SONATA Finance Private Limited

Internal Capital Adequecy Assessment Process

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V.1	07.02.2023
V.2	30.05.2023

Context

Reserve bank of India (RBI) vide its circular "RBI/2021-22/112 DOR.CRE.REC.No.60/03.10.001/2021-22 October" has come up with revised regulatory framework for Non-Banking Finance Companies (NBFCs) viz. Scale Based Regulation (SBR) . The objective of the SBR frame work is to align risk of the NBFCs with its size and complexity. On the basis of size, activity and the perceived risk, the frame work divides the NBFCs in four broader layers which are as under –

1. Base layer (NBFC – BL)
2. Middle layer (NBFC – ML)
3. Upper layer (NBFC – UL)
4. Top layer (NBFC – TL)

Based on the categorisation descriptions, Sonata Finance Pvt. Ltd. (SFPL) shall fall under middle layer category and it has to follow the frame work guidelines applicable for middle layer category. Among the various facet of SBR, it is required for NBCs to put in place board approved capital adequacy assessment process to maintain adequate capital to absorb the potential business risk. This documents describes how the capital adequacy is assessed and maintained by the company.

Objective

Basic objective of Internal Capital Adequacy Assessment Process (ICAAP) is to aligned Company's capital with the risk associated with its business model and complexity of the business in various scenarios including unforeseen business scenarios. Assessment of risk will be done from time to time but at least once in a year to ensure Company is maintaining required capital to meet out its planned business growth and to be in compliant with the regulatory requirements set out by the regulators.

Capital adequacy assessment process

Company's capital requirement changes with the type of risk the company is exposed with. Being a microfinance company SFPL is exposed with following risks –

1. Credit risk
2. Market risk
3. Operational risk

Company reviews these risks from time to time and take necessary steps to mitigate it. Section below elaborates the risk assessment process and its mitigation strategy in detail and also analyse impact of these risk on company's capital.

1. ***Credit Risk –*** Company's main business is to extend microfinance loan to low income segment, particularly in rural areas. As the loans are extended to poor and vulnerable, the company is exposed to credit risk which may arise from the following factors
   (a) Steep fluctuations in borrowers' income and expenditures
   Low income borrowers have irregular income sources therefore they are exposed to income fluctuations. Moreover, if they experience any health issues in the family, significant portion of income is consumed in treatment of the concerned member. This increases the financial burden on the family. The company takes due care of these risks while doing the loan appraisal of the customers. Field staff of the company cross verify the source and quantum of income of the borrowers, they also ensure that borrowers have multiple income sources, which they can rely on if they face problem in one income source.

(b) Break down of borrower's business

Sometimes borrower's business fails because of small business size, lack of capital, as also due to consumption of the business proceed in the house hold expenses. To mitigate this risk filed staff consider the business size, business experience of borrowers and consistency of the cash-flow during the loan appraisal. While doing the loan appraisal, field staff also asses possible challenges which may emerge in her business.

(c) Undermining of the credit appraisal process of the company by the operations staff

There is possibility that the credit appraisal done by the staff are not up to the mark. This may be because of lack of knowledge or ignorance on the part of field staff. To mitigate this risk company has put in place strong monitoring system by the operations supervisors. Internal auditors of the company cross verify the quality of appraisal done by the field staff. Based on the feedback from the operations supervisors and audit team company keeps on designing and conducting suitable training/refresher training and on the job training. Besides, disciplinary action is also initiated in case of need.

(d) Will full default by the borrowers

Despite all precautions, sometime few (insignificant) borrowers become wilful defaulter because of their moral hazard. During Group recognition test as also obtaining group guarantee, such potential defaulters are weeded out at the outset. However, if few such borrowers still get into the system despite all effort, they are persuaded by various means to repay the loan as per schedule.

(e) Over indebtedness of the borrowers

At times borrowers get into trap of over indebtedness as they tempt to take loan more than they can manage. With the evolvement of the credit bureau specifically for the microfinance industry and active role of Self-Regulatory Organisations (SROs) this risk has been mitigated to a great extent.

(f) Concentration Risk

As a lending company concentration risk is another critical risk which may affect the loan portfolio quality of the company and thereby it may influence capital as well. Company may have following concentration risks

- Geographical concentration risk
- Product concentration risk

Geographical concentration risk may arise if the company loan asset is highly skewed in a particular state, district or branch. To mitigate the risk company has spread out its operations in 10 states, 146 districts and 493 branches. In terms of portfolio distribution 81% of the branches are having less than 1% and 75% of the branches are having less than 0.5% of the portfolio[1]. With granular distribution of the loan portfolio geographical concentration risk is perceived less for the company. However, company keeps close watch on the specific events such as election and any government announcement etc. and assess the impact of it on company's geography's and its loan portfolio.

Product concentration risk may arise if the company is dependent on single product and product demand may taper down, as it will reduce the profitability and there by the capital. To mitigate this risk company has diversified its product between Joint Liability group (JLG) loan and Individual (IL) loan. Differentiation between these two products are done on the basis of delivery model and loan size which able to cater various segments of customers. In addition to this company has also partnered with various bank under

[1] The given data is as of November 30,2022 and taken from company internal source

business correspondent model where company disburse the loan on behalf bank with shared risk.

(g) *Other socio, political and economic challenges*

Socioeconomic, political and other unforeseen events may adversely affect the microfinance business. In the recent past, two major events demonetisation and pandemic have affected the company's business to a large extent. As the company does not have any control on such events, it maintains adequate capital to absorb losses arising because of such risks. Apart from this, the company also tries to contain the losses by being very selective in business expansion in circumstances like demonetisation and pandemic.

2. **Market Risk –** SFPL capital is mixed of equity and debt and it is skewed towards debts. Company has availed debt through various instrument such as term loan with fixed and variable interest, Non-convertible debentures (NCDs), External commercial borrowings (ECBs) – in Indian currency as well as in foreign currency. Debt instruments are exposed to following market risk

a. **Interest Rate Risk**

Company has availed the term loan with variable interest therefore it is exposed to interest rate risk. To mitigate the risk, company closely reviews the impact of interest fluctuation on its borrowing cost of overall borrowing exposure. Revised, Reserve Bank of India (RBI) guideline has given a head room to adjust the interest rate of on-lending in consonance with fluctuating borrowing cost. This helps the company to mitigate the interest rate risk, however Company is very sensitive and keeps in consideration all important aspects while revising the on-lending interest rate.

As the interest rate fluctuation on over all borrowing is not sharp so far, the company has not faced any challenges in managing interest rate risk. Moreover, company has ensured the fluctuation in interest does not adversely impact its capital.

b. **Foreign Exchange Risk**

As the Company has availed the ECBs, it is exposed to foreign exchange risk. To mitigate this risk, the Company has policy to do 100% hedging of ECBs received in foreign currency and to be paid in foreign currency.

3. **Operational Risk**

Based on the SFPL own experiences, following are the key operational risks that SFPL may encounter. These risks are analysed in light of their impact on Company's capital.

a. Internal fraud

The Company has digitised its majority of the process, however the collection process is partially digitised. The scope of fraud exists when there are cash transactions. In a few of the Company's processes, cash transaction is involved which exposes it to internal fraud risk. To mitigate this risk, the company has taken due care by setting up various check points such as verification of cash transactions by calling team over a call with customer, operations supervisors during their field visit and internal auditors during their visits and over the call with the customers. Nature of this risk is of low frequency and low impact therefore it does not have any significant impact on company's capital.

b. **External operational risk**

SFPL branches deal with cash, when they collect cash from customers at SFPL branches and take it to the nearest bank branches to deposit. Such situation may attract the risk of robbery. To mitigate the risk company has taken fidelity and cash in transit insurance to make good the losses arising due to robbery. Therefore, there is no any significant impact on the company's capital due to this risk.

Other external risk may occur due to clients' moral hazard. Sometimes client at centre collude and do the misappropriation of the loan given. This misappropriation happens in variety of ways, such as centre leader or any other client with influence at centre, may corner the loan sanctioned to many customers. This may put the customers who have grabbed such loans in the over indebtedness, and may cause default in future. There may be certain other ways to defraud the company by the borrowers. Such risk may happen at moderate frequency, but impact is quite low as the company extends micro loan to borrowers.

c. **Employment practices and workplace safety**

This risk may arise due to breach in some of the statutory payments with respect to employee benefits such as timely payment and remittance of employee provident fund, gratuity, statutory bonus etc. In order to mitigate such risks company keeps track on timely payment and remittance of such dues. As the company has established a fool proof system of cross checking by the accounts team on monthly basis and it also verified by the statutory auditors every quarter, the perceived risk with respect to employee practices is considered insignificant.

Risk with regards to workplace safety may arise due to discrimination, sexual harassment or general liability because of damage incurred by the company's staff. The company policies have zero tolerance on such issues and take a strict disciplinary action, including even termination of such errant employee from his/her job. Because of such strict policy being in place perceived risk with respect to workplace safety is quite low. Impact on capital from both of these risks is also low.

d. **Clients, products and business practices**

Misuse of client confidential information, marketing of unauthorised or inappropriate products, omission or incorrect disclosure of effective interest rate may attract risk of legal compensation claim from the clients. To mitigate this risk, the company ensures strict compliance to industry code of conduct established by RBI and Self-Regulatory Organisations (SROs). Historically company has not faced such risk, therefore the risk is perceived low.

e. **Business disruption and system failures**

Business disruption risk due to unforeseen circumstances such as pandemic, political unrest, government policy decision such as demonetisation etc. are the high risk for the company. As the company do not have control over such kind of external risk, the company mitigate this risk by maintaining adequate capital and taking appropriate measures well in time.

Impact of Risk of system failures is low in frequency and medium in impact as the company has adopted adequate measures to mitigate this risk. Moreover, company do not perceive significant impact on capital because of this risk.

f. **Execution, delivery, and process management**

Ignorance of the business processes such as customer selection, loan appraisal and loan disbursement may lead to risk of delinquencies. Delay in product delivery may also lead to loss of potential customers which may lead to loss of business.

These risks have direct impact on company's capital by way of additional provisioning, if the delinquency level increases. To mitigate this risk, company assesses the expected credit loss through a scientifically devised credit loss estimation model and provide for adequately based on the loss estimated by the model. After adjusting such losses on account of loan portfolio provisioning, company ensures that it maintains the capital above the minimum threshold prescribed by the RBI.

SFPL Policy on Maintaining Minimum Capital

Based on the assessment of the various risks, it is clear that there are two risks which can majorly impact the company's capital - credit risk and operational risk. This is because, it majorly impacts the loan portfolio which is the major assets of the company. Though the market risk is impacting borrowing cost of the company but the risk is limited as the company has headroom to increase the interest rate of the on lending.

To mitigate the credit risk and operation risk, company makes the required provision which is estimated through very well defined expected credit loss estimation (ECL) model that is elaborated in the company ECL policy appended as ***Annexure – 1***

The company has been comfortably managing the perceived risks by maintaining the capital at RBI prescribed capital limit of Capital to Risk Weighted Assets (CRAR) of 15%, with Tier I capital more than 100% of Tier II capital. Keeping in view the dynamic risk scenario, the company management has decided to keep the CRAR at slightly higher than RBI prescribed CRAR rate. Therefore, the company will maintain minimum CRAR of 16%, post the approval of this policy from the board of director of the company. For reference, ***Table 1 & 2*** below give the historical as well as futuristic information about the CRAR and various financial indicators which impact the company's capital.

Table -1

Historical Financial Performance of the Company

(INR in Crore)

	Particulars	**Mar-22**	**Mar-21**	**Mar-20**	**Mar-19**
A	Own Portfolio	1,279	1,145	1,360	1,194
B	AUM	1,770	1,511	1,763	1,441
C	Borrowing	1,374	1,167	1,208	1,196
D	Profit before tax	21	7	20	28
E	Profit after tax	14	4	14	19
F	Net Worth	299	279	273	275
G	Borrowing Cost (%)	12.04	12.11	13.14	13.22
H	Net Interest Margin (in %)	7.99	7.02	9.26	8.17
I	Capital risk adequacy ratio (CRAR%)	21.69	23.01	23.07	25.95
J	CRAR - Tier I capital (%)	20.11	19.85	17.00	22.51
i	CRAR - Tier II capital (%)	1.58	3.15	6.07	3.44
ii	Net debt to equity ratio	4.60	4.18	4.43	4.35
K	Regulatory CRAR (%)	15	15	15	15
L	Credit cost as a % of portfolio	3.29%	2.73%	6.15%	3.02%

Table -2

Current and Projected Financial Positions of the Company

(INR in Crore)

	Particulars	Sep-22	March 2023 (Projected)
A	Own Portfolio	1,429	1,776
B	AUM	1,860	2,467
C	Borrowing	1,447	1,761
D	Profit before tax	9	31
E	Profit after tax	6	22
F	Net Worth	306	322
G	Borrowing Cost (%)	12.37	12.4
H	Net Interest Margin (in %)	9.97	10
I	Capital risk adequacy ratio (CRAR%)	20.53	20
J	CRAR - Tier I capital (%)	18.87	18
i	CRAR - Tier II capital (%)	1.66	2
ii	Net debt to equity ratio	4.73	5.47
K	Credit cost as a % of portfolio	2.38	2.03

Annexure 1 – Estimation of Credit Loss (ECL) Policy

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

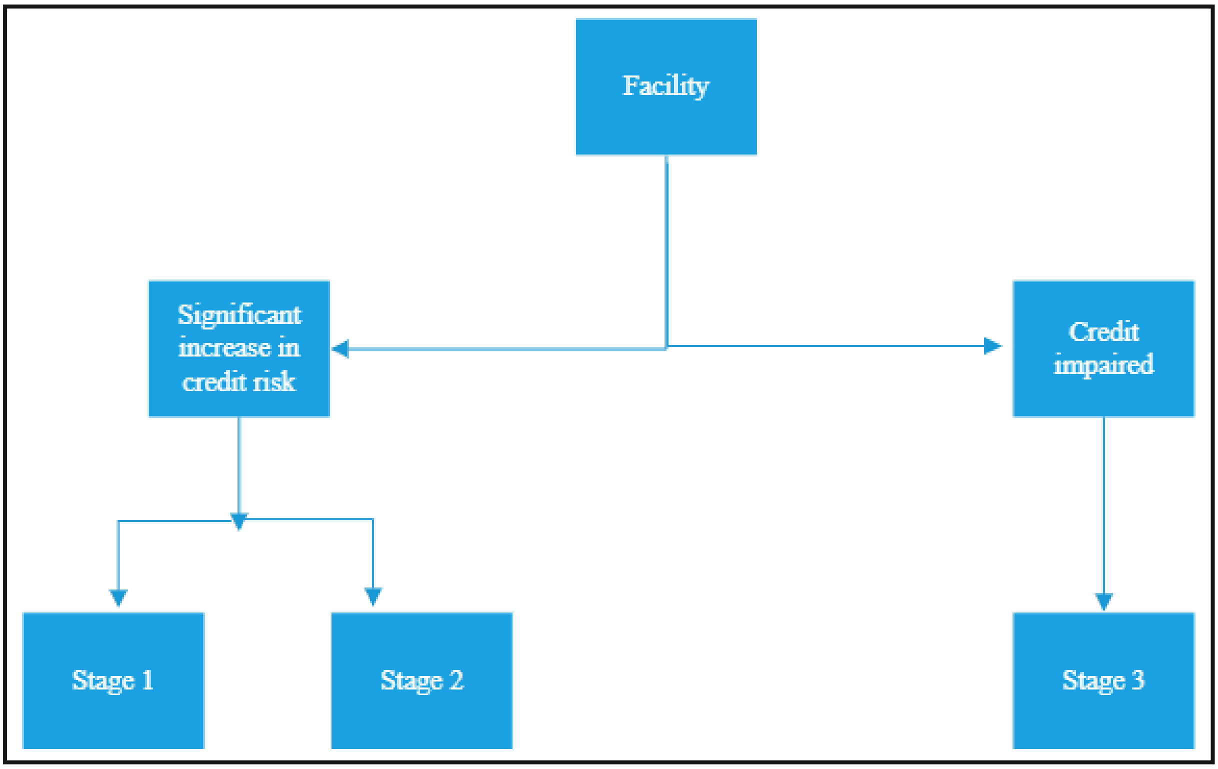
Any financial instrument classified and measured at FVTPL is not covered in the scope of the impairment requirements of Ind AS 109. Ind AS 109 does not prescribe a single method to measure ECL and instead there are three broad approaches that are provided in the standard.

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 recognition 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, securitisationand 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 reorganisation; (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[2].

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.

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

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

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 ofdefault 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 1moving into stage 3 in 12-months' time. PD for stage 2: is derived as %age of all loans in stage2 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 2017 to March 2022 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 2017 to Mar 2022 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. However, the company shall take the benefit of exemption given by RBI till Sep2022 with respect to the guideline.

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 initialrecognition (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 anymaterial 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 changein internal or external environment of the business. In case of a conflict, the Government direction onthis 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.

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