix. Communicating information pertaining to outsourcing risks to the Board every quarter
- x. Ensuring that contingency plans are in place and tested;
- xi. Undertaking periodic review of outsourcing arrangements to identify new material outsourcing risks as they arise

## **Review and Monitoring of Outsourcing**

SFPL will ensure that outsourcing agreements with the service provider contain provisions required to address their monitoring and control of outsourced activities. A central record of all material outsourcing that is readily accessible for review by the Board and senior management of SFPL is maintained.

Regular audits by either the internal auditors of SFPL or external auditors as approved by the Board assesses the adequacy of the risk management practices with regards to supervising outsourcing arrangements and SFPL's compliance with its risk management framework.

SFPL on an annual basis, reviews the financial and operational condition of the service provider to assess its ability to continue to meet its outsourcing obligations. These due diligence reviews, based on all available information about the service provider, highlight any deterioration or breach in performance standards, confidentiality and security, and in business continuity preparedness. In the event of termination of the agreement for any reason, it is publicised so as to ensure that clients and internal stakeholders of SFPL do not continue to entertain the service provider.

### **Role of Chief Risk Officer/Advisor, Board of Directors and the Senior Management Team**

SFPL's Board has the ultimate responsibility and oversight over BCP activity of SFPL. The Board approves the Business Continuity Plan of SFPL.

The Chief Risk Officer/Advisor of SFPL is responsible for:

- Determining how SFPL will manage and control identified risks
- Review the adequacy of the institution's business recovery, contingency plans and the test results and put up the same to the Board on an annual basis
- Ensuring that the BCP is regularly tested on an enterprise-wide basis
- Reviewing the BCP testing programme and test results on a regular basis and
- Ensuring the BCP is continually updated to reflect the current operating environment

The Management team is responsible for overseeing the BCP process which includes:

- Allocating knowledgeable personnel and sufficient financial resources to implement the BCP
- Prioritizing critical business functions
- Ensuring that the BCP is independently reviewed and approved, at least annually;
- Ensuring employees are trained and aware of their roles in the implementation of the BCP

## **Approval of New Products and Processes**

SFPL adheres to the following process for approval of new products/markets/processes:

1. Concerned risk owner (department or unit) prepares a note on the risks associated with the introduction of new product/market/process along with control measures to mitigate risks. Risk owner shares this note on risks along with control measures with the Chief Risk Officer/Advisor of SFPL
2. The Chief Risk Officer/Advisor will carry out an independent operational risk evaluation. He will consult the head of Resources Head and MIS/IT to ensure that the necessary human resources and technology are in place before the new product/processes are introduced or a new market is opened up. The Chief Risk Officer/Advisor during his assessment should evaluate the following:
  - Risk impact of the new product/market/process
  - The new product/process is in compliance with all relevant RBI guidelines for NBFC-MFIs, and
  - Assess risk interactions with existing products and markets that may only become apparent once the new product or service are fully scaled up.
3. The Chief Risk Officer/Advisor will present the findings of the evaluation to the Board for approval
4. The Managing Director will be the final authority to approve the introduction of new products/markets.

### **Annexure I: PAR THRESHOLD INDICATORS**

Loan disbursed in last one year:

<b>Risk Indicators</b>	<b>Exposure Limits</b>
PAR>30 days	<=5.00%
PAR>60 days	<=3.00%
PAR>90 days	<=2.00%

<b>Risk Indicators</b>	<b>Exposure Limits</b>
PAR>30 days per branch	<=4.00%
PAR>30 per loan officer	<=4.00%
PAR>30 days per loan product	<=4.00%
PAR>30 days per region (district in this case)	<=5.00%

**Annexure II: FINANCIAL RATIOS & THRESHOLDS**

Ratio	Institutional Threshold
Liquid Assets Ratio= Liquid Assets/Total Assets  Liquid Assets consist of cash assets plus other liquid assets such as current account balances, investment in liquid mutual funds and bank fixed deposits (which can be converted into cash in a maximum of T+30day) that can readily be converted into cash with negligible price depreciation.	10-20%
Capacity Ratio=Net Loans/Total Assets  Net loans are defined as total gross loans minus the accumulated loan loss reserve.  Capacity Ratio indicates the extent to which an institution is already loaned-up, a higher Capacity Ratio points to lower liquid assets and higher liquidity risk.	60-70%
Purchased Funds Ratio=Short-Term Borrowings/Total Assets  Purchased funds are short-term wholesale borrowing instruments such as overdrafts which have tenure of below 1 year  Purchased funds are hot money that must be used sparingly and should generally not fund long-term illiquid assets such as the microfinance loan portfolio.  Recourse to purchased funds should not exceed 15% of total assets	0.5%-1%
Debt to Equity Ratio  The Board has fixed this ratio and this will be reviewed annually.	<b>6:1</b>

### **ANNEXURE III: PORTFOLIO CONCENTRATION LIMITS**

<b>Indicators</b>	<b>Limits</b>
<b><i>Geographical Concentration</i></b>	
Portfolio per State	<=50%
Portfolio per District	<=8%
Portfolio per Branch	<=Rs.5 crores
<b><i>Line of Business/Product Concentration</i></b>	
Microfinance Loan	>= 75%
Non- Microfinance Loan	<=25%
<b>Exposures</b>	
Exposure to single borrower	<=5 Lacs (here employees should not be included in the definition of borrower)

### **RISK TOLERANCE LEVELS**

The following table indicates the Risk tolerance level of the Loan portfolio disbursed in last one year:

<b>Indicator</b>	<b>Tolerance Level</b>
PAR>30 days	<=10%
PAR>60 days	<=7.5%
PAR>90 days	<=5.00%
PAR>30 days per branch	<=2%
PAR>30 per loan officer	<=3%
PAR>30 days per region (district in this case)	<=2 %
Loan loss provision expense ratio (loan loss provision expense is divided by average gross loan portfolio)	>=1% and <=2%
Loan loss provision expense/ ( PAR>=90 days)	>= 50%
No of times joint liability is invoked in a group	<=2 times
Rescheduled loans	<0.25%
Write off ratio	<=0.5%

#### **Annexure IV: KEY RISK INDICATOR**

S. No.	Functional Area/Department	Indicators	Thresholds	Data Source	Frequency
1	<b>Operational Risk</b>  <b>Human Resource</b>	Staff turnover at the branch level (Confirmed operation's staffs)	<=10%	HRIS, Human Resource Department	Quarterly
2		Staff turnover at the middle management level (up to DVP & department head)	<=10%	HRIS, Human Resource Department	Quarterly
3		Staff turnover at the senior management level	<=10%	HRIS, Human Resource Department	Quarterly
4		No. of disciplinary cases excluding fraud	0	HRIS, Human Resource Department	Quarterly
5		No. of staff with unsatisfactory or lower performance reviews	<=10%	HRIS, Human Resource Department	Quarterly
6		No. of staff complaints unresolved	0	HRIS, Human Resource Department	Quarterly
7		No. of incidents of staff fraud	0	HRIS, Human Resource Department	Quarterly
8		No. of clients' complaints against staff	0	HRIS, Human Resource Department /Grievance Cell	Quarterly
9		No. of work-related accidents or injuries	0	HRIS, Human Resource Department	Quarterly
10	<b>Credit Risk</b>	No. of clients with multiple loans from more than two other MFIs	0	Internal Audit Summary Report	Quarterly
11		% of unsatisfactory CGTs/GRTs/LU Cs following internal audit reviews (% within the audited sample)	<=10	Internal Audit Summary Report	Quarterly
12		No. of unauthorised agents' incidents	0	Internal Audit Summary Report	Quarterly
13		No. of ghost borrowers	0	Internal Audit Summary Report	Quarterly
14		No. of critical errors detected in credit files	0	Internal Audit Summary Report	Quarterly

S. No.	Functional Area/Department	Indicators	Thresholds	Data Source	Frequency
15		No. of incidents of staff override credit bureau reports per branch	0	Internal Audit reports for branches	Quarterly
16	Operational Risk	Cash held in excess of operational limit	<=3	Accounts/MIS	Monthly
		No. of client complaints unresolved	<=50	Grievance Cell	Quarterly
		No. of unresolved client complaints within 7 days of registering	<=10	Grievance Cell	Weekly
		No of fraudulent transactions	0	HRIS, Human Resource Department, Internal Audit Summary Report	Quarterly
		No of cash shortfall incidents	0	Internal Audit Summary Report, Accounts Department	Quarterly
		No of procedural non-compliance identified in audit report per branch/department	<=5	Internal Audit Department – Audit report for branches and Audit report of HO	Quarterly
		Non-compliance of internal audit/ control observations per branch	<=5	Internal Audit reports for branches	Quarterly
17	Operational Risk	No. of software upgrade and releases	100%	Developer team of IT	Quarterly
18		No. of business requirements received for integration into system	0	IT Department	Quarterly
19		No. of IT Audit	1	IT Department	Yearly
20		No. of pending AMC contracts for renewal	0	IT Department/Contract Manager at SFPL	Quarterly
21		No. of incidents system downtime	<=3	IT Department	Quarterly
22		Average length of system breakdown	<=2 hours	IT Department	Quarterly
23		No of user credential resets	<=10	IT Department	Quarterly
24		No. of pending unresolved tickets	<=3	IT Department	Quarterly

S. No.	Functional Area/Department		Indicators	Thresholds	Data Source	Frequency
25	<b>Regulatory Legal Risk</b>	<b>Compliance</b>	No. of financial penalties by regulator for non-compliance	0	Company Secretary	Quarterly
26			No. of regulatory citations /sanctions for non-compliance	0	Company Secretary	Quarterly
27			No. of business relationship and transactions with non-tax compliant suppliers	0	Company Secretary	Quarterly
28	<b>Operational Risk</b>	<b>Administration</b>	No. of instances of irregularities in purchases made by the company	0	Audit Reports	Quarterly
29	<b>Operational Risk</b>	<b>Finance &amp; Accounting</b>	No. of missed monthly closing deadlines	0	Accounting Team, IT Team	Quarterly
31			No. of journal voucher reversals and adjustments	<=5	Accounting Team, IT Team	Quarterly

## ANNEXURE V-EXPLANATION OF LOSS EVENT DATABASE

### **List of data fields in the database**

The following data fields are maintained in a manual database using an excel spreadsheet. In this spreadsheet, one incident is one record in the database and represented by one line. In the near future, SFPL will aim to automate this database in its existing information system:

- 1. ID:** A unique id is given to risk incidents. In the information system, this id will be auto generated.
- 2. Date Case Opened:** Refers to the date that the event was declared discovered and open
- 3. Initial Capture By:** Staff code who captured the even in the database
- 4. Date Case Accepted/Rejected by Risk Management:** Refers to the date on which the event was accepted or rejected by the risk management team to be put in the database.
- 5. Case Accepted-Rejected by (Staff Code):** The Chief Risk Officer/Advisor of SFPL will assign the risk event to the concerned staff who will take the final decision on acceptance or rejection of the case.
- 6. Case Accept-Reject Decision:** In this column, the final decision regarding the acceptance and rejection of the case is mentioned. The data owner must review new cases and make sure that those cases are relevant and bonafide cases and not duplicates or aborted entries.
- 7. Case Status:** This column indicates whether the loss is related to an open event, or whether the event is closed.
- 8. Assigned to: Staff Code:** In this column, the person who accepted the case, may assign (depending upon the situation) it further to the staff who will be responsible for follow up.
- 9. Next Diary Date:** Follow up date for the case is recorded in this column
- 10. Next Diary Date Memo:** In this column, subjective remarks may be mentioned with respect to the next follow up date.
- 11. Reference Type:** In this column, event's type of reference is mentioned such as loan id, client id, etc.
- 12. Reference No / Code:** Serial number or unique code of the reference type is mentioned.
- 13.** In cross references, there are 4 columns in which the user can out case ids of those incidents which are related to the one being entered.
- 14.** In **standard industry classification**, column Event type level I represents the 7 Basel II level 1 event type categories set by the Bank for International Settlements. The event type provides a classification for the risk event that caused the loss. Event type level II: Represents the Basel II level 2 event type categories
- 15. Organizational unit:** In this column, the user can select the name of department or mention branch code where the incident took place.
- 16. Credit Process Related Incidents:** Since most frequent incidents are typically related to the credit process, the database contains number of self-explanatory granular classifications for operational risk incidents
- 17. Other Events:** This column simply provides the free format description and follow up log for all other events, which are not related to the credit process. Authorized users capture their notes and comments in chronological order.
- 18. Loss Outcome:** This section applies to all types of events, credit -related or not. There are various status indicators captured in this section such as loss status (initial versus materialized), loss classification, gross loss and recovered amount. SFPL also captures the soft loss assessment of the risk incident, which is essentially reputational damage caused by the incident or a group of related incidents.

The tool is designed in such a manner that common and frequent irregularities are provided as drop down choices. Incident data can be updated using internal audit findings, monitoring reports submitted by the supervisors, client grievance system, and all of the functional departments of SFPL. Chief Risk Officer/Advisor will be the data owner of this database and has the widest scope of user rights who may create, edit, annotate, assign, and delete cases as necessary. The management team (MD and all functional heads) and

internal audit will have view rights on all records in the database. Functional Heads may view all cases that relate to their business units or that have been assigned to them for further action by the database owner.

## **ANNEXURE-VI – FOREX RISK MANAGEMENT POLICY**

### **Preamble**

- **Scope:** This policy forms part of Risk Policy of SFPL.
- The policy covers the risk management of Forex Exposure that the company is exposed to owing to the volatility in the currency market and global interest rates and stipulate appropriate control parameters & MIS reporting for the forex Risk management function.
- **Purpose:** This policy will act as a framework and enable SFPL to meet the necessary regulatory requirements of RBI and will help in mitigating risk arising out of foreign currency borrowings

This document is intended for the following:

**The Board and the Chairman:** As an aid for effective control over the currency risk management activities and for Corporate Governance purposes.

**Directors, Chief Financial Officer:** As a basis for discussion and review of operational activities and performance of the currency risk management function.

**Treasury and related personnel:** To provide the operating ground rules for currency risk management function and timely reporting of Currency exposures to treasury desk for further process.

### **Use of the Policy Document**

1. This Document is strictly confidential for the use of SFPL.
2. Guidelines on risk identification, measurement & Control
3. Guidelines & procedure to be followed with respect to revaluation & monitoring of positions
4. Designation of officials authorized to undertake transactions & limits per transaction assigned to them & a requirement that the assignment of limits to an official would be on per transaction basis
5. Accounting policy & disclosure norms to be followed in respect of derivative transactions
6. A requirement to disclose the MTM valuations appropriately
7. Mechanism regarding reporting of data to the Board including financial position of transaction etc.

### **Forex Exposure Classification**

- SFPL is exposed to forex exchange rate risk up to the extent of borrowings from abroad in foreign currency& to be repaid in due course of time.
- As the repayment is to be made in instalments at fixed periods or fully at the end of tenure, to manage the impact on financials of SFPL & ensure its competitiveness, exchange rate risk need to be covered.

### **1. Objectives of Risk Management**

SFPL Risk Management philosophy would be risk mitigation through a policy of “*Selective Hedging*” of exposures. The objectives of the Board in laying down policy with respect to Management of Currency risks would be:

1. To reduce the cost of funding by raising funds in foreign currency, when advantageous, or use other approved instruments to achieve the same objective.
2. To manage risks to the budgeted costs and revenues from the adverse impact of currency fluctuations.
3. To reduce the Rupee cost of the Company's foreign currency payables by selective hedging of exposures.
4. To achieve results better than what would result from a passive, automatic 100% hedge policy.
5. To reduce transaction costs and bank exchange margins to bare minimum at the company level, across all business units, through effective negotiation with banks.

## **2. Management of Exposure:**

### Management of exposures on a Net basis vs. Gross basis

By and large, exposures at SFPL shall be managed on a Gross Basis, However, the exceptional un-hedged positions can be managed on spot basis to minimize the transaction cost.

### Management of exposures on a Portfolio vs. Individual Contract basis

Wherever required the Finance Department will Monitor and Manage currency exposures on transaction basis and take the hedging instruments for the same will be done on an Individual Contract basis. However, where a number of transactions are to be taken simultaneously, management may consider hedging instruments on Portfolio basis (bulk cover would be taken and individual exposures would be allocated to the cover), so as to derive the benefit of economies of scale.

## **3. Recognition of Exposure:**

SFPL shall recognize the currency risk associated with borrowing (debt/equity) on the date of receipt of funds.

## **4. Benchmarking of Exposure:**

### **Introduction:**

Benchmarking could be defined as setting the target exchange rate for transactions. This will be the spot rate on the date of receipt of funds and premium prevailing till the time of payment as without proper benchmarking, it becomes very difficult to evaluate the performance of the risk management process. The main task in the process of benchmarking is to decide upon the target rates to be achieved on exposures.

For the purpose of currency risk management SFPL shall consider the First Day Forward Rate (FDFR) from the date of receipt of funds till date of payment as the benchmark rate for exposures. Benchmark rate will be basis for all costing purpose. This will factor the number of days from the receipt of fund & period till date of payment.

### **a. Coverage:**

SFPL will have discretion to fix the minimum exposure which needs to be covered at any point of time. Core cover could be defined in two manners. It could either be placed in terms of number of day exposure or as a percentage of total exposure.

**SFPL** will make efforts to keep at least 70 % of its current exposure always covered.

## **Authorized Instruments**

The risk management policy authorizes SFPL to use the following tools to hedge their currency risk on trade exposures:

1. **Forwards:** Forward contracts can be booked for a fixed date or PUT or OPTION period. Cover can be rolled over in case of deferral of payment, the contract has to be booked based on recommendation of Banker /Consultant.
2. **Foreign Exchange, Cash, Tom, spot and Currency swaps including cross currency swaps.**
  - a. The maturity of the hedge shall not exceed the maturity of the underlying transactions
  - b. **SFPL** shall take most competitive quotes from Banks of which one should be a PSU Bank to earn the best deal. However, taking quote from PSU Bank shall be taken as a matter of strategy and not as a rule. A Comparative Summary of quotes taken from the Banks need to be maintained to ensure complete transparency in deals before finalizing any hedging transaction
  - c. **SFPL** shall not execute exotic derivative products which are disallowed / not allowed by RBI to hedge its Forex risks. Each & every forex hedge must comply with RBI directions.
  - d. **SFPL shall** be open to usage of new derivative products available in the market provided for hedging its trade exposure provided that such a product is hedge compliant as per RBI directives. *Further, such usage of new derivative product shall be subject to a prior approval by the Board of Directors / Risk Management Committee (RMC).*
  - e. *It shall be permissible for SFPL to have cross currency hedge, i.e. hedge currency may be different from the currency of exposure.*

## **B) Authorized Personnel and limits:**

1. The execution of hedge shall be done by the officers authorized by the board.
2. In order to ensure authority / responsibility, criteria need to be adhered to in execution of transactions, specific limits have been assigned to various persons. To maintain a balance between autonomy and controls, appropriate authority is given in the matrix below so that no person at any point of time, whether knowingly or unknowingly, exceeds his / their authority. For this purpose, authorization levels for various actions carried out by the concerned personnel are predefined as follows:

Sr.	Designation	Tenor	Instrument-wise Authorize Limit			Total Limit (\$)
			(in \$ million)			
1	Finance Head	Up to year3**	Fwd.	Fut.	opt	Upto 10 Mn
2	Chief Financial Officer (CFO)	Up to years 5**				Upto 15Mn.
3	Managing Director (MD)/ RMC	Up to years 5**				Upto 30 Mn.

\*\* The limits mentioned in the above table are indicative and may be reviewed and changed periodically.

- the signing of the transaction as per the above table would be valid only when both the conditions of Tenor and Amount are satisfied simultaneously.

### **Other Guidelines:**

No derivative structure can be entered into unless an appropriate Board / Committee resolution has been passed. The Board / Committee resolution, amongst other things, shall:

- be signed by a person, other than the persons, authorized to undertake the transactions;
- be specific and should articulate specific products, amount and tenor that can be transacted;
- also mention the person(s) authorized to sign the ISDA and similar agreements; other documents.
- Explicitly mention the limits assigned to a particular person; and specify the names of the people to whom transactions should be reported by the bank. These personnel should be distinct from those authorized to undertake the transactions.

Further, SFPL will ensure the following:

- The maturity of the hedge should not exceed the maturity of the underlying transaction
- The facility of *cancellation and rebooking* for current account transactions and capital account transactions *within 1 year* would not be permitted unless the exposure information, as prescribed by the bank, is submitted.
- The notional principal amount of the swap should not exceed the outstanding amount of the underlying loan.

### **Role Identification**

For ensuring the effectiveness from control perspective of the risk management process, the finance department shall undertake the following functions:

- a) Track exchange Rate Movements
- b) Analyse the micro and macro factors affecting the markets
- c) Monitor exposures in light of market dynamics
- d) Hedge Exposures within the ambit of the provisions laid down in this document.
- e) Execution of decisions laid down as per the defined take profit and stop loss levels for open positions.
- f) Analyse structures with appropriate risk reward and internal suitability by getting quotes from at least two Banks.
- g) Track Regulatory changes and incorporate the same
- h) Recording of deals executed
- i) Reconciliation of deals executed
- j) Monitoring of MTM positions and reporting the same to various levels of Management at pre-defined intervals

### **Monitoring, Reporting & Control**

#### **Monitoring & Revaluation:**

Monitoring of the hedged positions would be done on an ongoing basis. Once the hedge is initiated the same would be monitored based on **MTM** valuations given by the bank or by any reputed independent valuer. Every hedged transaction undertaken by **SFPL** would be monitored on a monthly basis for MTM obligations. In case of any exceptional volatility resulting in an **MTM** movement by over 5% on a period on period basis, it would necessitate closer monitoring of the transaction and **MTM** valuation on a monthly basis. **Certified MTM Statement** of all hedged transactions undertaken would be reviewed by the CFO

once every month. Such a Certified MTM statement may be obtained from any independent agency as approved by the Board of Directors / RMC

### **Reporting & Control:**

A system of enforcing checks and controls on the risk management process are essential to ensure the continuing success of the treasury function. The first step towards the same would be to set up a Forex Risk Management Committee (FRMC).

#### **a) Forex Risk Management Committee**

A Forex Risk Management Committee may be set up for reviewing the treasury and forex operations. The members should be distinct from those authorized to undertake the transactions.

The suggested composition of the Forex Risk Management Committee (FRMC) is as follows: -

- Chief Financial Officer
- Chief Finance Advisor
- Chief Risk Advisor
- Chief Account Controller

This committee may also include any other management personnel whom the top management will nominate for this purpose.

This committee would be formed with the following objectives:

- Review exposure statements/ MTM valuations.
- Review Stop Loss levels and Take Profit Levels.
- Review Core Cover strategy.
- Authorize new instruments/products to be used for hedging.
- Review the authorized limits/ the levels for which specific authorizations would be mandatory.

**b) Since, at present, not much forex exposure is projected / expected, the FRMC may meet on a need to meet basis.**

#### **c) Exception Reporting**

The finance personnel would be required to report to FRMC in case of any substantial divergence in the aforementioned MTM positions. Further, non-adherence with respect to any terms mentioned in the policy will also be reported to the CFO.

### **Accounting Treatment & Disclosure:**

As per the Companies Act, 2013 and with reference to various guidelines issued by RBI from time to time, the company is required to follow the Indian accounting standards issued by ICAI and accordingly due disclosures to be made in accounts.

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