Hindusthan Microfinance Private Limited (HMPL)

Risk Management Policy Framework

Hindusthan Microfinance Private Limited (*HMPL*)

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(For internal circulation only)

Foreword

This **Risk Management Framework contains** the guiding principles, main procedures for internal controls while delivering financial services to the clients of **HMPL**. The Risk Management Frameworks serves as a strategic guide for the Risk department as well as for the Board and Senior Management of **HMPL** and is aimed at ensuring correct and timely strategic action.

The Risk Management Frameworks has been approved by the Board of Directors of HMPL as a guide to refer to ensure effective risk monitoring.

Any issue lying outside the scope of this document will be decided by the Board of Directors separately and any policy decision with regards to such an issue will be included in this Risk Management Framworks for the reference of every employee in HMPL.

Sd/-

Mr. Anil Laxmanrao Jadhav

(Chairman & Managing Director)

RISK MANAGEMENT FRAMEWORK OF HINDUSTHAN MICROFINANCE PVT.LTD.

The salient features of Risk Management Framework of Hindusthan Microfinance Pvt. Ltd., are enumerated below.

In assessing the financial health of the company, the risks considered are Company's asset and liability management, including credit risk, as well as operational risks such as fraud.

This integrated risk assessment framework for HMPL, which analyzes institutional development and financial health issues, is organized into four categories of risk, viz; Institutional, operational, financial, and external Risks. This framework provides managers and directors with a step-by-step means of assessing current and potential vulnerabilities.

1.1 Institutional Risks:

Microfinance success is defined as an independent organization providing financial services to large numbers of low-income persons over the long-term. An assessment of risks against this definition results in two categories of institutional risk i.e. social mission, and commercial mission.

1.1.1 Social Mission:

HMPL have dual mission a social mission and a commercial mission. Our social mission is to provide valuable financial services to large volumes of low-income women groups in urban/semi-urban/rural areas that will enable them to undertake small business activities which shall augment their household income to improve their livelihood and welfare.

Microfinance institutions are vulnerable to social mission risk if they do not have a clearly defined target market and monitoring mechanisms to ensure that they are providing appropriate financial services to their intended clientele. While sourcing clients it is to be ensured that all the Regulatory norms, guidelines of Reserve Bank of India and Statutory Regulatory Organisations viz.MFIN/SADHAN are fulfilled.

1.1.2 Commercial Mission:

The commercial mission of HMPL is to provide financial services in a way that allows to be an on-going concern; that is, to exist for the long-term as a self-sufficient organization. We may be exposed to commercial mission risk if we do not charge interest to cover the costs and if we do not manage business efficiently. In this connection, the regulatory norms of RBI vis-a-vis Margin cap, credit pricing, rate of interest charged are to be adhered meticulously. It is however imperative to monitor the operative expenses also for sustainability.

1.2 Operational Risks:

Operational risks are the vulnerabilities that HMPL may face in its daily operations, including portfolio quality (credit risk), fraud risk and theft (security risk).

Operational Risk Management Function:

- Review and approve policies, products / processes / systems & procedures etc. involving Operational Risk elements introduced from time to time
- Review the risk profile, understand future changes and threats, and prioritize action steps
- Review and approve the development and implementation of Operational Risk methodologies and tools, including assessments, reporting and loss event databases
- Monitor and ensure that appropriate Operational Risk Management Framework is in place
- Review and manage potential risks which may arise from regulatory changes/ or changes in economic / political environment to keep pace with the required changes
- Discuss and recommend suitable controls/ mitigant for managing Operational Risk
- Create and promote risk awareness across all business units
- Communicate to business areas and staff components the importance of Operational Risk Management
- Ensure adequate resources are being assigned to mitigate risks as needed

A. Group lending to minimise risks:

Group lending is the model that is extensively used by HMPL as a risk management technique. Under this model the credit is provided to the borrowers without collateral who get together to form the groups. Such groups are popularly known as Joint Liability Groups (JLG). The method is adopted by HMPL due to the feature of Mutual joint liability of group members. This risk management technique is related to the process of keeping the group members together and giving guarantee to each other towards repayment of EMIs on default of any member in the group. This further helps in supervising of the steps of member by the social group members as they maintain the peer pressure.

B. Progressive lending to mitigate risk under Loan cycle methods:

Progressive lending or step lending is another risk mitigating tool under which the aim of the lender is to check the loan repayment capabilities and records of the borrower, concurrently with providing him with the loan. As such, the loan is given in the small amounts to the borrower at the outset. Consequently, the amount is augmented based on the loan repayment record of the customer . The technique assures the competencies of the borrower simultaneously with providing them with the credit facilities. In HMPL, we have the system of sanctioning the small ticket size loans ranging from Rs.25000/- to Rs.50000/- under Joint Liability Group model vide its 1st cycle loan and subsequent cycle loans.

C. Geographical Diversification of portfolio:

Geographical Portfolio diversification assist the MFIs in re shaping their portfolios after assessing carefully the monthly trends of loss pertaining to loan repayment failure in particular region. It becomes a prominent need of such enterprises to continuously assess the trends of credit failure, check the status of repayment in various sectors and the risk profiles to limit the exposure of credit hazard. The loan structure must be decided for different sectors as per its various characteristics and the respective risk profiles. This is done in order to diminish the chances and trends of delinquencies.

In HMPL it has been decided to have maximum 25% geographical concentration of its portfolios in one particular region in order to mitigate the risk of overheating and delinquencies. The past historical data, track record, credit history of clients in the regions would be key factor for identification of such regions.

1.2.1 Credit risk:

As with any financial institution, the biggest risk in microfinance is lending money and not getting it back. Credit risk is a particular concern for MFIs because the entire portfolio is unsecured one.

To determine an institution's vulnerability to credit risk, we in HMPL must review the policies and procedures at every stage in the lending process to determine whether they reduce delinquencies and loan losses to an acceptable level. These policies and procedures include the loan eligibility criteria, the application review process and authorization levels.

The credit risk management process encompasses identification, assessment, measurement, monitoring, controlling and reporting of credit risk exposures. The goal of credit risk management at the HMPL is to ensure the risk that the organization is exposed to is within acceptable limits and tolerance level.

The HMPL manages credit risk inherent in the entire portfolio as well as the risk in individual credits and transactions. The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of the HMPL.

The HMPL's approach for credit appraisal facilitates assessment of credit risks underlying the JLG portfolio, and Small Business Loan Portfolio. All credit proposals are subject to a rigorous appraisal process and credit scoring process to support credit approvals and decision making as well as to enhance risk management capabilities for portfolio management.

The operating staff should be imparted proper training about the sourcing, appraisal of proposals and servicing the loans, in order to ensure the better quality assets. While doing so, the concerned staff should also be trained about the statutory provisions of Code of Conducts and Fair Practice Codes of RBI/SRO viz.,MFIN/SADHAN.

Credit Risk Management Function:

- Recommend to the RMCB/ Board, for its approval, the credit risk appetite of the HMPL
- Formulation, review and implementation of credit risk appetite
- Monitor credit risks on a HMPL wide basis and ensure compliance with the board approved risk parameters/prudential limits and monitor risk concentrations
- Recommend to the Board/ RMCB, for its approval, delegation of authorities
- Review status of portfolio management, loan review mechanism, risk monitoring and evaluation, regulatory/legal compliance, adequacy of provision, risk concentrations, industry reviews and suggest corrective measures
- Review the use of internal risk rating systems for business and risk management purposes and placing recommendations before the RMCB
- Review all rating system validation results, where available, to assess efficacy and effectiveness of model performance and the need for any adjustments, and placing recommendations before RMCB

1.2.2 Risk of Fraud & Misappropriation:

Any organization that handles large volumes of money is vulnerable to fraud. Exposure to fraud is particularly acute where money changes hands. These vulnerabilities in a microfinance institution can be exacerbated if the organization has a weak information management system. A failure to detect fraud could lead to the loss to the company's valuable assets. In the detection of fraud, it is critical to identify and address the problem as quickly as possible to send a sharp message to staff before it gets out of hand. The audit and vigilant team needs to be extra vigilant and cautious while discharging their duties at the operating levels to avoid any such mishaps or malpractices.

Moreover, in order to mitigate such unforeseen contingencies, HMPL has to be prepared for such eventualities by subscribing for the suitable and appropriate insurance policy and keep it in force from time to time to cover the loss.

1.2.3 Security risk:

As with vulnerability to fraud, the fact that most MFIs handle money also exposes them to theft. This exposure is compounded by the fact the MFIs tend to operate in environments where crime is prevalent or where, because of poverty, temptation is high. To mitigate this security risk the company has taken the pre-emptive measures by insuring all its cash and valuables to avoid any such losses.

1.2 Financial Management Risks:

1.3.1 Asset and Liability

Asset liability management (ALM) is an ongoing process of formulating, implementing, monitoring and revising strategies related to assets and liabilities in an attempt to achieve financial objectives for a given set of risk tolerances and constraints. These strategies involve balance sheet management and forecasting, liquidity and funding planning and pricing.

The financial vulnerability of an MFI is summarized in asset and liability risks, which include interest rate, liquidity.

Interest rate risk rises when the terms and interest rates of assets and liabilities are mismatched. For example, if the interest rate on short-term liabilities rises before we adjust lending rates, the spread between interest earnings and interest payments will narrow, seriously affecting profit margin. Accordingly, the focus should be on the percentage loan sourcing entities exposure limit also.

Liquidity risk involves the possibility of borrowing expensive short term funds to finance immediate needs such as loan disbursement, overhead payments, or debt repayment in the eventuality of cash flow mismatch. This could be mitigated by having the prudent long term funds management program.

1.4 External Risks:

Although we have less control over external risks factors, we should nonetheless assess the external risks to which they are exposed. Though we have efficient management and staff, and adequate systems and controls, but still are prone to major problems stemming from the environment in which we operate **e.g. political interference.** The political interference poses threat to our microfinance program by creating hurdles and obstacles in loan recoveries. The issues should be redressed tactfully and amicably at all levels with the assistance of SROs.

External risks are usually outside the control of the MFI, however it is important that these risks are perceived as challenges that the MFI should address, rather than excuses for poor performance.

1.4.1 Regulatory risk:

The Policy makers, Regulatory bodies can create vulnerability in an MFI by imposing bans, restrictions on its activities for not fulfilling statutory compliances. Hence it is incumbent to follow all the laid down guidelines and regulatory norms of statutory bodies.

1.4.2 Competition risk :

The competition from other Micro finance institutions in the operating geographies is inevitable and is becoming increasingly competitive, with new players, such as banks and consumer credit companies entering the market. We have to be sufficiently familiar with the services of others to position, price, and sell our products. Competition risk can be exacerbated if MFIs do not have access to information about applicants' current and past credit performance with other institutions.

1.4.3.Risk Management Department function:

- The roles and responsibilities of the Risk Management Department are as follows:

- RMD is responsible for establishing systems and implementing processes related to identification, assessment, measurement, control, monitoring and reporting of credit, operational, market & ALM, liquidity and interest rate risks.
- To manage risk in line with the risk appetite and tolerance structure.
- To clearly assign authority, responsibility and reporting relationships to encourage and maintain accountability.
- To ensure necessary resources are available to perform risk management related activities.

- To ensure co-ordination & communication between staff responsible for managing various risk across and those who are responsible for outsourcing and procurement of services. Failure to do so can result in significant gaps/overlaps in the overall risk management programme.
- To control and monitor all material risks on a firm wide basis within the approved risk parameters.
- To ensuring that the risk management policy and standards are complete, effectively maintained and clearly communicated.
- To review the risk management policy annually and update the same based on RBI regulations and internal events
- To effectively communicate risk management policy to key stakeholders
- Provides periodic trainings to organization's employees to generate awareness and communicate any updates about Operational risk management and Credit risk management.

1.4.4. Internal Audit Department function:

- The IAD is responsible for review and monitor the risk framework within our organization. The roles and responsibilities of the Internal Audit Department with respect to risk management are as follows:

- To provide independent assurance on the effectiveness of implementation of risk management framework, including the overall adequacy of the internal control system and the risk control function and compliance with internal policies and procedures.
- To review HMPL's performance on fulfilment of code of conduct and fair practice codes related issues at operation units.
- To assess compliance of the risk management policies and procedures with the regulatory requirements
- To evaluate whether the risk management policy is reviewed, approved and clearly communicated by the appropriate authorities on a periodic basis
- To ensure that report – both regulatory and internal, are prepared and reviewed as prescribed by the regulatory/internal policies.

- To share audit findings and observations with the risk management department as a background for facilitating risk assessments.

To Report to the Senior Management, Risk Management Committee and Audit Committee the results of their independent review both at the level of the Head Office and Branches.

In HMPL internal audit executives conducts operation and procedure audit at branches on monthly basis and submits the audit reports to the Senior management at H.O., for information and review by them. The reports with audit observations are placed in the quarterly Audit committee meetings and in Board meetings for further their review and discussed for the assessment of risk, addressing the issues with remedial measures.

1.5 Conclusion

The management and board shall consider each of the risks identified in this document as vulnerability points. It is incumbent upon them to assess HMPL's level of exposure, prioritize areas of greater vulnerability, and to ensure that proper controls are in place to mitigate the risk.

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