KUSHAL FINNOVATION CAPITAL PRIVATE LIMITED

ALM POLICY

NBFCs are often vulnerable to credit and market risks due to the asset-liability transition. The risks associated with NBFCs' operations have become complex and large, necessitating strategic management, as a result of the liberalization of Indian financial markets over the past few years, the increasing integration of domestic markets with external markets, and the entry of MNCs to meet the credit needs of not only corporations but also retail segments. NBFCs now operate in a largely deregulatory environment and are required to set their own interest rates on deposits, subject to a maximum rate of interest on deposits set by the Reserve Bank, and to make dynamic decisions regarding advances. NBFCs' rates of return on investments in government and other securities have also become market-based.

1. The management of NBFCs are under pressure to maintain a healthy balance between spreads, profitability, and long-term survival due to intense competition for business involving both assets and liabilities. Earnings and reputation of NBFCs might be jeopardised by irresponsible liquidity management. These constraints necessitate planned and extensive measures, as opposed to ad hoc response. The business choices of NBFC management must be based on a dynamic and integrated risk management system and process that is guided by corporate strategy. Throughout the course of their operations, NBFCs are exposed to a number of significant risks, including credit risk, interest rate risk, equity/commodity price risk, liquidity risk, and operational risk. Therefore, it is essential for NBFCs to implement comprehensive risk management systems that handle interest rate and liquidity risks.
2. NBFCs must address these risks in a systematic manner by enhancing their risk management and adopting Asset-Liability Management (ALM) techniques that are more thorough than those previously implemented. ALM, among other functions, is concerned with risk management and provides a comprehensive and dynamic framework for measuring, monitoring, and managing liquidity and interest rate equity and commodity price risks of major operators in the financial system. This framework must be tightly integrated into the business strategy of NBFCs. Risk management involves assessing various forms of risks and modifying the asset-liability portfolio dynamically.
3. Having recognized the importance of effective ALM practices, Kushal Finnovation Capital Private Limited (KFCPL) suggested establishing broad standards for the company's interest rate and liquidity risks management systems, which include the Asset-Liability Management (ALM) function. The first objective of the ALM function would be to enforce the risk management discipline, i.e., business management based on risk assessment. The purpose of effective risk management systems should be that they evolve into a strategic management tool for the MAS.
4. The ALM process rests on three pillars:
   - **ALM Information Systems**
     - Management Information Systems
     - Information availability, accuracy, adequacy and expediency
   - **ALM Organisation**
     - Structure and responsibilities
     - Level of top management involvement
   - **ALM Process**
     - Risk parameters
     - Risk identification

- Risk measurement
- Risk management
- Risk policies and tolerance levels.

5. ALM Information Systems

ALM must be supported by a management philosophy that sets risk principles and tolerance limits in detail. This framework must be based on a solid methodology with a supporting information system. Hence, information is essential to the ALM process. There are a variety of prominent risk measurement techniques worldwide. These methods range from the straightforward Gap Statement to the more complex and data-intensive Risk-Adjusted Profitability Assessment techniques. Yet, the essential aspect of the entire ALM process is the prompt availability of adequate and correct information; and the existence of mechanisms. With full-scale computerization, sufficient procedures must be done to acquire reliable data in a timely manner.

6. ALM Organisation

6.1 a) Effective implementation of the risk management process would necessitate a strong commitment from the company's senior management to integrate risk management with basic operations and strategic decision-making. The Board of Directors, under the direction of the Executive Director, will have overall oversight of risk management and should determine the NBFC's risk management policy and set limitations for liquidity, interest rate, and equity price risks.

b) The Asset-Liability Committee (ALCO) comprised of Board-appointed members should be responsible for ensuring compliance with the Board's limits and determining the company's business strategy (on the assets and liabilities sides) in accordance with the company's budget and risk management objectives.

c) The ALM Support Groups, comprised of operating personnel, shall be responsible for analyzing, monitoring, and reporting risk profiles to the ALCO. In addition, the staff should develop projections (simulations) depicting the consequences of various potential changes in market conditions on the balance sheet and prescribe the actions required to comply to the company's internal restrictions.

6.2 The ALCO is the entity responsible for balance sheet planning from a risk-return perspective, along with strategic management of interest rate and liquidity concerns. The company's business and risk management strategy will guarantee that it works within the constraints specified by the Board. Among the business concerns that an ALCO would address include product pricing for both deposits and advances, the intended maturity profile and mix of the new assets and liabilities, the prevalent interest rates offered by other comparable NBFCs for similar services/products, etc. In addition to monitoring the company's risk levels, the ALCO should assess the implementation outcomes and progress of decisions made at prior sessions. The ALCO would also articulate the company's present interest rate outlook and base future business strategy decisions on this outlook. Regarding the finance policy, for instance, it would be its job to determine the source and composition of liabilities or the sale of assets. In order to accomplish this, it will need to formulate an opinion on the future direction of interest rate movements and determine the funding mix between fixed and floating rate funds, wholesale and retail deposits, Supply Chain and Farm Credit finance, etc. ALCO meetings will be held on a monthly basis and as necessary. But, if the necessity for an emergency meeting arises, the ALCO will convene with less notice.

6.3 Board

The Board will oversee the implementation of the system and periodically examine its operation.

6.4 ALM Process:

The scope of ALM function can be described as follows:

- Liquidity risk management

- Management of market risks
- Funding and capital planning
- Profit planning and growth projection
- Forecasting and analyzing 'What if scenario' and preparation of contingency plans

The guidelines given in this note mainly address Liquidity and Interest Rate risks.

7. Liquidity Risk Management

7.1 7.1 Assessing and controlling a company's liquidity requirements is essential for its proper operation. The significance of liquidity transcends individual institutions, since a lack of liquidity in a single institution can have ramifications for the entire system. ALCO should not only assess the company's liquidity levels on an ongoing basis, but also examine how liquidity requirements are anticipated to change under various scenarios. When the market and participants are unidirectional, assets that are typically considered liquid, such as government securities and other money market instruments, can become illiquid. Liquidity must therefore be monitored via maturity or cash flow anomalies. Using a maturity ladder and calculating the cumulative surplus or deficit of funds at designated maturity dates is a basic method for measuring and managing net funding requirements. The Central Bank of India-mandated format for the **Statement of Structural Liquidity** would be used for this purpose.

7.2 The Maturity Profile based on the format prescribed by Reserve Bank of India could be used for measuring the future cash flows of the company in different time buckets. The time buckets, may be distributed as under:

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

While KFCPL does not hold public deposits, all investment securities would be classified as "non-mandatory securities." Any non-mandatory securities may be placed in future time buckets for the purpose of calculating their cash flows depending on the maturity of the investment and the intention to retain it till maturity.

7.3 Alternatively, the company may also follow the concept of Trading Book which is as follows:

i) The composition and volume are clearly defined;
ii) Maximum maturity/duration of the portfolio is restricted;
iii) The holding period not to exceed 90 days;
iv) Cut-loss limit prescribed;
v) Defeasance periods (product-wise) i.e. time taken to liquidate the position on the basis of Liquidity in the secondary market is prescribed;

Based on defeasance periods, a corporation proposing to maintain such 'Trading Books' and according to the aforementioned rules may classify its trading securities as "1 day to 30/31 days (One month)," "Over one month and up to two months," and "Over two months and up to three months." The amount, composition, holding/defeasance duration, cut loss, etc. of the "Trade Book" shall be approved by the Board/ALCO of the firm. According to Prudential Norms, the remaining investments should also be categorized as either short-term or long-term investments.

7.4 The policy note recorded by the firm on the treatment of the investment portfolio for the purposes of ALM and authorised by their Board/ALCO must be provided to the Regional Office of the Department of Non-Banking Supervision of RBI whose jurisdiction includes the company's registered office.

7.5 There may be anomalies within each time bucket, depending on cash inputs and outflows. The primary focus should be on the short-term anomalies, i.e., 1-30/31 days. Although discrepancies up to one year are relevant since they serve as early alerts of imminent liquidity concerns, they should not be the primary focus. Business must monitor its cumulative anomalies (running total) throughout all time buckets by integrating prudential restrictions with ALCO's approval. In typical circumstances, the mismatches (negative gap) during 1- 30/31 days cannot exceed 15% of the cash withdrawals in this time period.

7.6 The **Statement of Structural Liquidity** must be created by arranging all cash inflows and outflows in the maturity ladder in accordance with their anticipated timing. A maturing liability results in a financial outflow, whereas a maturing asset results in a cash inflow. According to their asset-liability profiles, a corporation will need to make a number of assumptions when estimating future cash inflows and outflows. The corporation may consider all relevant factors, such as its asset-liability basis, nature of operation, future strategy, etc., when defining tolerance thresholds.

7.7 To enable the company to monitor its short-term liquidity dynamically over a time horizon of one day to six months, the company will estimate its short-term liquidity profiles for planning purposes using business estimates and other commitments. For this aim, the RBI-issued indicative format ALM – I for estimating Short-term Dynamic Liquidity will be utilized..

8. Currency Risk

The company is currently not exposed to any currency risk because it has not yet engaged in any transactions involving currency risk. However, if similar transactions are conducted in the future, the company will change this policy and add currency risk mitigation mechanisms.

9. Interest Rate Risk (IRR)

9.1 The operational flexibility granted to NBFCs in pricing the majority of their assets and liabilities necessitates that the financial sector hedge Interest Rate Risk. Interest rate risk is the risk that fluctuations in market interest rates could have a negative impact on the financial situation of an NBFC. The fluctuations in interest rates have some effect on businesses. Changes in interest rates have an immediate effect on a company's profitability (reported profits) by altering its Net Interest Income (NII). As a result, KFCPL finances loans with fixed/variable interest rates. The majority of bank loans have fluctuating interest rates. The corporation handles this risk associated with NII by pricing its loan products at a rate that accounts for interest rate risk. Changes in Net Interest Income (NII) or Net Interest Margin (NIM) can be used to gauge the risk from an earnings standpoint (NIM). This risk is evaluated while determining the rates to be charged to clients. After the ALCO has assessed the interest rate risk, loan rates are finalized. The Reserve Bank of India has prescribed ALM – III for Interest Rate Risk Monitoring, and companies may use it for measuring and monitoring interest rate risk.

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