SONATA Finance Private Limited

Business Model Policy

Version	Date of Approval / Review
V.1	24-10-2020
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V.4	30-05-2023

Preamble

The Board of Directors **(the "Board")** of **Sonata Finance Pvt. Ltd. (the "Company" or "Sonata"),** has adopted the Business Model for classification of financial assets and restriction on subsequent reclassification of the same. The policy has been framed following notification of the Ministry of Corporate Affairs (MCA) dated 18th January 2016 and complied with the requirements enumerated in IND AS 109- Financial Instruments and notification DOR (NBFC).CC.PD. No.109/22.10.106/2019-20 of Reserve Bank of India requiring the company to change from Indian Generally Accepted Accounting Principal (IGAAP) to Indian Accounting Standard (Ind AS) effective from April 1, 2018 i.e. the date of transition to Ind AS.

Purpose

The purpose of this business model assessment policy is to reflect the grouping of the financial assets and liabilities in line with the business objective of the Company. Based on the business models assessment in light of the IND AS 109, the accounting policies are adopted for reflection of fair and transparent financial position of the Company.

Company's Overview

The Company is engaged in providing financial services to economically weaker section of the society. The Company offers various financial products viz. credit and insurance in partnership with various financial institutions. Credit is extended to increase the household income by way of loan for various business activities, including trading, manufacturing , agri and agri allied activities. Company also caters to critical household need which require uplifting the socio economic status of the customers. The Company offers following loan products at present:

1. **Income Generating Loans**: The Company primarily objective is to increase household income by way of encouraging income generating activities in the household. Company extends income generating loans to set up new business or expand existing business. These loans are given through Joint Liability Groups or Individual lending models.
2. **Home improvement/sanitation Loans**: Objective of this product is to improve the social and health status of the customers by way giving them loan for house repair, toilet construction and arranging water facility in or near their house.

3. **Medium Enterprise loans**: This loan is designed to help our customers who want to graduate from micro to medium size enterprise by way of expanding their existing business or add new product line to their existing business.

Business Model Analysis

The Loans disbursed are primarily funded through equity or borrowings from banks/NBFCs/financial institutions/foreign financial institutions etc.. The Company services the repayment of the borrowings from the installments collected from the loans on-lent to the Company's end customers.

The Company holds the portfolio assets and collects the entire contractual cash flows throughout the life of the loan assets, i.e., the cash flows are generated on specified dates and comprises solely payment of Principal and Interest (SPPI) on the principal outstanding. The typical characteristic of contractual cash flow and test of the same is as under:

CONTRACTUAL CASH FLOWS CHARACTERISTICS TEST- SOLELY PAYMENT OF PRINCIPAL AND INTEREST ('SPPI') TEST:

- Contractual cash flows that are SPPI are consistent with a basic lending arrangement
- Principal is the fair value of the financial asset at initial recognition – principal amount may change over the life of the financial asset (for example, if there are repayments of principal)
- Interest elements – consideration consistent with basic lending arrangement:
  - time value of money
  - credit risk
  - other basic lending risks (example, liquidity risk)
  - costs associated with holding the financial asset for a particular period of time
  - profit margin that is consistent with a basic lending arrangement
- Assessment done in the currency in which financial asset is denominated

The Company is working in a dynamic micro and macro-economic environment and the cost of fund keeps changing and at times the Company in order to curtail high cost of funding or for creating liquidity enters into other funding arrangements like Securitization/direct assignments which is selling the portfolio generated by the company. This creates liquidity for the company as well it helps in mitigating the threat of increased cost of funds.

In case of Securitization, the Company sells the portfolio generated out of own fund and offers collateral in the form of fixed deposit in addition to certain percentage of book debt . The Company carries risk of default, to the extent of collateral given to securitized partner. Securitized portfolio does not meet the derecognition criteria as specified under Ind AS 109 and

hence the portfolio is not derecognized from the booksof account.

In case of direct assignment, the Company does not carry any risk after selling off the loan portfolio. Direct assignment transactions are not entered into frequently and the Company in principle doesnot prefer doing direct assignment transactions.

Future cash flow model of the Company also does not include any cash flows arising from direct assignment transactions. In either of the two cases the Company continues to collect cash from the respective portfolio sold and remit the same to the trustee of the portfolio buying partners without any delay, Trustee then remits the money to the partner and the company in defined proportion.

In addition to this, the Company is also engaged as business correspondent to various banks to extend microfinance loans on their behalf. Amounts received from the bank are disbursed to the customers organized in joint-liability groups. The loan portfolio is reflected in the books of the bank, and the Company provides services such as recovery and monitoring of the loans.

The Company has provided collaterals in the form of fixed deposits & corporate guarantee, company shares the default risk to an extent of the given collateral..

The Company also invests surplus money in mutual funds and term deposits to earn interest on idle funds.

Accounting of the above financial products and investments along with rationale held by the Company is as under:

Nature of the Product	**Objective of the Company**	**Treatment**	**Business model test/Contractual cashflow test**
Income generating portfolio / Other loans.	To collect contractual cash flows for servicing of debt obligation and ensuring better returns to share holders	Financial assets are *measured at amortized cost* using the effective interest Rate (EIR) method less impairment loss on such assets.	**(i)Contractual cashflows solely payments of principal and Interest on the principal outstanding?** Yes , loan portfolio disbursed by the Company solely consist of principal and Interest. **(ii)Is financial asset held within a business model whose objective is to hold financial asset to collect contractual cashflow?** Yes, the Company has an objective of holding financial asset to collect contractual cashflows. **(iii)At initial recognition - is the financial asset irrevocably designated at Fair Value Through Profit or Loss (FVTPL) as doing so eliminates or significantly reduces a measurement or recognition inconsistency?** Under exceptional circumstances, portfolio measured at amortised cost is sold off.

Securitization	To fulfill liquidity needs	In Ind AS financials, the Securitized assets are re-recognized as ON Balance sheet loans with a corresponding financial liability. In the profit and loss statement, the whole of interest income on these loans are re- recognised with a corresponding finance cost.	**i) Whether the seller has transferred contractual right to receive cash flows?** As per the Service Agreement, the Seller has agreed to continue to provide servicing in the form of collecting cash flows on behalf of the Trust in a capacity as an agent, rather than for its own benefits for an agreed service fee. Therefore, retention of servicing rights by the entity transferring the financial assets does not in itself cause the transfer to fail the requirements of Ind
			AS 109. The Seller / Originator has transferred the contractual right to receive cash flows as per the Securitization agreement. **(ii) Whether substantially all the risk and rewards of ownership have been transferred?** There are two separate approaches to be fulfilled while assessing derecognition principles, 'risk and reward' approach and 'control' approach. It is expressly agreed and acknowledged that the seller is not obligated to support any losses with respect to the receivables, except to the extent of Seller's credit enhancement and will not have any economic interest in the Assigned assets. Further, giving such credit default protection in the form of credit enhancement or overcollateralization, mainly fails the control test given as per Ind AS 109. As the SPV will not be able to sell the asset independently to third party without such credit enhancement,it can be concluded that the Seller has not transferred substantial risk and reward to the investors.

Direct assignment	To fulfil liquidity requirement.	Under Ind AS financials, the assigned portfolio excluding Minimum Retention Requirement (MRR) portioned are derecognized. Interest income earned on the MRR portion is accounted for as Interest income. Based on the waterfall for each assignment transactions, the excess spread income is recognized upfront as “Gain on derecognition of loans”	In case of Assignment arrangement, the Assignor has not given any credit enhancement either in the form of credit guarantee or overcollateralization or sub-ordinated some or all of its interest retained in the Assigned portfolio.Further, any shortfall in Schedule Principal and interest collection will result in shortfall in all the above- mentioned interest payments i.e. any default from obligors shall be borne on pari-passu basis. Hence it can be concluded that credit risk has beentransferred to the Assignee on the sold portion of the portfolio (excluding Minimum Retention Rate of Assignor)and agreed yield. ➢ As per the sharing of monthly collections, the Assignee will get 9% coupon rate whereas the Assigned loans are carrying lending rate at the time of disbursement. . Hence, the Assignor in the above case will retain significant interest in the transferred asset in the form of right to the excess spread. ➢ As the overall assigned loan assets are carrying fixed interest rate, hence prepayment risk should be considered while judging the transfer of risk and reward. In case of any prepayments from any obligor, the same shall be prepaid to the bank proportionately in the ratio of 90:10. Hence, mostly prepayment risk is shared by both the parties to the extent of loss of future interest. Based on our analysis of the Assignment agreement, we can conclude that the Assignor has transferred substantial risk and reward and control pertaining to assigned portfolio

Direct sales agreement (Business Correspondent)	To earn additional income by way of servicing of collections of the loans disbursed by/on behalf of banks	Financial assets are derecognized from the books of accounts	The Company has no obligation to pay amounts to the BC partner unless it has collected equivalent amounts from the original asset except to the extent of performance guarantee given. The company retains the right of collection of EMIs from the borrowers and service charges /commission is being received from the respective BC partner.
Investments in equity / mutual funds	No specific liability to match	Fair value through profit and loss account	To earn income on idle funds and the company has taken in principle decision to account for fair value changes through profit and loss account.

The Company in consonance with Indian accounting standard 109 for financial instruments has adopted the following accounting policies based on the business model assessment.

Definition of Financial instruments

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

(i) Financial Assets

Initial recognition and measurement

Financial assets are initially recognized on the trade date, i.e., the date that the Company becomes a party to the contractual provisions of the instrument. The classification of financial instruments at initial recognition depends on their purpose and characteristics and the management's intention when acquiring them. All financial assets (not measured subsequently at fair value through profit or loss) are recognized initially at fair value plus transaction costs that are attributable to the acquisition of the financial asset.

Classification and Subsequent measurement

For purposes of subsequent measurement, financial assets are classified in three categories:

- Loans at amortized cost

- Loans at Fair Value Through Other Comprehensive Income (FVTOCI)

- Investments in debt instruments and equity instruments at Fair Value Through Profit or Loss (FVTPL)

Loans at amortized costs

Loans are measured at the amortized cost if the following two conditions are met:

(a) Such loan is held within a business model whose objective is to hold assets for collecting contractual cash flows, and

(b) Contractual terms of the asset give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding. After initial measurement, such financial assets are subsequently measured at amortized cost using the effective interest rate (EIR) method less impairment. Amortized cost is calculated by taking into account fees or costs that are an integral part of the EIR. The EIR amortization is included in interest income in the statement of profit or loss. The losses arising from impairment are recognized in the statement of profit and loss.

Loans at fair value through other comprehensive income (FVTOCI)

Loans are classified as at the FVTOCI if both of the following criteria are met:

- The objective of the business model is achieved both by collecting contractual cash flows and selling the financial assets, and

- The asset's contractual cash flows represent SPPI.

Loans included within the FVTOCI category are measured initially as well as at each reporting date at fair value. Fair value movements are recognized in the other comprehensive income (OCI). However, the Company recognizes interest income, impairment losses & reversals and foreign exchange gain or loss in the statement of profit and loss. Interest earned whilst holding FVTOCI debt instrument is recognized as interest income using the EIR method.

Investment in debt instruments and equity instruments at fair value through profit or loss (FVTPL)

FVTPL is a residual category for debt instruments. Any debt instrument, which does not meet the criteria for categorization as at amortized cost or as FVTOCI, is classified as at FVTPL.

(ii) Financial Liabilities

Initial recognition and measurement

Financial liabilities are classified and measured at amortized cost or FVTPL. A financial liability is classified as at FVTPL if it is classified as held-for trading or it is designated as on initial recognition. The company's financial liabilities comprising loans and borrowings including bank overdrafts and derivative financial instruments are measured at amortized cost.

Borrowings

After initial recognition, interest-bearing loans and borrowings are subsequently measured at amortized cost using the EIR method. The EIR amortization is included as finance costs in the statement of profit and loss.

Reclassification of financial assets and liabilities

The company doesn't reclassify its financial assets subsequent to their initial recognition, apart from the exceptional circumstances in which the company acquires, disposes of, or terminates a business line. Financial liabilities are never reclassified.

De-recognition of financial assets and liabilities

(a) De-recognition of financial assets

A financial asset (or, where applicable, a part of a financial asset or part of a group of similar financial assets) is de-recognized when the rights to receive cash flows from the financial asset have expired. The Company also de-recognizes the financial asset if it has transferred the financial asset and the transfer qualifies for de-recognition. The Company has transferred the financial asset if, and only if, either:

- It has transferred its contractual rights to receive cash flows from the financial asset Or

- It retains the rights to the cash flows, but has assumed an obligation to pay the received cash flows in full without material delay to a third party under a 'pass-through' arrangement. Pass-through arrangements are transactions whereby the Company retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), when all of the following three conditions are met:

- The Company has no obligation to pay amounts to the eventual recipients unless it has collected equivalent amounts from the original asset, excluding short-term advances with the right to full recovery of the amount lent plus accrued interest at market rates.

- The Company cannot sell or pledge the original asset other than as security to the eventual recipients.

- The Company has to remit any cash flows it collects on behalf of the eventual recipients without material delay.

In addition, the Company is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents including interest earned, during the period between the collection date and the date of required remittance to the eventual recipients. A transfer only qualifies for de-recognition if either:

- The Company has transferred substantially all the risks and rewards of the asset or

- The Company has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

The Company considers control to be transferred if and only if, the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer. When the Company has neither transferred nor retained substantially all the risks and rewards and has retained control of the asset, the asset continues to be recognized only to the extent of the Company's continuing

involvement, in which case, the Company also recognizes an associated liability. The transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the Company has retained.

(b) De-recognition of financial liabilities

Financial liability is de-recognized when the obligation under the liability is discharged, cancelled or expires. Where an existing financial liability is replaced by another from the same lender on substantially different terms or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a de-recognition of the original liability and the re-cognition of a new liability. The difference in the respective carrying amounts is recognized in the statement of profit and loss.