



MUTHOOT MICROFIN LIMITED

RISK MANAGEMENT POLICY

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Approving Authority	Board of Directors
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V 1.0	01-12-2015	RMD	BoD

Risk Management is the **identification** and **measurement** of **collective risks** affecting the value of an enterprise and implementation of **strategy for monitoring and control** of these risks by systematic actions in a planned manner through proper understanding and communication. The major elements of Risk Management are-

- Risk Management Philosophy
- Risk Management structure and Strategy
- Risk identification
- Risk Monitoring and control
- Risk Measurement/assessment
- Risk aggregation and capital allocation
- Risk Audit and Review

The Company (MML- Muthoot Microfin Limited) is having following major Risk:

1. Credit Risk
2. Operational Risk
3. Liquidity Risk
4. Reputational Risk
5. Strategic Risk
6. Contagion Risk
7. Information Security Risk

1. CREDIT RISK

Credit risk is defined as the possibility of losses associated with diminution in the credit quality of borrowers or counterparties. In a MML's portfolio, losses stem from outright default due to inability or unwillingness of a customer or counterparty to meet commitments in relation to lending, settlement and other financial transactions. Default and credit quality are two aspects of credit risk:

Default Risk – where MML does not receive amount due from the borrower.

Credit quality – Income of the borrower affected and due to which borrower's ability to pay deteriorates.

The risk can result from:

- Information asymmetry and excessive reliance on Credit Bureau check, not backed by soft information or market intelligence on a territory or group of borrowers, leading to adverse selection of borrowers.
- A volatile political presence in a region of exposure

Exposure to activities with a high probability of variation in earnings Default due to over-indebtedness or business failure Credit Risk also includes Credit Concentration Risk, arising out of concentrated exposure to a particular geographical location/territory or to an activity in which a large group of borrowers are engaged in, vulnerable to external events.

1.1 Identification of Risks:

1.1.1 Credit Risk is generally made up of transaction risk (standalone risk at individual account level) and portfolio risk.

1.1.2 Portfolio risk arises due to adverse credit distribution, credit concentration/investment concentration etc. The portfolio risk in turn comprises of intrinsic (systemic risk) and concentration risk. Concentration Risk can also be defined as the additional risk resulting from increased exposure to business, branch, geographic area etc.

1.1.3 While identification of credit risk has been done at the generic level, the functional departments /Business units should bear in mind the risks involved while designing new products and modifying existing products, procedures/systems and the same should be got cleared from the risk management committee at the operational level.

1.2 Building Blocks of Credit Risk Management:

1.2.1 The credit risk management framework of MML should comprise of the following distinct building blocks:

- i) Policy and Strategy
- ii) Organizational Structure
- iii) Operations/ Systems

1.3 Policy and Strategy

- ❖ The Board of Directors shall approve and periodically review the credit risk strategy and significant Product & Policy notes.
- ❖ Senior management of MML shall be responsible for implementing the Product & Policy notes and credit risk strategy approved by the Board.

1.3.1 Product & Policy Notes:

- ❖ The Product & Policy notes and Risk policies approved by the Board should be communicated to branches/ Regional offices. All dealing employees should clearly understand MML's approach for credit sanction and shall be held responsible for complying with established policies and procedures.
- ❖ The credit risk of MML's portfolio depends on both external and internal factors. The external factors are state of economy, political interventions, climatic changes, pandemics, Government Policies etc. The internal factors are deficiencies in loan policies/administration, absence of prudential credit concentration limits, deficiencies in appraisal of borrower's financial position, Loan monitoring and post sanction loan utilizations. To take care of the internal factors MML has the following policies in place which shall form integral part of the Product & Policy Notes of MML
 - a) Product & Policy Notes covering the areas of –
 - Clientele, Marketing, Credit Thrust - dealing with target markets

- Credit Acquisition, covering risk acceptance criteria,
- Pricing,
- Credit Appraisal, Review of Relationship, Approach to lending, Assessment of credit, Credit Delivery - detailing credit origination/maintenance procedures
- Monitoring and Control, Exposure Norms, Recovery
- Documentation.

b) Audit Policy

c) Restructuring Policy and Write Off Policy

1.3.1.1 Portfolio Management-

1.3.1.1.1 Traditionally, companies have focused on monitoring of individual credits in managing the overall credit risk. While this focus is important, it is also important to have in place a system for monitoring the overall composition and quality of various credit portfolios and investments.

To start with a simple portfolio-monitoring framework may be put in place to focus on the credit and investment portfolio from the following perspectives-

- Delinquency Bucket wise
- Geography wise
- Size wise
- Occupation wise

1.3.1.1.2 MML can manage the risk return trade off proactively by adopting portfolio approach to credit risk management. Sophisticated and scientific portfolio management for tracking of asset correlations and concentration requires statistical models to be put in place and upgradation of risk management / MIS / IT capabilities.

1.3.1.1.3 Going forward, MML should introduce in stages the following measures to maintain the portfolio quality after obtaining approval at the appropriate level.

- i) Analysis of prevailing risk posture for deciding asset build up, business development activities and provisioning. Analysis of pricing decisions, provisioning requirements, loss on default and incremental impact of MML's profitability shall be undertaken to assess risk adjusted return for a specific credit product.
- ii) Undertake rapid portfolio reviews, stress tests and scenario analysis when external environment undergoes rapid changes (e.g. changes in the fiscal/monetary policies, general slowdown of the economy, market risk events, extreme liquidity conditions, etc.) The stress tests would reveal undetected areas of potential credit risk exposure and linkages between different categories of risk. In adverse circumstances, there may be substantial correlation of various risks, especially credit and market risks. The output of such portfolio-wide stress tests shall be reviewed by the Board and suitable changes may be made in product policies. Stress tests could also include contingency plans, detailing management responses to stressful situations.

1.3.1.2 Credit Risk Strategy:

- ❖ MML should have its own credit risk strategy or plan that establishes the objectives guiding MML's credit-granting activities and adopt necessary policies/procedures for conducting such activities. This strategy should spell out clearly the organization's credit appetite and the acceptable level of risk-reward trade-off for its activities.
- ❖ The strategy should, therefore, include a statement of MML's willingness to grant loans based on the type of economic activity, geographical location, anticipated profitability. This would necessarily translate into the identification of target markets and business sectors, preferred levels of diversification and concentration, the cost of capital in granting credit and the cost of bad debts.
- ❖ The credit risk strategy should provide continuity in approach as also take into account the cyclical aspects of the economy and the resulting shifts in the composition/ quality of the overall credit portfolio. This strategy should be viable in the long run and through various credit cycles.

MML's credit strategy is embodied in the Product & Policy Notes and articulated in the business plan. While finalizing the Product & Policy Notes and the corporate plan the above directions should be borne in mind.

1.4 Organizational Structure:

The organizational structure for credit risk management should have the following basic features:

1.4.1 The Board of Directors shall have the overall oversight for management of risks. The Board shall decide the risk management policy of MML.

1.4.2 The Risk Management Committee of the Board for the overall management of risk in the organization.

1.4.3 At the operational level Sub Committee of Risk Management Committee will manage the Risk. The Committee is having CEO, CRO and all departmental heads as members.

- ❖ Be responsible for the implementation of the Product & Policy Notes/ strategy approved by the Board.
- ❖ Monitor credit risk on a company wide basis and ensure compliance with limits approved by the Board.

1.4.4 An independent Risk Management Department (RMD) headed by Chief Risk Officer (CRO)

- ❖ Measure, control and manage credit risk on a company-wide basis within the limits set by the Board/ Sub-Committee.
- ❖ Enforce compliance with the risk parameters set by the Board/ RMC.

- ❖ Lay down risk assessment systems, develop MIS, monitor quality of loan/ investment portfolio, identify problems, correct deficiencies
- ❖ Going forward, the Department should undertake portfolio evaluations and conduct comprehensive studies on the environment to test the resilience of the loan portfolio.

1.5 Credit Risk Mitigations:

1.5.1 Location Selection:

Before establishing any branch, a detailed survey is conducted which takes into account the following factors. A detailed branch approval note is prepared and signed off by the senior management.

- Credit Culture: To see if there is a history of a good credit culture and some level of financial literacy.
- Economic Activity: To see if it is in an economically active area not overly dependent on seasonal demands or on monsoons, etc.
- Political Stability: To see if there is any history of local political influence on micro finance activities.

This mitigates the risk of operating in negative areas.

1.5.2 Credit Bureau Check:

A credit check is done for every customer through an automated system-to-system integration with the Credit Bureau. As part of this check, the following parameters are looked at to verify a customer's credit-worthiness and also ensure that they are not overburdened.

- Default History: Only those customers who have no default or write-off at that time are approved.
- Multiple Borrowings: Only those customers who do not have more than one existing MFI loan are approved
- Indebtedness: Only those customers whose total loan outstanding under JLG/SHG including our proposed loan amount will be lesser than Rs 60000 are approved.

These will be dynamic and reviewed periodically based on RBI Regulations, MFIN Directives and our Internal Norms.

This mitigates the risk of customer defaults.

1.5.3 Multi-Step Customer Verification/disbursement process:

MML has a unique process of Credit officer who will oversee the client enrolment, House verification, CGT and GRT process followed. The credit officer is a separate vertical report to the Regional Credit Manager.

This would help in mitigating the risk of ghost borrowing and ring leader issues.

1.5.4 Client /spouse Insurance:

MML is taking credit shield insurance for the Member and Nominee which covers the risk of death of the Member or the nominee.

1.6 State wise Exposure:

1.6.1 MML intends to maintain a diversified exposure in advances across various states to mitigate the risks that could arise due to political or other factors within a particular state. With this in mind, MML has steadily diversified its presence 16 states.

1.6.2 To limit the On-Book exposure to a particular state, MML has an annual policy of capping the maximum exposure in a particular state in relation to the net worth of MML. The current exposure policy is:

- 1.5x of Net worth of the Financial Year.

1.6.3 Due to the monthly movements in values of securitized portfolio, the planned exposure policy is as below:

- 1.5x of Net worth of the Financial Year with a variance of 0.25x of Net worth

1.7 Relation Officer Wise threshold limit:

Threshold limit is defined for the client allocation to a Relationship Officer which is restricted with 750 clients for a week/weekly branches and 1200 clients for month/monthly branches across India.

1.8 Branch wise Threshold limit:

To monitor the concentration at Branch level and to ensure that the span of control at branch level, Branch can get split after reaching outstanding of Rs.10 Cr and above with the approval from Chief Executive Officer.

2. OPERATIONAL RISK

Operational Risk is the risk of possible losses, resulting from inadequate or failed internal processes, people and systems or from external events, which includes legal risks but excludes strategic and reputation risk. The risk can emanate from:

- Procedural lapses arising due to higher volumes of small-ticket transactions.
- Lapses in compliance with established norms; regulatory as well as internal guidelines.
- Misplaced/lost documents, collusion and fraud.
- Breakdown or non-availability of core business applications.

Skill gap and sudden attrition of key personnel in the organisation, is also an operational risk, which needs to be countered and addressed by the application of appropriate HR strategies.

2.1 Identification and Assessment of Risks:

2.1.1 MML would identify and assess the Operational Risk inherent in all material products, activities, processes and systems. It should also monitor that before new

products, activities, processes and systems are introduced, the Operational Risk inherent in them is adequately assessed.

2.1.2 MML along with new products / process assessments would primarily use the Risk and Control Self-Assessment (RCSA) to identify, evaluate, monitor and mitigate key operational Risks within MML.

2.1.3 The objective of the RCSA process is to:

- Identify key Operational Risks across various products and processes within MML;
- Assess the risks that matter in various business, products and processes;
- Assess the design and the effectiveness of internal controls;
- Prioritize the control improvement initiatives to manage the Operational Risk profile of MML;
- Develop (more effective) alternative controls for the unacceptable risks; and
- Assist in embedding Operational Risk Management process in day to day activities of MML.

2.1.4 Key steps involved in conducting an RCSA exercise would include:

- Identification and assessment of risks;
- Identification and assessment of controls design and operating effectiveness;
- Arriving at the residual risks; and
- Formulation of an action plan for the gaps identified and for risks beyond the tolerance level of MML.

2.2 Risk Measurement

2.2.1 The tracking of individual internal incidents data is an essential pre-requisite to the development and functioning of a robust Operational Risk Measurement System (ORMS). The losses and its analysis provide insight to the quantum of Operational Risk faced by MML.

2.2.2 An Operational Risk Loss is defined as loss from inadequate or failed internal processes, people and/or systems, or from external events causing any of the following adverse impact

- Events constituting actual loss.
- Events with future impact.
- Events without loss (or accidental gain).
- Events which seriously jeopardize the business operations (example: System downtime, strike etc.).
- Events caused / causing threat to employee life.

2.2.3 The operational loss data from each activity will be collected for analysis and further improvement.

2.2.4 The collection of loss data is not the goal of this exercise, the objective is to understand 'what went wrong'. Therefore for each significant incident a root cause and lessons learnt analysis should be drafted by the risk- management department.

2.3 Risk Monitoring

2.3.1 Based on the RCSA and other risk analysis, the Operational Risk Management cell in close coordination with the various departments would identify and monitor metrics called Key Risk Indicators. Reporting of which enables the management to monitor and mitigate risks that are reaching less acceptable levels. This is line with Sound principle 5 of Operational Risk Management, i.e. "There should be regular reporting of pertinent information to senior management and the board of directors that supports the proactive management of Operational Risk".

2.3.2 Key Risk Indicators typically monitors the risks/controls, whose slippage would trigger an Operational Risk. The starting point for identification of KRIs is adverse RCSA risk events. The following would be the key steps in establishing KRIs:

- Reference Meetings with heads of departments: Discuss and understand the key processes and RCSA results to arrive at the risks that matter, which should be monitored from a KRI perspective.
- Brainstorm Session: To find out the controls that need to be monitored for the risks that matter. While identifying the indicators, Operational Risk Management

cell would prefer leading indicators to lagging indicators i.e. indicators that signal changes in the likelihood of a risk event occurring rather than the indicators that identify the changes after the risk occurrence.

- Tolerance Level: As per the risk appetite of the function, the thresholds would be set for each Key Risk Indicator. The thresholds would be linked to traffic lights (Green, Red and Amber).

Red: Highlights the need for immediate resolution;

Amber: A potential problem, and which require further review and analysis;

Green: No immediate concern.

2.4 Operational Risk Mitigation

2.4.1 Process Compliance

MML ensures process compliance by under taking surprise checks on field branches and rates them on pre-defined compliance parameters, identifies gaps in process compliance and rolls out initiatives to correct loopholes. This is done primarily to

- Ensure that the designed processes are being followed on the field – including interaction with the customers during various stages of the relationship lifecycle.
- Ensure all branch activities are carried out as per norms/procedures as mentioned in the operational manual.
- Identify any process lapses/deviations and provide guidance to branches/employees to ensure compliance.

The Audit Team submits the following reports to the senior management on a time bound basis, this ensures that risks arising out of process lapses are mitigated.

2.4.2 Employee Rotation Policy:

We have a policy to ensure that no field employee is posted in the same location for over two years as an effort to mitigate any chances of collusion or fraud. All field employees are either transferred to another branch or rotated to another role in a programmed manner so as to mitigate the chances of collusion with other employees or customers. The policy ensures that the employees have the predictability of their movements without putting them into undue hardships. MML takes care of any additional expenses incurred on transfer to non-home base locations.

2.4.3 Document Storage and Retrieval:

MML recognizes the need for proper storage of documents as also their retrieval for audit and statutory requirements. We have put in place

- Physical Storage: We have entered into an agreement with an established record management MML so all the physical loan documents are bar-coded and stored in a specialized secure facility.

2.4.4 Insuring Key Assets:

MML has taken a comprehensive insurance cover with an Office Package Policy for

- Fixed Assets
- Office Equipment
- Cash In Transit
- Employee Fidelity

2.4.5 Non-Compliance Reporting Policy:

MML encourages all its employees to report any non-compliance of stated MML processes or policies without fear as we have a clearly stated “no-retaliation” policy. We have a formal policy that details the manner in which such issues are handled – background investigation, holding a hearing by a committee, and ensuring that action as per the committee’s recommendations is carried out.

All issues reported are categorized for nature and severity:

- Financial or Non-Financial
- Major or Minor
- Procedural Lapse or Gross Violation
 - Breach In Process or Disciplinary Issue
 - Monetary Malpractice or Violation of CoC

2.4.6 Internal Audits (by Independent audit firm appointed by Board).

2.4.7 Internal Financial Control:

In compliance with requirement of the new Companies Act 2013, MML has appointed an external advisory firm with key focus on the following

- Entity Level Assessment: Corporate Governance, IT Infrastructure, Enterprise Risk Management, Anti-Fraud Program and Financial Reporting
- Process Level Assessment: Process Flow Charts, Standard Operating Procedures, Risk Control Matrices, Control Design, Operating Effectiveness, Continuous Monitoring.

3. LIQUIDITY RISK

Liquidity Risk arises largely due to maturity mismatch associated with assets and liabilities of MML. Liquidity risk stems from the inability of MML to fund increase in assets, manage unplanned changes in funding sources and meet financial commitments when required.

Due to the high reliance on external sources of funds, MML is exposed to various funding and liquidity risks comprising:

- Funding Concentration Risk—Concentration of a single source of funds exposes MML to an inability to raise funds in a planned and timely manner and resort to high cost emergency sources of funds. Further, concentration of funding sources can also result in a skewed maturity profile of liabilities and resultant Asset-Liability mismatch.

- **Asset-Liability Mismatch**—A skewed asset-liability profile can lead to severe liquidity shortfall and result in significantly higher costs of funds; especially so during times of crises.
- **Interest Rate risk**—Interest Rate risk comprises the risk of increase in cost of funds due to an overall increase in the interest rates economy as well as sharp movements in interest rates across maturity profiles of the liabilities.
- **Market Perception Risk**—Due to inherent industry characteristics, MML is exposed to perception risks, which can lead to decline in ability of a lender to increase exposure to the Microfinance sector and result lack of adequate and timely inflow of funds.
- **Leverage Risk**— a high degree of leverage can severely impact the liquidity profile of MML and lead to default in meeting its liabilities.

Closely related to the liquidity risk is the Interest Rate Risk, which refers to loss in earnings, due to movement in interest rates. Interest rate risk is largely in the form of Re-Pricing Risk, arising from timing differences in the maturity and repricing of its assets and liabilities. This is particularly significant for a MML, which due to its inherent business metrics, chooses to going for large scale fixed rate funding of its assets, most of which essentially has a shorter duration maturity, prone to repricing risk.

Securitisation Risk, as an embedded part of credit risk for the originator, refers to the possible risk of foregoing cash collaterals, besides the need to top up or provide credit enhancement, in the event of deterioration in the quality of assets securitised.

3.1 Mitigation

The key liquidity management policies being followed at MML include:

- 3.1.1 **Rolling Short Term Liquidity Forecasts:** This is done to identify any short-term liquidity gaps and thereby take immediate corrective actions to bridge the same.
- 3.1.2 **Lender Exposure Updates.**
- 3.1.3 **MML currently has around 60% of its borrowings on a floating basis as against the entire lending on a fixed rate basis.** This minimizes the impact of any adverse impact in the event of a credit shock in MMLing system and any continuing effects of the same on overall interest rates in the economy and on MML.
- 3.1.4 **MML is exposed to perception risk because of inherent industry characteristics.** At the risk of negative carry on its funds, it is prudent to maintain some amount of excess liquidity. MML has a policy of carrying excess liquidity to cover obligations at 5% of balance sheet. This enables MML to meet its repayment obligations as well give MML time to take necessary corrective actions to ensure an adequate funding pipeline.
- 3.1.5 **MML targets a leverage of maximum 4x in light of the unsecured nature of advances and adequately safeguard itself against the impact of adverse market conditions.** It also affords MML reasonable time to tie-up timely equity infusion.
- 3.1.6 **Regular stress testing / scenario analysis to determine sufficiency of liquid assets to meet stressful situations.**

4. REPUTATION RISK

Reputation risk is the risk to earnings and capital arising from adverse perception of the image or MML, on the part of customers, counterparties shareholders, investors and regulators. It refers to the potential adverse effects, which can arise from MML's reputation getting tarnished due to factors such as unethical practices, regulatory actions, customer dissatisfaction and complaints leading to negative publicity.

Presence in a regulated and socially sensitive industry can result in significant impact on MML's reputation and brand equity as perceived by multiple entities like the RBI, Central/State/Local authorities, MMLing industry and last but not least, MML's customers. The risk can emanate from:

- Political activism.
- Non-Compliance with Regulations.
- Customer Dissatisfaction.

4.1 Mitigation

4.1.1 Considering the vulnerability of our customer segment and the potential for negative political activism to affect the reputation of MML, we have in place

- Strict Adherence to Fair Practices Code: All employees are trained and instructed to follow fair practices in all their dealings
- Grievance Redressal Mechanism: MML has a defined GRM in place and the same is communicated to all customers with the contact number also mentioned in their Loan cards.
- Customer Connect: MML has established a call center to pro-actively reach out to customers to ensure service quality and adherence to MML policies/processes by the field employees.
- Delinquency Management: MML does not resort to any coercive recovery practices and has an approved delinquency management policy including restructuring of loans where necessary.

4.1.2 Further, MML as a member of MFIN, works closely with other members who have business operations in that area, to pro-actively identify potential issues and engage with stakeholders to ensure there is no adverse impact arising out of isolated incidents.

5. STRATEGIC RISK

It is the risk to earnings and capital arising from lack of responsiveness to changes in the business environment and/or adverse business decisions, besides adoption of wrong strategies and choices.

5.1 Mitigation

This is being addressed and the risk mitigated to a great extent, by referring matters of strategic importance to the Board, consisting of members with diversified

experience in the respective fields, for intense deliberations, so as to derive the benefit of collective wisdom.

6. CONTAGION RISK

Contagion risk as an enlarged version of systemic risk, refers to the probability of credit default among a large group of borrowers in a particular geographical Territory or State, arising out of external factors or political overtones, spreading to culturally-aligned neighboring Territory or State, resulting in moral hazard, thereby escalating the risk of possible default. Further in the context of micro finance, it could result mostly from ghost-borrowing and ring-leader scenarios.

6.1 Mitigation

This is being addressed by-

- 1) Customer connect program wherein we pro-actively reach out to customers in each center to validate that the customers have genuinely applied for the loan and there has been no incidence of commission.
- 2) Following a relationship based mode of engagement so the customer feels a sense of loyalty to MML and is therefore less likely to be part of a mass default by others.
- 3) Implementing an analytics solution to study the credit bureau data and look for warning signs of increased defaults – up to the pin-code level.

7. INFORMATION SECURITY RISK

The process of formally and consistently determining the information security threats that an organisation faces is known as information security risk assessment. It is used to assess their effects as well as find and implement measures that are suitable and supported by the risks. Sensitive information shall be protected against the following per MML policy:-

- Confidentiality: Only authorised personnel will have access to the information.
- Information: Correctness and completeness, or integrity, will be upheld
- Availability: When needed, authorised users and processes will have access to the information.

7.1 Mitigation

MML shall implement a comprehensive Information Security management function to manage IT-related risks, including Cyber Security related risks. The Risk Management Committee of the Board (RMC) in consultation with the IT Strategy Committee shall review such risks periodically. Along with necessary internal controls and processes for Information security management, MML shall mitigate/ manage identified IT risks with applicable insurance covers as applicable.