KERALA STATE INDUSTRIAL DEVELOPMENT CORPORATION LTD

CREDIT RISK MANAGEMENT POLICY

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1. **Introduction**

Credit risk is the potential of loss due to failure of the borrower to meet its contractual obligation to repay debt in accordance with the agreed terms. The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential for the long-term success of any financial organization. Financial organization's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. RBI has directed all NBFCs to devise a risk management framework oriented towards their requirements, dictated by size, complexity of business, risk philosophy, marketing perception, etc.

RBI in the year 2021 had issued a circular (RBI/2021-22/112 DOR.CRE.REC. No.60/03.10.001/2021-22 dated October 22, 2021) wherein NBFC's shall be classified based on their size, activity and perceived riskiness based on the asset size. As per the present Scale Based Regulations of RBI, KSIDC is in the Middle Layer and shall be subject to various compliances and regulations applicable to Middle Layer NBFCs. Accordingly, the Credit Risk Management Policy of KSIDC encompasses identification, assessment, monitoring and mitigation of credit risks in compliance with the norms laid down by Reserve Bank of India (Non-Banking Financial Company –Scale Based Regulation) Directions, 2023 (RBI/DoR/2023-24/105-DoR.FIN.REC. No.45/03.10.119/2023-24 dated October 19, 2023).

2. **Objective**

a) To take informed credit decisions based on adequate assessment of the relevant factors involved in credit risk.
b) To screen credit proposals and assume only such credit risk that is acceptable to KSIDC as per the Credit Risk Assessment guidelines.
c) To ensure diversification of the credit portfolio, by avoiding concentration in credit exposures to individual/group borrowers, industry/sector etc. well within the RBI/KSIDC's prudential exposure norms and taking proactive and corrective action in the event of a likely breach.
d) To attain and maintain standards of good practices in respect of credit risk management.
e) To monitor the quality of the portfolio at periodic intervals and suggesting mitigating measures to prevent slippage in credit quality.
f) To enable risk-based pricing that facilitates optimization of the risk-return profile.
g) Compliance of applicable norms/guidelines/ policies concerning credit risk management as specified by RBI and other regulatory authorities of NBFCs.

3. **Scope of the Policy:**

The Credit Risk Management Policy (CRM Policy), as enunciated herein, encompasses the entire credit operations of KSIDC. While operating in line with these guidelines, KSIDC is required to keep in view the regulations/ parameters laid down by RBI/other regulatory agencies and by KSIDC's Board of Directors from time to time. KSIDC's policy on credit appraisals, approval, loan pricing, documentation, credit administration and monitoring, recovery process etc. have been set out in the Credit Policy. The CRM policy provides a broad framework for management of credit risks in the lending operations of KSIDC. Credit/Project Finance and other concerned divisions are expected to devise products, formulate schemes and issue procedural instructions within this broad framework keeping in view the credit risks inherent in these products, schemes and instructions.

4. Credit Risk Management Framework

The overall frame work of credit risk management in KSIDC would comprise of following: -

a) Credit Risk Management Structure
b) Credit Risk Assessment Policies and Procedures.
c) Portfolio Monitoring
d) Credit Risk Controls and Monitoring.

4.1 Credit Risk Management Structure

The effectiveness of a risk management system depends on putting in place appropriate and effective risk management architecture. In pursuance of RBI guidelines, necessary role centres should be created in the organization structure to facilitate discharge of risk management function. The organization structure for CRM in KSIDC would comprise of Board of Directors, Risk Management Committee of Directors (RMCB), and the Credit Risk Management Division (CRMD).

4.2 The Board of Directors

In pursuance of the RBI guidelines, the Board of Directors and RMCB shall oversee the implementation of Risk management on the basis of the recommendations of the CRMD, CCO and the Regulatory directions. The Board, as per the recommendations of RMCB, will approve the CRM policy, credit exposures/ concentration limits, risk mitigation/ control policy and other credit risk policy matters.

4.3 Risk Management Committee of the Board (RMCB):

A sub-committee of the Board of Directors is vested with the responsibility of monitoring and overseeing enterprise-wise risk at apex level in the Institutions and apprising the Board at periodic intervals. The Chairman and the Managing Director shall be mandatorily a part of the Committee. The Committee shall meet on quarterly basis or as and when required with a minimum quorum of 3 members. The broad responsibilities are:

(i) Overseeing risk management, clearly identifying the risks to which capital is exposed.
(ii) Defining the risk appetite of the Institution/setting up of prudential exposure/ concentration limits, etc.
(iii) Examine and recommend all risk-related policies of the Institutions before they are presented before the Board of Directors for approval.

In respect of credit risk management, the RMCB shall have the followings responsibilities:

(a) To formulate the broad framework of the credit risk management system, which shall be adopted, on approval of the Board of Directors. The CRMD shall monitor the credit management system periodically and CCO shall ensure the compliance of the credit management system on credit proposals for approval and sanction of Board/EC/MD.
(b) Modification of the guidelines for Risk Management System and prudential exposure/concentration limits etc. (individual/ group borrowers, industries, sectors from time to time, if required, to take care of the changing business environment, which will be implemented by CRMD on approval of the Board of Directors.
(c) To update the Board at periodic intervals with KSIDC's credit risk exposure profiles- concentration risk (borrower groups/industries/location/sectors), risk rating of the obligors and to recommend corrective measures, if needed.
(d) To review the risk analysis reports from CRMD and provide necessary guidance for

future analysis.

(e) Approving exceptions to risk exposure/ limits, including Delegation of Powers approved by the Board of Directors

(f) To ensure that the credit functions are managed in compliance with the extant Credit Lending Policy of KSIDC.

4.4 Credit Risk Management Division (CRMD)

CRMD will be the Project Finance Division of the Corporation. The division assesses the various credit risk associated with each project proposal and in compliance with the loan credit policy and interest policy. The project finance division shall assess the various credit risk parameters associated with each project proposals and compliance with the credit policy and other guidelines /procedures issued by the Board/RMCB from time to time. CRMD shall submit an annual risk analysis report to the RMCB for its review and guidance for changes in the policy parameters.

5. Credit Risk Assessment - Policies and Procedures

5.1 Credit Risk Assessment Process

KSIDC recognises that risk is inherent part of business of any financial intermediary and accordingly feels that identification, measurement, monitoring and management of risk are critical to build a sound asset-base. Accordingly, policy guidelines on comprehensive risk management system have been developed and adopted by KSIDC which will be followed in case of all the new business proposals. The risk assessment process would involve judgment being made of the commitment, reliability, resilience and financial/other capability of the prospective customer. This may include an examination of industry scenario, client's track record, financial history, competitive position, skills of promoters etc.

The credit risk would reflect the risks involved both in the borrower and in the facility being considered and would represent an evaluation of the credit customer's intrinsic strengths and weaknesses. The proposals are assessed on the following parameters:

i. Entrepreneur Assessment
ii. Technical analysis for project feasibility
iii. Market Assessment and commercial viability
iv. Financial viability assessment including sensitivity analysis
v. SWOT analysis in case of loans above Rs. 5 crores.

5.2 Risk Identification

Identification of risk is the first step in the Credit Risk assessment system. The credit risk inherent in credit proposal is a function of certain risk factors, such as function of certain factors, some of which are specified below: -

- Financial Risk - This would include assessment of the entity's overall financial strength based on performance and financial indicators, as derived from its financial statements-historical and projected. Some of the key parameters would be:
    - Debt Equity Ratio
    - Interest Coverage Ratio
    - Debt Service Coverage Ratio (DSCR)
    - Current Ratio
    - Fixed Asset Coverage Ratio
    - Security margin

- Profit Volume/Contribution Ratio
- EBIDT
- Cash Profit & Net Profit Ratio
- Break-Even Analysis
- Payback period
- Return on Capital Employed
- Return on Investment
- Internal Rate of Return

While assessing the overall financial strength of the unit, the financial ratios and future prospects of the unit would be considered.

- **Business risk**: Business risk analysis assesses the business fundamentals of the unit, the competitive market position in the industry and its operational efficiency. Key factors would include its geographic reach, distribution and selling arrangements, capacity utilization, nature of the technology employed. The business risk associated with the unit would be reflected in its financial risk ratios and their comparison with the industry average, which are covered under financial risk parameters.
- **Industry Ris**k: This relates to the industry of which the unit is a constituent. The unit/ firm will be subject to the risk factors to which the industry is exposed. In assessing the industry risk, the key parameters would be competition, entry barriers, cyclicality, industry outlook, regulatory risk/ government policies and other contemporary issues.
- **Management Risk**: It involves evaluation of the management of the enterprise, their risk philosophy, competence and past track record. The key parameters are the integrity (corporate governance), managerial competence and commitment, credibility (ability to meet the sales/income and profit projections), payment track record, management system, capability of the management to bailout the entity in case of distress, and the structure and length of relationship with KSIDC.
- **Transaction Specific Risk/Security Risk**:The risk parameters would be tenor of the facility, nature of the security, value of the security and type of the charge over the security.
- **Project Related Risk**: This risk would apply only to project loans, as distinct from corporate loans. The key parameters for risk assessment would be completion risk, technology risk, environment risk, market/supplier risk, availability of raw material/power/utilities, project execution & management capability etc.

5.3 Credit Risk Measurement Parameters

Credit Risk measurement and providing Expected Credit Loss involves identification of certain risk components described in Ind AS 109 as under:

- **Probability of Default (PD) -** The likelihood that the borrower will fail to make full and timely repayment of its financial obligations.
- **Exposure at Default (EAD**) -The expected value of the loan at the time of default.
- **Loss Given Default (LGD) -** The amount of the loss suffered in the event of a default occurring on an exposure, expressed as a percentage of the EAD
- **Expected Loss (EL) -** That part of the credit loss in a portfolio that happens in the normal course of business due to default in exposures and for which institutions have to either make provision or load a factor for the same in the pricing of the loans.

- **Unexpected Loss (UL) -**The part of the credit loss that cannot be estimated or priced into the product and hence institutions have to provide after risk-weighting their assets.

In line with Ind AS 109 requirements and extant RBI guidelines, as the Institution moves from current scoring model towards the Advanced Approaches for Credit Risk Management, with sufficient credit history, it would be necessary to correctly measure PD, EAD, LGD, EL & UL for determining the extant of capital to be maintained for credit risk. These would be computed after generating sufficient historical data. For the existing loans, sufficient information from the date of sanction is available with KSIDC. The projects finance division shall collect the required data from assisted units on a quarterly basis as well as collate information from Credit Information Utilities for a continuous evaluation of risks associated with loan exposures. Project Finance Division shall review the data and make use in the credit risk measurement of proposals and also for monitoring credit exposures for appropriate risk mitigation actions.

5.4 Credit Risk Assessment (CRA) Models

Prior to sanctioning a credit facility to any client/obligator, the risk level should be measured as per institution's credit risk assessment framework. The credit risk assessment framework in KSIDC includes the use of internal risk assessment model and use of credit rating from external credit rating agencies, wherever necessary.

Priority sector related proposals would continue to be examined, in terms of the risk-rating module developed and implemented in KSIDC. The internal risk-rating module evaluates each proposal for various risks, such as industry business risk, project risk, management risk, external risk as also security available, income value to KSIDC, profitability/ financial projections, etc. All proposals are scrutinized for various parameters as laid down under the module which assigns score on a scale of 1 to 100.
The rates are worked out based on the following parameters and scoring methodology;

1. Line of Experience
2. Proposed Business Activity
3. Debt Equity Ratio
4. Value of tangible securities in proportion to the loan
5. Past Performance in terms of turnover growth, profit growth, return on equity
6. Track record with Bank/FIs
7. Repayment period of the loan
8. Profitability indicators like Payback Period, DSCR

In case of exposure in excess of Rs. 25 crores, external rating from any of the RBI approved Credit Rating Agency is made mandatory.

6. Credit Portfolio Monitoring

As per RBI guidelines on risk management for NBFCs, the company should evolve proper systems for identification of credit weaknesses well in advance. Project Finance Division shall ensure periodic visit to loanee units and undertake performance review, financial health review, management review and security coverage review. Slippages from SMA 0 to SMA 1 shall be trigger point for field inspections and reporting. Slippages from STD to Substandard shall have mandatory Default Review Meeting by divisional head for immediate actions. Each divisional head (AGM/DGM) shall have a monthly review on all exposures under their monitoring and shall provide a consolidated action taken report to General Manger of Project Finance Division. The functional head (GM) shall review all exposures on a quarterly basis for appropriate recover measures in the case of loan slippages. The slippages shall be analysed and reported to ALCO and Executive Committee on a quarterly basis. The summary of slippages shall also be reported to Board along with agenda on Quarterly Performance reporting.

6.1 Credit Audit

RBI guidelines on loan review mechanism for NBFCs propose periodic credit review for constantly evaluating the quality of credit portfolio and to bring about qualitative improvements in the credit administration process. Eventually, the Credit Audit function shall be the basis of implementing Risk Based Internal Audit in future once RBI make it mandatory for Middle Layer NBFCs.

The main objectives of credit audit are:

a) To identify prompt loans which develop credit weaknesses and initiate timely corrective action
b) To evaluate portfolio quality and isolate potential problem areas
c) To provide information on adequacy of loan loss provision
d) To assess the adequacy of and adherence to, loan policies and procedures, and to monitor compliance with
e) To provide information on credit administration covering all loans and review of high value loans usually within six months of full disbursement.

In addition, KSIDC should also target other accounts that present elevated risk characteristics and at least 25% of the portfolio should be subject to credit audit in a year to provide reasonable assurance that all the major credit risk embedded in the balance sheet have been tracked.

The credit audit, however, will not include the following aspects:

- Adequacy and correctness of legal documentation and security creation (Scope of Legal Division)
- Inspection/valuation of assets/stocks/securities under mortgage or pledge (Scope of Credit Officers/Project Finance division - However, exceptional findings, if any, of the legal division, would be brought out in the credit audit report.)

It is proposed to nominate an officer in the Manager cadre and above to act as the Credit Auditor. The scope of Credit Audit shall include:

- Audit examination of the Approval/Sanction Process
- Adherence to policies and procedures stipulated by KSIDC
- Compliance with RBI regulatory guidelines and loan covenants
- Sufficiency of loan documents and security creation.
- Post-sanction follow-up and supervision
- Effectiveness of credit monitoring and control
- Early warning signals
- Asset quality and portfolio concentration.

Following shall be parameters for the selection of cases for Credit Audit:

i. All first and final disbursed loans sanctioned by EC & Board
ii. All slippages from Standard to Substandard category
iii. All slippages from Substandard to D1 category
iv. Loan outstanding > 5 Cr – On sample basis under direction of CFO
v. Loan outstanding =< 5 Cr – On sample basis under direction of CFO

The reports of the Credit Auditor categorised under High/Medium/Low shall be submitted to the CFO and MD. The summary reports shall be placed before the Executive Committee & Audit Committee by MD. The Credit Audit report may be the basis for Policy amendments, compliance check, improvements in SOP, internal systems & control etc. After credit audit of an account, any major change in financials, conduct of account, management, security, additional liability, etc. in such accounts, would be tracked and reported to higher authorities by monitoring division. In case where additional loan is sanctioned to an existing borrower and credit audit for earlier facility has already been carried out, the credit audit would be carried out once again on full disbursement of additional loan. The credit audit in such cases would include the existing loan(s) of such borrower.

7. Credit Risk Control and Reporting

7.1 Prudential Exposure Norms.

The Credit Risk Management policy recognizes the need for implementing measures aimed at improving risk management and avoiding risks associated with concentration of credit. For this purpose, limits have been prescribed for exposure to individual/group borrowers. The objective of credit risk management at portfolio level is to achieve and maintain a portfolio that is well diversified across companies, sector, geographical areas etc.

KSIDC has been categorized as "Systemically Important Non-Deposit taking NBFC (NBFC-ND-SI)". KSIDC's exposure to different business segments i.e. for Individual borrower and group borrower are primarily guided by exposure norms prescribed for NBFC-ND-SI by RBI.

The Framework for Scale Based Regulation issued in October 2021, has merged the credit concentration limits into a single exposure limit of 25% for single borrower and 40% single group of borrowers. In line with aforesaid RBI guidelines, the maximum exposure based on the Tier -1 Capital would be as follows:

Particulars	Single Borrower	Group Borrower
Concentration of credit/ investment	25% of Tier 1 Capital	40% of Tier 1 Capital

The undisbursed commitment should also be reckoned for arriving at the exposure. KSIDC would continue to work within the exposure ceiling fixed as above in respect of individual borrower as well as group, while considering the proposal(s) for financial assistance. The exposure ceiling would be revised annually based on the owned funds of KSIDC, as on the year ending, after the finalization of accounts.

Definition of Group

In terms of RBI guidelines, "Companies in group" shall mean an arrangement involving two or more entities related to each other through any of the following relationship: subsidiary-parent(defined in terms of IND AS 110), Associate(defined in terms of IND AS 27), Joint venture(defined in terms of IND AS 27/IND AS 111), promoter-promotee (as provided in the SEBI (Acquisition of Shares and Takeover) Regulations, 1997), related party(defined in terms of IND AS 24), common brand name and investment in equity shares of 20% and above.

The concept of 'Group' and the task of identification of the borrowers belonging to specific industrial groups are left to the perception of the banks/ financial institutions. Banks/financial institutions are generally aware of the basic constitution of their clientele for the purpose of regulating their exposure to risk assets. The group to which a particular borrowing unit belongs, can be decided by them on the basis of the relevant information available with them, the guiding principle being Commonality of management and effective control.

7.2 Restrictions of lending:

1. Without the prior approval of the Board, KSIDC shall not lend to a connected party to KSIDC, i.e., Director/employees/or their relatives or entities where KSIDC's directors/ employees or their relatives are the directors/ shareholders having major shareholding. (However, loans to employees shall be covered under staff Rules of KSIDC)
2. KSIDC will not sanction any financial assistance in the form of share investments to a company in which any Director of KSIDC is interested. However, this clause shall not be made applicable in the case of additional assistance by way of right issue of existing investments and also in cases of subsidiaries/ associates/ assisted companies where the MD/ Directors is/are a part of the Board in the nominated director capacity.
3. KSIDC will not grant loans and advances to industries producing or consuming Ozone Depleting Substances, in terms of Montreal Protocol to which Government of India is a party.
4. KSIDC will not sanction additional facility to the borrowers or their associates appearing in the defaulter's list/ caution list/ blacklist circulated by RBI/CICs/FIU from time to time.

7.3 Restrictions relating to security for lending

KSIDC will not grant loans and advances against the security of

1. Its own shares
2. Partly paid shares of a company;
3. Certificates of Deposits (CDs); and
4. Money Market Mutual Funds
5. Bullion and other precious metals, gems, stones, diamonds

7.4 Industry Research & Restricted Sectors

While prudential guidelines for avoiding excessive concentration of credit serve as broad indicators, the risk impact of other dynamic elements such as market conditions, government policies, legal changes, economic indicators, stock market movements etc. are to be assessed on a regular basis to ascertain risks that are intrinsic to different exposures. Since KSIDC's exposure is increasing across the various sectors, at a later stage there might be need for a dedicated Industry Research Division in KSIDC to monitor industry specific developments and provide key inputs to ensure a healthy credit portfolio. However, at present, to keep abreast of industry developments, KSIDC may subscribe industry research report of being published by professional agencies / Credit Rating CRISIL or other renowned credit rating agencies.

7.5 Rating-wise Exposure Ceilings

As part of RBI guidelines on CRM (Customer Relationship Management), the NBFCs have to eventually move over to Internal Rating Based approach for Capital Adequacy standards. Accordingly, as a best practice, KSIDC shall endeavour to restrict its exposure under the lower rated categories of borrowers.

In the case of industries/ sectors that are not performing well or in which the outlook in the near future is not likely to improve, the exposure shall be taken only in respect of better rated clients as determined/advised by Board.

8. Risk Reporting

Project finance division shall examine the credit risk exposures of KSIDC on a regular basis and shall furnish report to ALCO for a periodic review. The annual review report on credit risk exposure shall be placed before the RMCB and Board of Directors. While the reports may vary based on the Institution's Risk Profile and regulatory requirements, they shall include the following:

a) Prudential Exposure Norms Status Report
b) Monitoring of in-house Exposure Norms, if any
c) Risk based analysis of KSIDCs Credit Portfolio
d) Review of Industry/Sector wise exposures

9. Policy Review

The CRM Policy would ideally be reviewed on an annual basis. However, the policy can be reviewed at short notice depending on the exigencies/ extraordinary situations, which may emanate during the course of KSIDCs business. Such extraordinary situations may include significant changes in Government/ Reserve Bank of India policies, global/national macro-economic conditions, financial performance, etc.

Being a developmental finance institution of the State and a Government company, the priorities and the schemes announced by Government will have to be incorporated in policy document as and when required.

10. Validity/Authority of The Policy

The CRM Policy would be the principal document for the credit risk management function of KSIDC. The CRM Policy shall become effective from the date of its approval by the Committee. This CRM Policy shall remain in force till the next revision is carried out and disseminated. This policy is to be read in consonance with the extant Credit Policy, Credit/ other manuals in the company and extant regulatory prescriptions.

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