ASSET LIABILITY MANAGEMENT (ALM) POLICY

Introduction:

Kanakadurga Finance Limited (KFL), a company registered as systematically important non deposit taking NBFC with Reserve Bank of India, is predominantly engaged in the business of Vehicle Finance and lending against household jeweler. KFL's funding consists of both short term and long-term sources with different maturity patterns and varying rates of interest. Its assets also are of varying duration and interest. Hence, maturity mis- matches can occur which has an impact on the liquidity and profitability of the company. It is therefore necessary that KFL constantly monitor and manage its asset and liability in such a manner that asset liability mismatches remain within reasonable limits.

Purpose:

This Policy has been framed in accordance with the ALM framework as issued by Reserve Bank of India ("RBI") vide Master Direction DNBR. PD. 008/03.10.119/2016-17 dated September 01, 2016 ("RBI Circular") and amendments thereon and Liquidity Risk Management Framework for Non-Banking Financial Companies and Core Investment Companies vide notification DOR.NBFC (PD) CC. No.102/03.10.001/2019-20 dated November 04, 2019.

This policy is aimed at establishing internal systems. Processes and controls to manage the assets and liabilities of the Company judiciously and prudently so as to proactively identify measure, manage and mitigate the key risks - liquidity and interest rate risks by monitoring the same at regular intervals.

Objective and Scope:

This objective of this policy is to create an institutional mechanism to compute and monitor periodically the maturity pattern of the various liabilities and assets of KFL to

(a) ascertain in percentage terms the nature and extent of mismatch in different maturity buckets, especially the 1-30/31days bucket, which would indicate the structural liquidity.

(b) the extent and nature of cumulative mismatch in different buckets indicative of short-term dynamic liquidity.

(c) the residual maturity pattern of repricing of assets and liabilities which would show the likely impact of movement of interest rate in either direction. on profitability. This policy will guide the ALM system in KFL.

An efficient ALM needs

(a) a good information system

(b) a policy for the company setting limits for liquidity, interest rate

(c) a Committee of Senior functionaries for ensuring adherence to the limits approved by the Board of Directors

(d) a well-defined process.

The primary and foremost objective is to manage the assets and liabilities of the company judiciously and prudently to minimize / avert any asset liability mismatch which may arise during the normal course of business.

The Management must perform one or a combination of the following to meet liquidity and lending needs of the Company:

1. Increase liabilities of a term nature.
2. Increase short-term borrowings.
3. Dispose of liquid assets.
4. Postponement of disbursement Schedules
5. Slowing down the pace of disbursements
6. Intensive Recovery follow up to scale up the Recovery Performance.
7. Increase capital funds.

Roles & Responsibilities:

Successful implementation of the risk management process requires candid strong commitment on the part of the senior management to integrate basic operations and strategic decision making with risk management. The following is the organizational set up for effective management of liquidity risk management.

a) **Board of Directors**
The Board is responsible for management of liquidity risk by defining the strategy, policies, procedures and controls to manage liquidity risk in accordance with the liquidity risk tolerance/limits decided by it.

b) **Asset-Liability Management Committee (ALCO)**
The ALCO, headed by the Managing Director, is responsible for ensuring adherence to the risk tolerance / limits set by the Board as well as implementing the liquidity risk management strategy and to;

- Review the Cash flows so as to avert the possible Liquidity Mismatches, if any.
- Review any mismatch / possible mismatch of assets and liabilities and steps tobe taken to minimize / avert the same.
- Direct the management to take necessary steps to minimize / avert the mismatch.
- Update the Board from time to time about any mismatch / possible mismatch of assets and liabilities and the steps taken by the Committee / Management of the Company to minimize / avert suchmismatch.
- Review the prevailing Interest Rate dynamics and the Interest-Rate Sensitivityposition
- Review the Resource mobilization plan its Deployment vis-a-vis Cost of borrowings / Yields on advances
- Review the product mix and product pricing
- Strategies for deployment of surplus funds
- Ensuring appropriate mix of different forms of debt i.e. Bank Loans, Commercial Paper,Non-Convertible Debentures, etc.
- Giving directions to the ALM team on the interest rate risk.
- ALCO delegates the daily management of liquidity risk and interest rate risk to ALM.

The role of the ALCO includes the decision on desired maturity profile and mix of incremental assets and liabilities, sale of Receivables as a source of funding, the structure, responsibilities and controls for managing liquidity risk, and overseeing the liquidity position.

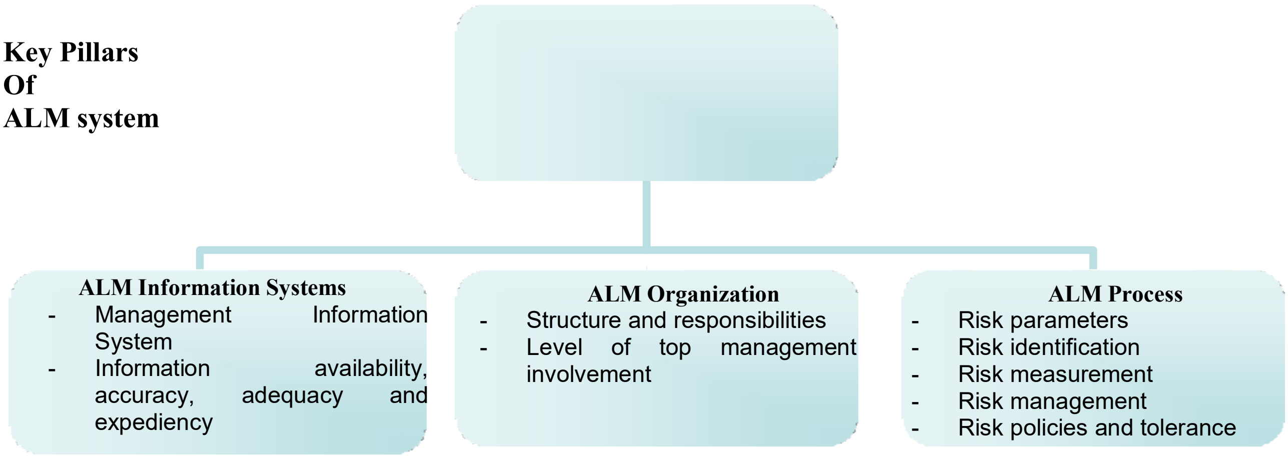
c) Asset Liability Management (ALM) Support Group

The ALM Support Group comprises of Chief Financial Officer (CFO) and Chiefs of Credit, Resource Planning, Funds Management etc. and is responsible for analyzing, monitoring and reporting the liquidity risk profile to the ALCO. The group would scan the macroeconomic environment to provide key information to ALCO for taking critical decisions, if require

Key Pillars of ALM:

ALM system of the Company is based on the following key pillars:

Key Pillars
Of
ALM system



I. ALM Information systems

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  ALM needs be supported by a management philosophy which clearly specifies the risk policies and tolerance limits. This framework needs to be built on sound methodology with necessary information system as back up. Thus, information is the key to the ALM process.There are various methods prevalent world-wide for measuring risks. These range from the simple Gap Statement to extremely sophisticated and data intensive Risk Adjusted Profitability Measurement methods.

- **Information availability, accuracy, adequacy, and expediency**

  However, though the central element for the entire ALM exercise is the availability of adequate and accurate information with expedience, and the systems existing. Adequate measures are to be taken to collect accurate data in a timely manner through computerization.

II. ALM Organization

- **Structure and responsibilities**

  Successful implementation of the risk management process shall require strong commitment on the part of the senior management in the NBFC, to integrate basic operations and strategic decision making with risk management. The Board shall have overall responsibility for management of risks and shall decide the risk management policy of the NBFC and set limits for liquidity, interest rate and equity price risks.

- **Level of top management involvement Asset - Liability Committee (ALCO)**

  The Asset - Liability Committee (ALCO) consisting of the company’s senior management including Joint Managing Directors shall be responsible for ensuring adherence to the limits set by the Board as well as for deciding the business strategy of company (on the assets and liabilities sides) in line with the company's budget and decided risk management objectives.

  The ALM Support Groups consisting of operating staff shall be responsible for analyzing, monitoring, and reporting the risk profiles to the ALCO. The staff shall also prepare forecasts (simulations) showing the effects of various possible changes in market conditions related to the balance sheet and recommend the action needed to adhere to Company’s internal limits.

  The ALCO is a decision-making unit responsible for balance sheet planning from risk- return perspective including the strategic management of interest rate and liquidity risks. The business and risk management strategy of the Company shall ensure that it operates within the limits / parameters set by the Board. The business issues that an ALCO shall consider, inter alia, shall include product pricing for both deposits and advances, desired maturity profile and mix of the incremental assets and liabilities, prevailing interest rates offered by other peer NBFCs for the similar services/product, etc. In addition to monitoring the risk levels of the NBFC, the ALCO shall review the results of and progress in implementation of the decisions made in the previous meetings. The ALCO shall also articulate the current interest rate view of the NBFC and base its decisions for future business strategy on this view. In respect of the funding policy, for instance, its responsibility shall be to decide on source and mix of liabilities or sale of assets. Towards this end, it will have to develop a view on future direction of interest rate movements and decide on funding mixes between fixed vs floating rate funds, wholesale vs retail deposits, money market vs capital market funding, domestic vs foreign currency funding, etc. Individual NBFCs shall have to decide the frequency of holding their ALCO meetings.

Board of Directors Meeting and Reviews

The Board of directors in their Board meetings will oversee the implementation of the system and review its functioning periodically.

III. ALM Process:

The scope of ALM function can be described as follows:

(i) Liquidity risk management
(ii) Management of market risks
(iii) Funding and capital planning
(iv) Profit planning and growth projection
(v) Forecasting and analyzing 'What if scenario' and preparation of contingency plans

Liquidity Risks Management

Identifying, measuring, monitoring and controlling the liquidity risk is a very critical to ensure the Company’s ability to meet its liabilities as they become due. Effective liquidity management ensures reduction of the probability of developing an adverse situation. Liquidity management involves not only measuring liquidity position on ongoing basis but also examine how liquidity requirements are likely to evolve under different assumptions. For measuring and managing net funding requirements, the use of a maturity profiling for both assets and liabilities and calculation of cumulative surplus or deficit of funds at selected maturity bucket is to be adopted as a standard tool, in line with RBI stipulations.

The Maturity Profile should be used for measuring the future cash flows of the Company in different time buckets as mentioned under;

(i) 1 day to 7 days
(ii) 8 day to 14 days
(iii) 15 days to 30/31 days (One month)
(iv) Over one month and upto 2 months
(v) Over two months and upto 3 months
(vi) Over 3 months and upto 6 months
(vii) Over 6 months and upto 1year
(viii) Over 1 year and upto 3 years
(ix) Over 3 years and upto 5 years
(x) Over 5 years

The Statement of Structural Liquidity should be prepared by placing all cash inflows and outflows in the maturity ladder according to the expected timing of cash flows. A maturing liability will be a cash outflow while a maturing asset will be a cash inflow.

Cash Buffer

Due to liquidity crunch witnessed by the financial sector over the past decade due to various economic and governance factors within the sector amongst some companies due to which Non-Banking Financial Company ("NBFCs") and Housing Finance Companies ("HFCs") found it difficult to raise long term and short-term funds from banks as well as the capital markets due to the negative sentiment towards the NBFC and HFC sector. Due to such liquidity crunch in the market, the cost of borrowing also increased significantly due to which the Company on a conservative basis may keep 2 months of liabilities and expenses available in cash i.e. liquid funds or fixed deposits or sanctioned and other immediately drawable limits to cover from any kind of ALM mismatch.

It was also decided that an update to the senior management on the present market situation and its impact on the business of the Company be provided on a weekly basis.

Resource Allocation

Considering the Assets of the Business, ALCO has decided to have the following short term and long-term resources for the company depending on the business plans for FY 2021-22:

- Short term- Cash Credit Limits- 25%
- Long Term- Bank Borrowing/NCD's/ECB/ Other Long-term borrowings- 75%

These limits have been allocated based on past borrowing trends and also depending on the requirements of each business line and operations. Such % of resources can vary depending upon availability of the funds from the market and the same will be decided/changed by ALCO accordingly.

Currency Risk

The Company is to put in place appropriate currency risk management tools as and when decided to opt for raising funds by way of External Commercial Borrowings

Interest Rate Risk ('IRR')

IRR management and reporting helps identify potential risks to earnings and capital resulting from adverse fluctuations in market interest rates. It also identifies asset/funding balance and re- pricing mismatches. Proper identification of potential risks and mismatches assists management in devising asset/liability strategies to minimize these potential risks.

The Gap or Mismatch risk can be measured by calculating Gaps over different time intervals as at a given date. Gap analysis measures mismatches between rate sensitive liabilities and rate sensitive assets (including off-balance sheet positions). An asset or liability is normally classified as rate sensitive if:

(i) Within the time interval under consideration, there is a cash flow.
(ii) The interest rate resets/re-prices contractually during the interval.
(iii) Dependent on RBI changes in the interest rates/Bank Rate.
(iv) It is contractually pre-payable or withdrawal before the stated maturities.

The Gap Report should be generated by grouping rate sensitive liabilities (NIL in KFL's case), assets and off-balance sheet positions into time buckets according to residual maturity or next re- pricing period, whichever is earlier. The difficult task in Gap analysis is determining rate sensitivity. All investments, advances, deposits, borrowings, purchased funds, etc. that mature/re- price within a specified timeframe are interest rate sensitive. Similarly, any principal repayment of loan is also rate sensitive if KFL expects to receive it within the time horizon. This includes final principal payment and interim installments. Certain assets and liabilities to receive/pay rates that vary with a reference rate. These assets and liabilities are re-priced at pre-determined intervals and are rate sensitive at the time of re-pricing. While the interest rates on term deposits are fixed during their currency, the tranches of advances portfolio are basically floating. The interest rates on advances received could be re-priced any number of occasions, corresponding to the changes in PLR.
The Gaps may be identified in the following time buckets:

(i) 1-30/31 days (One month)
(ii) Over one month to 2 months
(iii) Over two months to 3 months
(iv) Over 3 months to 6 months
(v) Over 6 months to 1 year
(vi) Over 1 year to 3 years
(vii) Over 3 years to 5 years

(viii) Over 5 years

(ix) Non-sensitive

The Gap is the difference between Rate Sensitive Assets (RSA) and Rate Sensitive Liabilities (RSL) for each time bucket. The positive Gap indicates that it has more RSAs than RSLs whereas the negative Gap indicates that it has more RSLs than RLAs. The Gap reports indicate whether the Company is in a position to benefit from rising interest rates by having a positive Gap (RSA > RSL) or whether it is in a position to benefit from declining interest rates by a negative Gap (RSL > RSA). The Gap can, therefore, be used as a measure of interest rate sensitivity.

Meetings of ALCO

The meetings of the ALCO shall be meet frequently but no later than half yearly and at least 2 meetings will be held in each year. Apart from the members, CFO and persons involved in fund raising activities can also be a part of the meeting but would not form part of quorum.

ALM Reporting

Comprehensive reporting is designed to monitor key risks and their controls as per the NBFC regulations as enacted from time to time by RBI. Decisions relating to any corrective action are made as and when they seem necessary.

The following reports will be provided to ALCO showing compliance with established guidelines outlined in this policy and in accordance with guidelines established by RBI.

- DNBS01- Important Financial Parameter - Quarterly
- DNBS04A – Short Term Dynamic Liquidity (STDL) - Quarterly
- DNBS04B- Structural Liquidity & Interest Rate Sensitivity - Monthly

Exceptions to guidelines outlined in this policy will be reported to ALCO not later than the next regularly scheduled meeting after a policy exception is identified.

Internal Controls:

Effective internal controls are an integral part of managing financial risk. Pursuant to the guidelines set forth in this policy, adequate controls must be established to ensure proper management of financial risks and to provide safeguards against mismanagement of KFL funds and capital resources.

Policy Review and Approval

The policy governing financial risk management activities and guidelines described herein shall be submitted to the ALCO of KFL at least annually for review and approval.