Capital Trust

RISK MANAGEMENT POLICY
OF
CAPITAL TRUST LIMITED

LAST REVIEWED AND APPROVED BY BOARD OF DIRECTORS ON
14TH NOVEMBER, 2018

Table of Contents

Introduction

Risk in the context of business is defined as probability of liability, loss or any other negative occurrence that is caused by external or internal vulnerabilities.

While risk is inherent to every institution, it assumes greater significance in the context of microfinance due to the very nature of the business with its absence of collaterals quality and the vulnerable, financially excluded customer segment it serves.

Risks may be avoided through preemptive action and hence the need to identify the risks and put in place various mitigation mechanisms.

Capital Trust has identified the following potential risks that could have an adverse impact on the company:

1. Credit Risk
2. Operational Risk
3. Liquidity Risk
4. Portfolio Concentration Risk
5. Compliance Risk
6. Reputation Risk
7. Strategic Risk
8. Contagion Risk

This document lists the nature of risks and the various mitigation strategies of the company.

Risk Mitigation

• CREDIT RISK

Credit Risk for Capital Trust is the risk of loss of interest income and the Company's inability to recover of the principal amount of the loan disbursed to its customers.

This 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.

MITIGATION

1.1. 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.

1.2. 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.we must also rule out the possibility of customer having dual credit history by checking multiple KYC .
- **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/SEL including our proposed loan amount will be lesser than Rsxxx (as decided by the management under RBI guidelines) are approved.
  These will be dynamic and reviewed periodically based on RBI Regulations and our Internal Norms
- **Income check**: We must also ensure that customer has a regular source of income but not the seasonal incomes .too much overdependence in a specific sector must be avoided.

This mitigates the risk of customer defaults.

A periodic review must be held between Risk, Business & Credit to check if above mentioned things are being followed up or not to make required changes .

1.3. Multi-Step Customer Verification

Capital Trust has established separate customer relationship (acquisition and maintenance) and customer evaluation (credit) personnel in order to ensure the quality of customers acquired as well as eliminate coerced borrowing practices which may lead to genuine customers becoming delinquent.

A Relationship Offer (CM/FO) is responsible for customer acquisition and maintenance while anCredit Officer (CO) is responsible for customer house verification and KYC validation. We have a dedicated CO in every branch, who carries out 100% pre-disbursement check in addition to that done by the CM/FO, which helps in establishing the customer's identity and address as provided in the Know Your Customer (KYC) documentation.

The loan application is processed only after the CVO approves the customer upon physically verifying the customer's address and documents provided. The CVO's are not outsourced personnel but full-time permanent employees on our payroll and they have a separate reporting hierarchy independent of the CM/FO and Branch Manager with a view to eliminate any conflict of interest in credit decisions.

Every Customer is met by three different personnel before their loan is approved

- **Customer Point Verification 1 (CM-CPV)**: This is a First Level CPV done by the CM/FO - the frontline field employee who is responsible for customer acquisition and maintenance. In this step, the CM/FO visits the customer's residence to confirm their place of stay, permanent structure as residence, nature of business and KYC copies verified with originals.
- **Customer Point Verification 2 (CVO-CPV)**: This is a Second Level CPV done for 100% of all cases by an independent CVO, who also visit's the customer's residence to verify what has been confirmed in CM/FO-CPV and also confirm the proposed Loan Utilization

- **Compulsory Group Training (CGT):** This is done by the CM/FOto all customers in the group to ensure they have full understanding of the joint liability, loan product, interest rate, repayment schedule, terms and conditions. This also helps establish that only genuine borrowers have applied for the loan
- **Group Recognition Test (GRT):** The GRT is done by the Branch Manager during which he revalidates the customer's credentials and loan purpose.

This mitigates the risk of ghost borrowing and ring leader issues. Risk along with internal audit will be monitoring that customer verification process is followed properly else action to be recommended which should be accepted by business .

• 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.

Internal Audit team checks the various aspects of operational risk by auditing the various SOPs/Processes.

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.

MITIGATION

2.1. <u>Process Compliance</u>

Capital Trust has an independent Internal Audit department which carries out 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 branches are rated on various pre-defined criteria for its adherence to the processes. Based on the score obtained by the branch, the next visit date shall be determined in the following manner:

Score	Grading	Color Code	Next Visit
90+	Excellent	Blue	Within 90 Days
80-89	Satisfactory	Green	Within 60 Days
70-79	Adequate	Yellow	Within 45 Days
<70	Unsatisfactory	Red	Within 30 Days

However, for branches that are of less than three months vintage, the next visit shall be scheduled within 90 Days even if they get Excellent/Blue Rating.

The Process Compliance Team submits the following reports to the senior management

- Major Findings – Every Monday for all branches visited in the previous week.
- Monthly and Quarterly Consolidated Reports

Further, branches not showing any improvement for three continuous audits (i.e. rated either Adequate/Yellow or Unsatisfactory/Red consecutively) shall be flagged separately for appropriate action – which is to be tracked in consultation with Business Head and HR Head.

This ensures that risks arising out of process lapses are mitigated. Risk should ensure that above mentioned guidelines is being followed up .

2.2. 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. The company takes care of any additional expenses incurred on transfer to non-home base locations.

2.3. Document Storage and Retrieval:

Capital Trust 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 company so all the physical loan documents are bar-coded and stored in a specialized secure facility.
- **Scanned Copies:** We have also started storing scanned copies of the loan documents for easy retrieval especially for audit purposes where physical documents are not required.

2.4. Non-Compliance Reporting Policy:

Capital Trust encourages all its employees to report any non-compliance of stated company 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 of Violation of CoC

The Risk Manager maintains a record of all the entire case history which is signed off by senior management on closure.

• LIQUIDITY RISK

Liquidity Risk arises largely due to maturity mismatch associated with assets and liabilities of the company. Liquidity risk stems from the inability of the company 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, CT is exposed to various funding and liquidity risks comprising:

- **Funding Concentration Risk**—Concentration of a single source of funds exposes the Company 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, the Company 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 highdegree ofleverage can severely impact the liquidity profile of the company 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 re-pricing of its assets and liabilities. This is particularly significant for a company, 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 re-pricing 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 securitized.

• PORTFOLIO CONCENTRATION RISK

Portfolio Concentration Risk is the risk to the company due to a very high credit exposure to a particular business segment, industry, geography, location, etc though in the context of micro finance, it pertains predominantly to geographical concentration.

MITIGATION

Capital Trust 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, Capital Trust has steadily diversified its presence from 3-4 states to 10 states as of Jan 2018.

• COMPLIANCE RISK

Capital Trust is present in an industry where the Company has to ensure compliance with regulatory and statutory requirements. Non-Compliance can result in stringent actions and penalties from the Regulator and/or Statutory Authorities and which also poses a risk to Capital Trust's reputation. These risks can take the form of:

- Non-Compliance with RBI Regulations
- Non-Compliance with Statutory Regulations
- Non-Compliance with covenants laid down by Lenders

MITIGATION

The company has implemented a Compliance Management through its Compliance Committee with in-built workflows to track, update and monitor compliances.

• REPUTATION RISK

Reputation risk is the risk to earnings and capital arising from adverse perception of the image or the company, on the part of customers, counterparties shareholders, investors and regulators. It refers to the potential adverse effects, which can arise from the company'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 Capital Trust's reputation and brand equity as perceived by multiple entities like the RBI, Central/State/Local authorities, banking industry and last but not least, Capital Trust's customers. The risk can emanate from:

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

MITIGATION

Considering the vulnerability of our customer segment and the potential for negative political activism to affect the reputation of the company, 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:** The company has a defined GRM is place and the same is communicated to all customers with the toll-free number also mentioned in their passbooks.
- **Customer Connect:** The Company has established a call center to pro-actively reach out to customers to ensure service quality and adherence to company policies/processes by the field employees.
- **Delinquency Management**: The Company does not resort to any coercive recovery practices and has an approved delinquency management policy including restructuring of loans where necessary.

Further, the company as a member of SA-DHAN, 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.

• 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.

MITIGATION

This is being addressed and the risk mitigated to a great extent, by referring matters of strategic importance to the Management, consisting of members with diversified experience in the respective fields, for intense deliberations, so as to derive the benefit of collective wisdom.

• 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.

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 the company 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 – upto the pin-code level

Summing Up

The company aims to progress towards building up an ecosystem within the organization, were there is proper awareness of the risks and its implications among the decision makers and further aims at “right sizing of the risk”, so that there is a cautious and measured approach to risk taking, that does not suppress the risk appetite of the organization, for growth, when the going is good.