SONATA FINANCE®

CREDIT LOSS ESTIMATION POLICY

Version	Date of Approval / Reviewal
V.1	26.06.2020
V.2	29.06.2021
V.3	27.05.2022
V.4	30.05.2023

Policy Management:

Policy Name	Expected Credit Loss (ECL) policy

In line with the RBI's requirement for the Board of Directors to approve sound methodologies for computation of Expected Credit Losses (ECL), that address policies, procedures and controls for assessing and measuring credit risk on all lending exposures, commensurate with the size, complexity and risk profile specific to the NBFC, the Company has formulated this ECL policy.

This policy will be reviewed at least annually or more frequently if required and approved as per the usual review process applicable. The review would incorporate changes in regulatory guidelines on ECL, new methodologies in the area of ECL, due to changes in the Company's business, changes in the organisation structure or as required.

ECL model management

Particulars	Team
Owner / developer	Accounts Team
Model documentation	Accounts Team
Review of inputs	Accounts Team
Model data extraction	IT Team
Model data processing	Accounts Team
Model user	Accounts Team
Output management	Accounts Team
Validation	Accounts Team and Senior management
Validation frequency	Quarterly

1. Preamble

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

2. Purpose

The purpose of this policy is to provide a model for calculation of the ECL for the credit impairment of its financial instruments. The implementation of the IND-AS as per the aforesaid circular of MCA requires changes in the methodology of calculating the credit impairment apart from the other changes in the

accounting of any entity. Under IGAP, company was following fix percentage-based model directed by RBI through its master directions from time to time, however with the introduction of IND-AS, it will change to Expected Credit Loss (ECL) based model. ECL based credit impairment model is considered pragmatic and include many factors which make model widely accepted. This policy describes the basis of ECL model and its key consideration while calculating the credit impairment for the company.

3. Overview of expected credit loss

Ind AS 109: Financial instruments ('Ind AS 109') requires financial assets to be classified and measured into one of the three basis below:

- Amortised Cost ('AC')
- Fair Value through Other Comprehensive Income ('FVOCI')
- Fair Value through Profit and Loss account ('FVTPL')

The expected credit loss model or the recognition of impairment on financial assets under Ind AS 109 is applicable to the following financial instrument classification:

- Debt instruments that are measured at Amortised Cost or Fair Value through Other Comprehensive Income
- Lease receivables recognised under Ind AS 116: Leases
- Certain contracts such as financial guarantee contracts and loan commitments that are not measured at FVTPL

Any financial instrument classified and measured at FVTPL is not covered in the scope of the impairment requirements of Ind AS 109. Ind AS 109 does not prescribe a single method to measure ECL and instead there are three broad approaches that are provided in the standard.

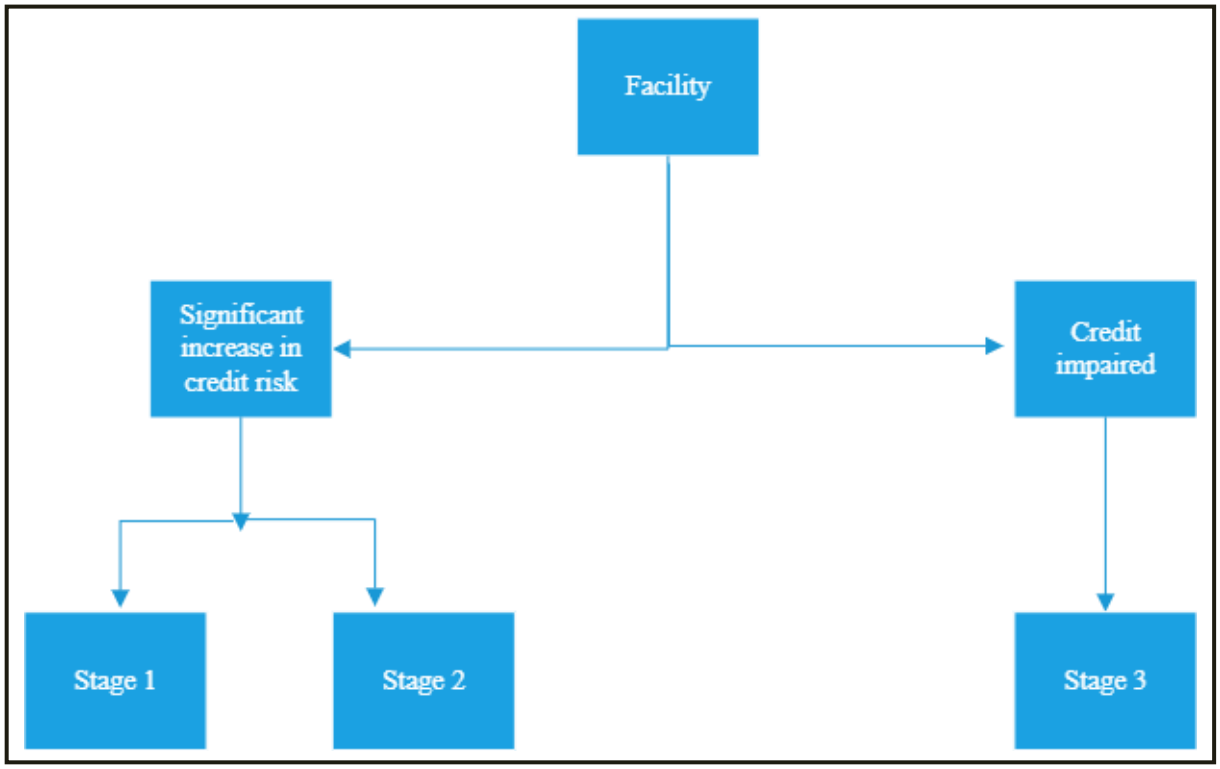
General approach	Simplified approach	Purchased or originated credit impaired (POCI)
• Recognise life time ECL for all in-scope financial instruments where credit risk has increased significantly since origination • Recognise 12-month ECL in all other cases of assets where credit risk has not increased significantly since origination	• Mandatorily required for trade and other receivables without significant financing component • Can be applied optionally for lease and other trade receivables which have a significant financing component. • Lifetime ECL is recognised for all assets under this approach, i.e. there is no staging	• Relevant only for those assets that are purchased or originated as credit impaired • No ECL recognised at initial recognistion since asset is recognised at fair value • changes in life time ECL are recognised in P&L subsequently.

The building blocks for the estimation of ECL that are considered by the Company are:

- Portfolio segmentation
- Staging (determination of significant increase in credit risk)
- Probability of Default (forward looking)
- Loss Given Default

- Exposure At Default
- Discount rates
- Probability weights to scenarios

The ECL calculation approach:



The Company's ECL policy and methodology in respect of the above is covered in the subsequent sections

4. Scope of the Policy

The ECL is calculated and accounted for all loan portfolio including own, direct assignment, securitisation and business correspondence.
The instruments out of the scope of ECL computation are:

- Investments in mutual funds
- Equity investments
- Security receipts
- Any other financial instruments measured at FVTPL

5. Defined terms

12-month expected credit losses	The portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.
Credit impaired financial asset	A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events: (a) significant financial difficulty of the issuer or the borrower; (b) a breach of contract, such as a default or past due event; (c) the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider; (d) it is becoming probable that the borrower will enter bankruptcy or other financial re-organisation; (e) the disappearance of an active market for that financial asset because of financial difficulties; or (f) the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses. It may not be possible to identify a single discrete event instead, the combined effect of several events may have caused financial assets to become credit-impaired.
Credit loss	The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash shortfalls) discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets). An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument. The cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms. There is a presumption that the expected life of a financial instrument can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.
Credit-adjusted effective interest rate	The rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial asset to the amortised cost of a financial asset that is a purchased or originated credit-impaired financial asset. When calculating the credit-adjusted effective interest rate, an entity shall estimate the expected cash flows by considering all contractual terms of the financial asset (for example, prepayment, extension, call and similar options) and expected credit losses. The calculation includes all fees and points paid or received between parties

	to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1–B5.4.3), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the remaining life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).
Credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
Default	When defining default for the purposes of determining the risk of a default occurring, an entity shall apply a default definition that is consistent with the definition used for internal credit risk management purposes for the relevant financial instrument and consider qualitative indicators (for example, financial covenants) when appropriate. However, there is a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate. The definition of default used for these purposes shall be applied consistently to all financial instruments unless information becomes available that demonstrates that another default definition is more appropriate for a particular financial instrument. [Ind AS 109 Paragraph B5.5.37]
Effective interest method	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the expected credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1–B5.4.3), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).
Expected credit losses	The weighted average of credit losses with the respective risks ofa default occurring as the weights.
Impairment gain or loss	Gains or losses that are recognised in profit or loss in accordance with paragraph 5.5.8 and that arise from applying the impairment requirements in Section 5.5.

Lifetime expected credit losses	The expected credit losses that result from all possible default events over the expected life of a financial instrument.
Loss allowance	The allowance for expected credit losses on financial assets measured in accordance with paragraph 4.1.2, lease receivables and contract assets, the accumulated impairment amount for financial assets measured in accordance with paragraph 4.1.2A and the provision for expected credit losses on loan commitments and financial guarantee contracts
Past due	A financial asset is past due when a counterparty has failed to make a payment when that payment was contractually due.
Purchased or originated credit-impaired financial asset	Purchased or originated financial asset(s) that are credit impaired on initial recognition.

6. Portfolio segmentation

Guidance under Ind AS on collective assessment of ECL

- As per Ind AS, depending on the nature of the financial instruments an entity may not be able to identify significant changes in credit risk for individual financial instruments before the financial instrument becomes past due as they are not monitored on an individual basis until the customer defaults or breaches the contractual terms. In such a situation, expected credit losses shall be recognised on a collective basis that considers comprehensive credit risk information.

- For the purpose of determining significant increases in credit risk and recognising a loss allowance on a collective basis, an entity can group financial instruments on the basis of shared credit risk characteristics with the objective of facilitating an analysis that is designed to enable significant increases in credit risk to be identified on a timely basis.
  Examples of shared risk characteristics include, amongst others, instrument type, credit ratings, collateral, industry, geography of borrower, etc. These are not exhaustive[1].

Company's policy for segmentation

The Company is operating in 9 states and it has been observed from the operations that portfolio generated at states level have different risk in spite of product being same. The reason of same can be the employment, agricultural output, level of poverty, literacy varying from one geographical reason to other and thus the Company had segregated portfolio for Expected Credit Loss state wise.

7. Grouping of financial assets measured on collective basis

Loan portfolio which is the major financial assets is originated and managed under two lending methodology viz. Joint Liability Group (JLG) and Individual Lending (IL) methodology. JLG is a group of borrowers who shares the same economic status and live in the same vicinity. Borrowers under IL methodology also belongs to the same economic status and same vicinity and in fact IL customers mostly spin off from the JLG after availing few cycles of loans. As risk profile of the borrowers under both the methodology is of same nature therefore, they are grouped together for the purpose of determining the impairment allowances.

[1] Ind AS 109 Para B5.5.3, B5.5.4 and B5.5.5

8. Control and validation of data for ECL:

The Company source data, directly from the loan management system (LMS) which also flows into the Financials. LMS pass through various independent Audits and checks such as General IT Controls (GITC), Information security (IS) audit. These Audit and checks ensure the accuracy of the data, LMS creates and preserve verifiable trails which ensures there is no any unauthorized change in the system. Data source for ECL also reconciles with the Financials statements of the Company. Additionally, the data extracted are rigorously validated through an in-depth reconciliation process.

Present value of the recovery amount of default loan accounts are calculated manual, It is first calculated and checked by IT team and then verified by the Accounts team. The verification is on sample basis of minimum 50 samples.

9. Credit Loss Estimation Model

(a) Overview

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

I. Defining thresholds for significant increase in credit risk and default.
II. Grouping of the loan portfolio under homogenous pools in order to determine probability of default on a collective basis.
III. Determining effect of less frequent past events on future probability of default.
IV. Estimation of management overlay for macroeconomic factors which could impact the credit quality of the loans

(b) Calculation of ECL:

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

(i) <u>Probability of Default (PD)</u>

The probability of default ('PD') is the likelihood that an obligor will default on its obligations in the future. Ind AS 109 requires a separate PD for a 12-month duration and lifetime duration depending on the stage allocation of the obligor.

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

PD calculation methodology

There are multiple methodologies available for the generation of a forward-looking PD term structure. Based on the nature of the products, the extent of historical defaults, number of years of existence of the product, amongst others, the Company has considered Vasicek single factor model for the generation of the forward-looking PD term structure.

PD generation approach- historical or TTC PD

The Company shall have data for each product demonstrating transition to default for the computation of historical PDs. Such data should be available for a minimum of five-year period or over the life cycle of the product whichever is higher.

In instances where adequate historical data or default data is not available, while identifying a close proxy of the new product, the criterion that will be followed is the similarity in the features of the two products.

For the purpose of calculation of the transition matrices, the 5-year migration from March 2018 to March 2023 has been considered. The migration is now based on quarterly data points as against the practice of yearly data points followed earlier.

PD generation procedure- PIT PD

The PD calculated using the 5-year data are historical and TTC PD. Ind AS 109 requires a forward-looking PIT PD.

Forward looking information is considered in addition to historical default rates to assess probability of default for stage 1 and stage 2 of loan contracts since its initial recognition and its measurement of ECL. Based on the consideration of a variety of external actual and forecast information, a 'base case' view is formed of the future direction of relevant economic variables as well as a representative range of other possible forecast scenarios.

The base case represents a most likely outcome while the other scenarios represent more optimistic and more pessimistic outcomes. More weight is applied to pessimistic outcome consistently as a matter of prudence than optimistic outcome.

The following macro-economic parameters are used in the assessment of developing forward looking PD term structure;

- Real GDP (% change pa) – *Source of data: Economic Intelligence Unit (EIU)*
- Agriculture (% of GDP) - *Source of data: Economic Intelligence Unit (EIU)*
- Inflation rate, average consumer prices (Annual percent change) - *Source of data*: IMF
- unemployment (%) - *Source of data: Economic Intelligence Unit (EIU)*

(ii) <u>Loss given default (LGD)</u>

The LGD is usually defined as the amount of the credit that is lost by a financial institution when an obligor defaults. The Company has not applied an individual account level computation of LGD in the absence of account level information of estimated LGD's.
The revised LGD approach is summarised as below:

LGD approach
The LGD approach is based on a generic LGD rate (i.e. Portfolio Segmentation) that is derived from and subsequently applied to the entire book to estimate potential losses at the time of default basis the i.e., the economic loss incurred when all of the feasible recoveries have been taken into consideration.

The LGD approach followed is as outlined in the steps below:

1) The defaults before March 2017 were not considered for model building mainly in order to ensure that the portfolio composition of the development sample was representative of the current Loans portfolio. Defaults from the period Mar 2018 to Mar 2023 were considered for computation of LGD.
2) Recoveries were considered from the first instance of default and carried till either it paid off completely.
3) The discount factor is estimated, which is required for computing the present value of the collections and recoveries from different periods of time. The computation of discount factor is based on the effective interest rate.
4) Compute discounted recoveries for the Default period.
5) LGD is the opposite of recovery rate of stage 3 loans. LGD = 1 – (Recovery rate of NPA loans) LGD is calculated based on historical (past 5 years) observations of NPA loans.

(iii) <u>Exposure at default (EAD)</u>

The amount which the obligor will owe to the Company at the time of default is defined as the exposure at default (EAD). Exposure at default (EAD) is the sum of outstanding principal and the interest amount accrued but not received on each loan as at reporting date. The EAD for Stage 3 assets is the gross principal outstanding at the date of default.

10. Curing period of restructured portfolio

(a) Restructure loan portfolio

In case of restructuring of loans, except loans restructure under RBI resolution plan 1.0 and 2.0, the company shall watch the performance of the loans for a minimum of three months before advancing it to standard assets. If the recovery in the restructure loan is regular at least for three months then it will be upgraded to standard assets, else it will be kept in its original stage as it was before restructuring. The loan will be placed under different stages based on its actual slippage after re-structuring of the loan.

(b) Non-restructured loan portfolio

In case of un-restructured loans, the company shall follow the RBI guideline on curing of NPA accounts. RBI guideline spells out that an NPA account will be upgraded to standard only after complete recovery of principal and interest overdue.

Provisioning for other financial assets at amortized cost

In addition to the ECL for loans and investments as prescribed above, the Company also holds other financial assets such as balances with bank, trade receivables and other financial assets. The Company recognizes ECL on such assets based on the historical loss experience measures (e.g. write off rates / provisioning rates) adjusted for expected losses in the future keeping in mind the nature of industry (e.g. regulated industry like banking) and credit ratings of such counterparties. The amount is currently not expected to have a significant impact and the Company will periodically assess the same.

11. Definition of default and stage assessment

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

Stage 1:

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

Stage 2:

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

Stage 3:

Includes default loans. A loan is considered default if the obligor is past due more than90 days on any

material credit obligation to the company.

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

Stage 1: 0 to 30 DPD

Stage 2: 31 to 90 DPD

Stage 3: above 90 DPD (Default)

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

12. Changes Effected in the ECL Model

Based on the recommendation made by the statutory auditors during the quarter ended December 2022, and subsequent assessment and analysis of the management following changes are made in ECL model

- The Company has change the frequency of the PD calculation from yearly to quarterly rests. Rational for change is customer EMIs are weekly, fortnightly and monthly and the maximum tenure of the loans are two years. Therefore, PD calculation on quarterly rest will be more realistic than calculating it yearly rest.

- The company has moved from TTC (through the cycle) PD to PIT (Point in time) PD by incorporating Micro Economic variables such as real GDP, Agriculture GDP, Unemployment etc. The PIT PD is based on forward looking approach which is consider more prudent than TTC approach.

- The Company has considered the outstanding as on the date of default for the purpose of LGD calculation instead of earlier practice of outstanding of NPA accounts in the respective years. This is to avoid neglecting accounts which were turned NPA and cured during the year.

- While calculating LGD the Company has discounted yearly recoveries and considered it at its present value, against its earlier practice of considering it without discounting.