**Basel III Disclosures as of 31 March, 2018**

ESAF Small Finance Bank Limited ("the Bank") is a public limited company incorporated in India on 05th May, 2016 under the provisions of Companies Act, 2013. The Bank received license from Reserve Bank of India (RBI) on November 18, 2016 to carry on the business of Small Finance Bank (SFB) in India and commenced its banking operations on March 10, 2017. The Bank is headquartered at Thrissur, Kerala, and provides services in urban, semi-urban and rural areas of the country, through its inclusive banking initiatives. The Bank does not have any foreign operations.

Basel III Disclosures on the capital adequacy and risk management framework are detailed in the following sections:

## 1. Capital Adequacy

### 1.1 Capital norms

The Bank is subject to the capital adequacy framework as per the Operating Guidelines for Small Finance Banks, issued by RBI. Accordingly, the Bank is required to maintain a minimum Capital to Risk Weighted Assets (CRAR) of 15%, with a minimum Tier I capital of 7.5%. As of now, Capital Conservation Buffer and Counter Cyclical Capital Buffer are not applicable for Small Finance Banks.

As per RBI guidelines DBR.NBD.No.4502/16.13.218/2017-2018 dated 08th November 2017, SFBs are not required to create separate capital charge for market risk and operational risk. As such, the Bank has taken into account capital charge for credit risk only, for arriving at capital adequacy. For credit risk, RBI has prescribed that SFBs shall follow Basel II Standardized Approach and permitted the use of external rating based risk weights for rated exposure and regulatory retail approach for small loans.

The Bank has a process for assessing the capital requirements and a strategy to maintain its capital levels. The Bank has also set up sound governance and control practices to identify, assess and manage risks, which are regularly reviewed by the Risk Management Committee of the Board (RMCB).

### 1.2 Capital Structure

Breakup of capital funds is as follows:

| Particulars | ₹ in Crores |
|---|---|
| **Tier I capital – I** | **390.85** |
| Paid Up Capital | 311.95 |
| Reserves | 31.40 |
| Perpetual Debt Instrument | 47.50 |
| **Deductions – II** | **0.72** |
| Intangible Assets (Prepaid expenses) | 0.72 |
| First loss credit enhancement provided for securitized assets | Nil |
| Second loss credit enhancement provided for securitized assets | Nil |
| Any Other Deductions | Nil |
| | |
| **Tier I Capital Total (I-II) A** | **390.13** |
| | |
| **Tier II Capital – I** | **142.28** |
| General provisions | 12.28 |
| Investment Reserve | Nil |
| Sub Ordinated term Debt | 130.00 |
| | |
| **Deductions – II** | |
| First loss credit enhancement provided for securitized assets | Nil |
| Second loss credit enhancement provided for securitized assets | Nil |
| | |
| **Total Tier II Capital (I-II) B** | **142.28** |
| **Total Capital (A+B)** | **532.41** |

## 1.3 Capital Adequacy

### a) Qualitative disclosures:

*A summary discussion of the Bank's approach to assess the adequacy of its capital to support its current and future activities:*

Policy on Internal Capital Adequacy Assessment Process (ICAAP) has been put in place and the assessment of capital commensurate to the risk profile is reviewed on a quarterly basis.

Capital requirement for current business levels and estimated future business levels is assessed on a periodic basis.

As per RBI guidelines for SFBs, minimum capital required to be maintained by the Bank for the period ended 31st March 2018 is 15%. The Bank's CRAR is above the regulatory minimum level.

The CRAR has been assessed using Basel II standardized approach for credit risk only, since SFBs are not required to create separate capital charge for market risk and operational risk.

### b) Quantitative Disclosures:

| S. No. | Particulars | ₹ in Crores |
|---|---|---|
| **A** | **Capital Requirements for Credit Risk** | 472.08 |
| A.1 | Portfolio Subject to Standardized approach | 423.52 |
| A.2 | For Securitized Portfolio | 48.56 |
| **B** | **Capital Requirements for Market Risk** | Nil |
| B.1 | For Interest Rate Risk | Nil |
| B.2 | For Equity Risk | Nil |
| B.3 | For Forex Risk (including gold) | Nil |
| B.4 | For Commodities Risk | Nil |
| B.5 | For Options risk | Nil |
| **C** | **Capital Requirements for Operational Risk** | Nil |
| | **Total Capital Requirement ( A+B+C)** | 472.08 |
| | **Total Risk Weighted Assets ( RWA for all types of assets, including credit )** | 3147.18 |
| | **Total Capital Funds** | 532.41 |
| | **CRAR (%)** | 16.92% |
| | Tier -1 Capital Adequacy Ratio (%) | 12.40% |
| | Tier -2 Capital Adequacy Ratio (%) | 4.52% |

## 2. Risk Management

The Risk Management Committee of the Board oversees and periodically reviews the processes and practices of risk management in the Bank. Credit Risk Management Committee (CRMC), Operational Risk Management Committee (ORMC), Asset Liability Management Committee (ALCO) and Information Security Governance Committee (ISGC) support RMCB to facilitate effective execution of the above responsibilities. The Risk Management Department (RMD) through its Credit Risk, Operational Risk, Market Risk and Information Security Divisions assist the above committees in effectively managing the risks. The RMD is headed by the Chief Risk Officer (CRO) who reports directly to MD & CEO and on a dotted line to the RMCB and the Board of Directors. The CRO is responsible for formulating and implementing enterprise wide integrated risk management systems for identification and management of risks in the Bank.

## 3. Credit Risk

Credit risk is the possibility of loss a bank might incur due to the following:

a) Default due to the inability or unwillingness of a customer or counterparty to meet commitments in relation to lending, trading, settlement or other financial transactions or

b) Reduction in portfolio value arising from actual or perceived deterioration in credit quality of borrowers or counterparties.

The objective of credit risk management is to maximize a bank's risk-adjusted rate of return while maintaining credit risk exposure within acceptable limits.

### 3.1 Credit risk governance:

The Bank has put in place the Credit Policy and Credit Risk Management Policy, approved by the Board of Directors. While the Credit Policy covers the rules and regulations for processing and sanction of credit, Bank's approach to monitoring of credit, etc., the Credit Risk Management Policy describes credit risk identification process, procedure for measurement of credit risk and risk mitigation strategies.

### 3.2 Structure and Organization of Credit Risk Management Framework

The Bank has put in place comprehensive Board approved Credit Risk Management Policy. The Policy sets out the guidelines, principles and approach to manage credit risk for the Bank and puts in place a framework to identify, assess, measure, monitor and control credit risks in a timely and effective manner.

The credit risk governance framework establishes the responsibility and approach through which the Board of Directors and the management of the Bank manage credit risk. Risk Management Committee of the Board (RMCB) oversees bank wide risk management. The senior executive level Credit Risk Management Committee (CRMC) manages implementation of credit risk management framework across the Bank and provides recommendations to the RMCB and the Board.

CRMC ensures implementation of credit risk policy and procedures, as approved by the RMCB and the Board, across the Bank and recommend changes thereto, considering any changes in the regulatory instructions, business or economic conditions. It also monitors quality of loan portfolio at periodic intervals, identifies problem areas and instructs business units with directions to rectify the deficiencies.

The Credit Risk Division of Risk Management Department, which is supported by all the business units, is entrusted with the responsibility of implementing processes for credit risk identification, assessment, measurement, monitoring and control. Credit risk appetite statements are drawn up with inputs from the business units and the credit risk parameters and credit exposure / concentration limits set by the Bank's Board of Directors / RMCB and RBI. The Division constructs credit risk identification systems, monitors quality of the bank's loan portfolio, identifies problem credits and undertakes asset quality reviews with support from the business units. The Division captures early warning signals in the loan portfolio for identification of weak exposures, suggests remedial measures and monitors the actions taken.

CRMC of the Bank meets once in two months to take stock of Bank's credit risk profile, based on the reports placed by Credit Risk Division.

Further, the Bank has put in place a detailed Credit Policy, spelling out various aspects of credit dispensation and credit administration. An effective governance framework to ensure the independence of the credit risk unit from the business units is being implemented. Through an effective, Board-approved credit risk governance framework, the Bank seeks to ensure adequate risk oversight, monitoring, and control of credit risks.

### 3.3 Credit Process

The Credit Policy of the Bank details the credit norms to be adhered to for each customer segment. An empowerment matrix is prescribed to ensure that a competent authority takes an informed decision on credit proposals and on any deviations to the norms. There are separate credit origination and appraisal processes for Joint Liability Groups (JLG) and Retail segments including agriculture. The Agriculture and Retail loan applications are evaluated by using statistical credit scoring model that serves as a single point indicator of diverse risk factors of the counter party, enabling the sanctioning authority to take decisions in a consistent manner. The score card is expected to evolve and get fine-tuned when more and more cases are sanctioned based on detailed credit appraisal.

#### 3.3.1 Risk Weights

The Bank adheres to RBI guidelines defined under the RBI Master Circular - Prudential Guidelines on Capital Adequacy and Market Discipline - New Capital Adequacy Framework (NCAF), for application of risk weights for credit risk measurement and capital computation purposes.

Credit Risk Mitigants have the effect of reducing the net exposure for application of risk weights. Credit Risk Mitigation techniques classified as eligible for reduction in the net exposure include:

i. Eligible financial collateral

ii. Guarantees

iii. On-balance sheet netting

### 3.4 Concentration Risk

The Bank manages concentration risk by means of prudential limits as directed by RBI, as well as internal limits. Credit concentration in the Bank's portfolios is monitored for the following:

(i) *Single party /Group exposure*: The Bank has set exposure limits individual borrower-wise and borrower group-wise which are continuously tracked and monitored.

(ii) *Geography-wise exposure:* The Bank continuously monitors the geographical concentration of the business and factors the inputs into strategic business planning. The Bank is aware of its credit concentration in southern states and is taking steps to reduce the same by growing the retail book in other geographies.

(iii) *Industry exposure:* The Bank's exposure to any single industry is currently not significant. Going forward, the Bank intends to track the exposure to specific industries and also to sensitive sectors, which would contribute to formulating the growth strategy of the Bank.

### 3.5 Credit Exposures & Risk Summary

**a) Exposure – Facility Type**

| S. No. | Exposure Type | ₹ in Crores |
|---|---|---|
| 1 | Fund Based* | 3249.25 |
| 2 | Non Fund Based | 3.12 |
| | **Total** | 3252.37 |

*Fund based exposure includes Non SLR investments of Rs.57.92 Cr.

**b) Geographic distribution of credit portfolio.**

| S. No. | Exposure Type | ₹ in Crores | Percentage |
|---|---|---|---|
| 1 | Domestic @ | 3191.33 | 100% |
| 2 | Foreign | Nil | 0% |
| | **Total** | 3191.33 | 100% |

@ Non-SLR investments (Rs.57.92 Cr) and Non Fund based exposure (corporate guarantee given for securitisation) of Rs.3.12 Cr excluded.

**b – 1) State-wise distribution of loan portfolio**

| S. No. | State | Portfolio Outstanding (In Rs. Crore) | % of Total Portfolio |
|---|---|---|---|
| 1 | Kerala | 1842.75 | 57.74 |
| 2 | Tamil Nadu | 708.08 | 22.19 |
| 3 | Maharashtra | 224.20 | 7.03 |
| 4 | Madhya Pradesh | 160.25 | 5.02 |
| 5 | Chhattisgarh | 95.47 | 2.99 |
| 6 | Karnataka | 71.32 | 2.24 |
| 7 | Jharkhand | 35.86 | 1.12 |
| 8 | Pondicherry | 26.31 | 0.82 |
| 9 | Bihar | 22.03 | 0.69 |
| 10 | West Bengal | 5.06 | 0.16 |
| | **Total** | 3191.33 | 100.00 |

The Bank is taking steps for reducing the geographic credit concentration by expanding its loan book to other states and geographies where the reach is less at present.

**c) Distribution of portfolio between secured and unsecured business (₹ in Crores)**

| S. No. | Exposure Type | ₹ in Crores |
|---|---|---|
| 1 | Secured | 18.32 |
| 2 | Unsecured | 3,173.01 |
| | **Total** | 3191.33 |

The Bank is taking steps to diversify the loan portfolio and increase the secured lending portfolio in a phased manner.

**d) Sector wise distribution (₹ in Crores)**

| S. No. | Industry Classification | Total Exposure | % of Total Exposure |
|---|---|---|---|
| 1 | Agriculture and Allied Activities | 1833.29 | 57.44% |
| 2 | Advances to Industries Sector eligible as Priority sector lending | 456.85 | 14.31% |
| 3 | Services | 272.98 | 8.56% |
| 4 | Personal Loans and others | 628.21 | 19.69% |
| | **Total** | 3191.33 | 100% |

### d) Maturity pattern of Assets (Rs. in lakhs)

| Maturity Bucket | Cash, Balances with RBI | Balances with Banks, Money at Call & Short Notice, Term Deposits and other placements | Investments | Loans & advances * | Fixed assets | Other assets | Total |
|---|---|---|---|---|---|---|---|
| Day – 1 | 31760.83 | 10478.61 | 6.08 | 739.19 | 0.00 | 0.00 | **42984.71** |
| 2-7 Days | 0.00 | 10000.00 | 5114.46 | 4435.12 | 0.00 | 0.00 | **19549.59** |
| 8-14 Days | 0.00 | 0.00 | 130.25 | 5174.31 | 0.00 | 0.00 | **5304.56** |
| 15-30 Days | 236.96 | 0.00 | 190.51 | 11827.00 | 0.00 | 0.00 | **12254.47** |
| 31 Days and upto 2 months | 757.49 | 172.51 | 608.98 | 14082.61 | 0.00 | 0.00 | **15621.59** |
| Over 2 Months and upto 3 months | 453.31 | 441.34 | 364.44 | 14082.61 | 0.00 | 0.00 | **15341.70** |
| Over 3 Months and upto 6 months | 1676.82 | 593.00 | 1348.08 | 62378.63 | 0.00 | 0.00 | **65996.53** |
| Over 6 Months and upto 1 year | 2700.57 | 3592.22 | 2171.13 | 107724.59 | 0.00 | 0.00 | **116188.51** |
| Over 1 Year and upto 3 years | 4148.76 | 622.67 | 4135.59 | 83861.65 | 0.00 | 0.00 | **92768.67** |
| Over 3 Years and upto 5 years | 801.68 | 0.00 | 644.52 | 1363.77 | 0.00 | 0.00 | **2809.97** |
| Over 5 years and upto 7 years | 359.09 | 20.00 | 288.69 | 1358.47 | 6870.25 | 7070.00 | **15966.50** |
| Over 7 years and up to 10 years | 0.81 | 12.50 | 18442.56 | 0.00 | 0.00 | 0.00 | **18455.87** |
| Over 10 year and up to 15 years | 0.00 | 0.00 | 12616.31 | 0.00 | 0.00 | 0.00 | **12616.31** |
| Over 15 years | 949.56 | 0.00 | 27124.74 | 0.00 | 0.00 | 0.00 | **28074.30** |
| **Total** | **43845.88** | **25932.85** | **73186.34** | **307027.95** | **6870.25** | **7070.00** | **463933.28** |

** NPA Excluded*

e) **Credit Exposure by Risk Weights (Rs. in Crores)**

| S. No. | Risk Weight | Gross Outstanding Credit | Risk Weighted Exposure for Credit |
|---|---|---|---|
| 1 | Below 100% risk weight | 2252.50 | 1683.29 |
| 2 | 100% Risk weight | 918.00 | 918.00 |
| 3 | More than 100% risk weight | 20.83 | 26.04 |
| | **Total** | 3191.33 | 2627.33 |

f) **Credit Risk Mitigation (Rs.in Crores)**

| S. No. | Particulars | Exposure | Credit Risk Mitigant | Net Exposure |
|---|---|---|---|---|
| 1 | Gold Loan | 0.20 | 0.20 | Nil |
| 2 | Loan against FD | 5.24 | 5.24 | Nil |

### 3.6 Classification of Non-Performing Assets

#### 3.6.1. Non-performing Assets

An asset including a leased asset becomes non-performing when it ceases to generate income for the Bank. A non-performing asset (NPA) is a loan or an advance where:

a) Interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan
b) The account remains ‘out of order’ as indicated in paragraph (i) below in respect of an Overdraft/Cash Credit (OD/CC).
c) The bill remains overdue for a period of more than 90 days, in case of bills purchased and discounted.
d) The instalment of principal or interest thereon remains overdue for two crop seasons for short duration crops
e) The instalment of principal or interest thereon remains overdue for one crop season for long duration crops

**(i) ‘Out of Order’ status:**

An account is treated as ‘out of order’ if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days, as on the date of balance sheet or the credits are not enough to cover the interest debited during the same period, these accounts are treated as ‘out of order’.

**(ii) Overdue:**

An amount due to the Bank under any credit facility is overdue, if it is not paid on the due date fixed by the Bank.

**(iii) Special Mention Accounts:**

The Bank is required to identify incipient stress in accounts by creating a sub asset category named Special Mention Accounts (SMA). It is considered as a corrective action plan to arrest slippages of standard assets to NPA status. Accordingly, the Bank is identifying three sub categories, under SMA as below:

- SMA -0- : Principal or interest payment or any other amount wholly or partly overdue between 1-30 days.
- SMA -1- : Principal or interest overdue between 31 – 60 days.
- SMA -2- : Principal or interest overdue between 61-90 days.

### 3.6.2. Relief for MSME Borrowers registered under Goods and Services Tax (GST)

RBI, vide notification dated 7th February 2018 (RBI/2017-18/129), has provided temporary relief on the NPA classification norms for MSME borrowers registered under Goods and Services Tax (GST) whose cash flows have been adversely impacted during the formalisation of business through registration under GST and consequently faced difficulties in meeting their repayment obligations.

As a measure of support to such smaller entities whose cash flows got affected, RBI has notified that exposures of borrowers classified as micro, small and medium enterprises under the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006, shall continue to be classified as standard asset in the books of banks and NBFCs, subject to the following conditions:

i. The borrower is registered under the GST regime as on January 31, 2018.
ii. The aggregate exposure, including non-fund based facilities, of banks and NBFCs, to the borrower does not exceed INR 250 million as on January 31, 2018.
iii. The borrower's account was standard as on August 31, 2017.
iv. The amount from the borrower overdue as on September 1, 2017 and payments from the borrower due between September 1, 2017 and January 31, 2018 are paid not later than 180 days from their respective original due dates.
v. A provision of 5% shall be made against the exposures not classified as NPA. The provision in respect of the account may be reversed as and when no amount is overdue beyond the 90-day norm.
vi. The additional time provided is for the purpose of asset classification only, and not for income recognition, i.e., if the interest from the borrower is overdue for more than 90 days, the same shall not be recognised on accrual basis

Loans & Advances are classified in the books of the Bank, as Performing Assets (Standard) and Non-Performing Assets (NPAs,) in accordance with RBI guidelines on Income Recognition and Asset Classification (IRAC) and the relief for MSME borrowers as mentioned above. NPAs are classified into sub-standard, doubtful and loss assets based on the criteria stipulated by RBI. The advances are stated net of specific provisions made towards NPAs, and unrealized interest on NPAs, if any. Interest on NPAs is transferred to an interest suspense account and not recognized in the Profit and Loss Account until realized.

### 3.6.3. Provisioning

Provision for non-performing advances comprising Sub-standard and Doubtful Assets is made in accordance with RBI guidelines.

**(i) Amount of NPA as on 31 March 2018**

| S. No. | Category | ₹ in Crores |
|---|---|---|
| A | Amount of NPA (Gross) | **121.05** |
| A.1 | Substandard | 113.07 |
| A.2 | Doubtful 1 | 7.98 |
| A.3 | Doubtful 2 | 0 |
| A.4 | Doubtful 3 | 0 |
| A.5 | Loss | 0 |
| B | Net NPAs | **84.81** |
| C | Advances | |
| C.1 | Gross Advances | 3191.33 |
| C.2 | Provision | 36.24 |
| C.3 | Net Advances | 3155.09 |
| D | **NPA Ratios** | |
| D.1 | Gross NPAs to gross advances (%) | 3.79% |
| D.2 | Net NPAs to net advances (%) | 2.69% |

**(ii) Movement of NPA for the year ending 31 March 2018 (₹ in crores)**

| Particulars | Gross NPA | Net NPA |
|---|---|---|
| Opening balance at April 1, 2017 | 7.85 | 3.59 |
| Addition during the period | 114.68 | 82.25 |
| Reduction/write-off during the period | 1.48 | 1.03 |
| Closing balance at March 2018 | 121.05 | 84.81 |

### (iii) Movement of Provision for the year ending 31 March 2018

| Particulars | ₹ in crores |
|---|---|
| Opening balance at April 1, 2017 | 4.25 |
| Provision made during the period | 32.43 |
| Write off/ write back excess provision | 0.44 |
| Closing balance at March 2018 | 36.24 |

## 4. Securitization Exposure:

### 4.1. Qualitative Disclosures

The Bank undertakes Securitization / Loan Assignment transactions with the objective of maximizing return on capital employed, managing liquidity and maximizing yield on assets. The revised securitisation guidelines issued by RBI on May 07, 2012 define minimum holding period, minimum retention requirements, due diligence, credit monitoring, stress testing requirements etc. The Bank undertakes sale transactions through both securitization and loan assignment routes in the following roles.

**Originator / Seller:** The Bank originates assets in its books and subsequently down sells them through the securitization or assignment route.

**Servicing and collection agent for sold assets:** The Bank undertakes the activity of collections and other servicing activities including preparation of monthly pay out reports.

**Credit Enhancement Provider:** The Bank may provide credit enhancement on securitisation (sale) transactions undertaken by the Bank for meeting shortfall arising out of delinquencies and prepayment losses in the underlying pool sold.

### 4.2 Risks involved.

#### 4.2.1 Regulatory & Legal Risks

The risks that arise as an originator of securitisation transactions, are mainly on account of non-compliance of transaction structures with the extant regulatory guidelines. In case the assets transferred do not meet the true sale criteria defined by RBI, the assets would be deemed to be on the balance sheet of the originator itself and the originator will be required to hold capital against the full value of securitised assets. Further, if the regulatory guidelines in respect of giving representations and warranties concerning the assets sold are not complied with or in case of non-compliance of regulatory guidelines on credit enhancement facility provided, the originator would require to maintain capital against the full value of securitised assets.

The Legal Risks arise when there is conflict between the provisions of the transaction document and those of the underlying financial facility agreement.

### 4.3 Accounting Transfer and servicing of assets:

The Bank transfer loans through securitisation transactions. The transferred loans are derecognized and gains / losses are accounted for, fully complying with the regulatory guidelines in this regard.

In accordance with RBI guidelines for securitization of standard assets, the profit / premium arising from sell down / securitization is amortised over the life of the transaction based on the method prescribed in the guidelines. Losses, if any, arising in the sell down / securitisation transaction, to be recognised upfront in the statement of profit or loss.

### 4.4 Quantitative details

#### 4.4.1. Quantitative details of securitization transactions originated.

| Particulars | FY 2016-2017<br>₹ in Crores | FY 2017-2018<br>₹ in Crores |
|---|---|---|
| Total number of loan assets securitised | Not Applicable | 329090 Numbers |
| Book value of loan assets securitized | Not Applicable | 553.03 |
| Sale consideration received for the securitized assets | Not Applicable | 539.73 |
| Gain / (Loss) on sale on account of securitization | 1.31 | 40.97 |
| Form of services provided * | Credit enhancement & post securitisation asset servicing | Credit enhancement & post securitisation asset servicing |
| Quantum (outstanding value) of services provided: | | |
| Cash Collateral | 45.43 | 41.11 |
| Over Collateral | 22.18 | 26.66 |
| Exposure to own securitization | 0 | 8.00 |

# ESAF SFB did not originate securitisation transactions during 2016-17. Securitisation transactions originated by ESAF Microfinance and taken over by ESAF SFB appears in FY 2016-17.

#### 4.4.2 Quantitative details of Assignment Transactions originated.

| Particulars | FY 2016-2017 | FY 2017-2018 |
|---|---|---|
| Total number of loan assets assigned | Not Applicable | Not Applicable |
| Book value of loan assets assigned | Not Applicable | Not Applicable |
| Sale consideration received for the assigned assets | Not Applicable | Not Applicable |
| Gain / (Loss) on sale on account of assignment | 0.95 Cr | 14.36 Cr |
| Form of services provided * | Post transaction asset servicing | Post transaction asset servicing |
| Quantum (outstanding value) of services provided | Not Applicable | Not Applicable |

# ESAF SFB did not originate any assignment transactions. Assignments originated by ESAF Microfinance and taken over by ESAF SFB appears in FY2016-17 and FY 2017-18.

### 5. Leverage Ratio

The Bank computes Leverage Ratio as per Basel III framework. Leverage Ratio is a non-risk based measure of exposure over capital. The leverage ratio is calibrated to act as a credible supplementary measure to the risk based capital requirements.

$$\text{Leverage Ratio} = \frac{\text{Capital Measure (Tier I Capital)}}{\text{Exposure Measure}}$$

| Leverage Ratio | | |
|---|---|---|
| | **Particulars** | **(₹ in Crores)** |
| **On Balance Sheet Exposure** | | |
| 1 | On-balance sheet items (excluding derivatives and Securities Financing Transactions (SFT), but including collateral) | 4724.13 |
| 2 | (Asset amounts deducted in determining Basel III Tier 1 capital) | |
| 3 | Total on-balance sheet exposures (excluding derivatives and SFTs) **(1 + 2)** | 4724.13 |
| | | |
| 4 | Replacement cost associated with all derivatives transactions (i.e. net of eligible cash variation margin) | 0 |
| 5 | Add-on amounts for Potential Future Exposure (PFE) associated with all derivatives transactions | 0 |
| 6 | Gross-up for derivatives collateral provided where deducted from the balance sheet assets pursuant to the operative accounting framework | 0 |
| 7 | (Deductions of receivables assets for cash variation margin provided in derivatives transactions) | 0 |

| | | |
|---|---|---|
| 8 | (Exempted Central Counter Party (CCP) leg of client-cleared trade exposures) | 0 |
| 9 | Adjusted effective notional amount of written credit derivatives | 0 |
| 10 | (Adjusted effective notional offsets and add-on deductions for written credit derivatives) | 0 |
| **11** | **Total derivative exposures (sum of lines 4 to 10)** | 0 |
| | | |
| 12 | Gross SFT assets (with no recognition of netting), after adjusting for sale accounting transactions | 0 |
| 13 | (Netted amounts of cash payables and cash receivables of gross SFT assets) | 0 |
| 14 | Counterparty Credit Risk (CCR) exposure for SFT assets | 0 |
| 15 | Agent transaction exposures | 0 |
| **16** | **Total securities financing transaction exposures (sum of lines 12 to 15)** | 0 |
| **Other off-balance sheet exposures** | | |
| 17 | Off-balance sheet exposure at gross notional amount | 897.41 |
| 18 | (Adjustments for conversion to credit equivalent amounts) | |
| **19** | **Off-balance sheet items (sum of lines 17 and 18)** | 897.41 |
| **Capital and total exposures** | | |
| **20** | **Tier 1 capital** | 390.13 |
| **21** | **Total exposures (sum of lines 3, 11, 16 and 19)** | 5621.54 |
| **Leverage ratio** | | |
| **22** | **Basel III leverage ratio** | 6.94% |

**Summary comparison of accounting assets vs. leverage ratio exposure measure**

| | Particulars | (₹ in Crores) |
|---|---|---|
| 1 | Total consolidated assets as per published financial statements | 4724.13 |
| 2 | Adjustment for investments in banking, financial, insurance or commercial entities that are consolidated for accounting purposes but outside the scope of regulatory consolidation | 0 |
| 3 | Adjustment for fiduciary assets recognized on the balance sheet pursuant to the operative accounting framework but excluded from the leverage ratio exposure measure | 0 |
| 4 | Adjustment for off-balance sheet items (i.e. conversion to credit equivalent amounts of off- balance sheet exposures) | 897.41 |
| 5 | Other adjustments | 0 |
| **6** | **Leverage ratio exposure** | 5621.54 |

## 6. Liquidity Risk

Liquidity refers to the Bank's ability to fund decreases in liabilities and / or increase in assets and meet both cash and collateral obligations at reasonable cost without adversely affecting its financial status. Liquidity risk arises if the Bank is unable to meet such obligations. The Bank's Asset Liability Management Committee (ALCO) is responsible for overseeing the management and governance of liquidity risk.

Liquidity risk management in the Bank is governed by the Board approved Asset Liability Management and Market Risk Management Policy, which covers the broad liquidity risk, Interest rate risk (Banking and Trading book) and Market Risk framework in accordance with RBI guidelines and as permitted under the rules applicable to Small Finance Banks.

## 7. Market Risk

The Basel Committee on Banking Supervision defines Market Risk as the risk of losses in on- or off-balance sheet positions that arise from movement in market prices.

The major components of market risk include:

1. Interest rate risk: The potential loss due to movements in interest rates. This risk arises because a bank's assets usually have a significantly longer maturity than its liabilities.
2. Equity risk: The potential loss due to an adverse change in the stock price.
3. Foreign exchange risk: The potential loss due to change in value of the bank's assets or liabilities resulting from exchange rate fluctuations.
4. Commodity risk: The potential loss due to an adverse change in commodity prices.

### 7.1 **Structure and organization of market risk management function**

The Risk Management Committee of the Board (RMCB) oversees the bank-wide market risk management. Asset Liability Management Committee (ALCO) also known as Market Risk Management Committee is primarily responsible for establishing Market Risk Management and Asset Liability Management in the Bank.

The ALCO headed by MD & CEO is responsible for implementing risk management guidelines issued by the regulator and monitoring adherence to the internal guidelines, procedures, practices/policies and risk management prudential limits. The major functions of ALCO, with respect to managing risks in the banking and investment books of the Bank include:

- Designing and implementing effective market risk management and ALM framework.
- Reviewing new directives and regulatory limits for market risk, interest rate risk and liquidity risk, monitoring and revisions to tolerance limits prescribed in the market risk management policy.
- Ensuring that business strategy of the Bank is in line with Bank's stated risk management objectives.
- Determining the structure, responsibilities and controls for managing Market Risk and for overseeing the liquidity positions.
- Ensuring independence of working of the Mid Office and Market Risk functions.

The Market Risk Division of the Risk Management Department is responsible for the design and implementation of the Bank's market risk management/ALM system. The Division is independent from business and trading units, and provides an independent risk assessment, which is critical to the ALCO's key function of controlling and managing market risks in accordance with the mandate established by the Board and Risk Management Committee. Mid Office of the Bank's Treasury function is attached to the Market Risk Division of Risk Management Department. Mid Office prepares and analyses daily reports on various activities of the Bank's Treasury. The Mid Office, which is responsible for the critical functions of independent market risk monitoring, measurement and analysis, reports to the Bank's Chief Risk Officer through the Head of Market Risk Division.

## 7.2. Interest Rate Risk in the Banking Book.

### 7.2.1 Qualitative Disclosures:

Interest rate risk refers to impact on Bank's Net Interest Income, and the value of its assets and liabilities arising from fluctuations in interest rate due to internal and external factors. Internal factors include the composition of Bank's assets and liabilities, quality, maturity, existing rates, and re-pricing period of deposits, borrowings, loans and investments. Economic factors cover general economic conditions. Rising or falling interest rates impact the Bank depending on whether the balance sheet is asset sensitive or liability sensitive.

The Asset-Liability Management Committee (ALCO) is responsible for evolving appropriate systems and procedures for on-going identification and analysis of Balance Sheet Risks and laying down parameters for efficient management of these risks through Asset-Liability Management Policy of the Bank. ALCO, therefore, periodically monitors and controls the risks and returns, funding and deployment, setting Bank's lending and deposit rates, and directing the investment activities of the Bank. ALCO also develops the market risk strategy by clearly articulating the acceptable levels of exposure to specific risk types (i.e. Interest rate, liquidity etc.)

RBI has stipulated monitoring of interest rate risk through a statement of Interest Rate Sensitivity (Re-pricing Gaps) to be prepared on a monthly basis. Accordingly, ALCO reviews interest rate sensitivity statement on monthly basis and monitors the Earnings at Risk (EaR) which measures the change in Net Interest Income of the Bank due to parallel change in interest rate on both assets and liabilities.

RBI has also stipulated to estimate the impact of change in interest rates on economic value of Bank's assets and liabilities through interest rate sensitivity under Duration Gap Analysis (IRS – DGA). Bank also carries out Duration Gap Analysis on a monthly basis as stipulated by RBI. The impact of interest rate changes on the market value of equity is monitored through Duration Gap Analysis by recognizing the changes in value of assets and liabilities by a given change in the market interest rate. The change in value of equity (including reserves) with 2% parallel shift in interest rates for both assets and liabilities is estimated.

### 7.2.2. Quantitative Disclosures:

**Earnings at Risk (EaR)**

| | Impact on NII<br>**(₹ in Crores)** |
|---|---|
| Impact of 100 bps parallel shift in interest rate on both assets & liabilities on Net Interest Income (NII) | 1.52 |

**Market Value of Equity (MVE)**

| | Impact on MVE<br>**(₹ in Crores)** |
|---|---|
| Impact of 200 bps parallel shift in interest rate on both assets & liabilities on Market Value of Equity | 26.23 |
| Impact of 100 bps parallel shift in interest rate on both assets & liabilities on Market Value of Equity | 13.12 |

As the Reserve Bank of India has not prescribed capital charge for market risk for SFBs, the Bank has not computed capital charge for Market Risk.

## 8. Operational Risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

Operational risk is primarily managed by prescribing adequate controls and mitigation measures which are being reviewed and updated on a regular basis to suit the changes in business practices, structure and risk profile.

### 8.1. Structure and organization of operational risk management function

Risk Management Committee of the Board oversees the bank-wide Operational Risk Management. Bank has put in place a detailed framework for Operational Risk Management under a Board approved ORM Policy.

While Operational Risk Management is the responsibility of all functions and business units handling operational activities, the Operational Risk Management Committee (ORMC) at the executive level oversees bank-wide implementation of the Board approved policies and processes. The principal objective of the ORMC is mitigation of operational risk in the institution by creation and maintenance of an explicit operational risk management process.

The ORMC reviews the risk profile to take into cognizance future changes and threats, and concurs on areas of highest priority and related mitigation strategy with different functions and business units. The committee ensures that adequate resources are being assigned to mitigate risks as needed, and communicates to business units and functions, the importance of operational risk management in business activities.

### 8.2. Business Continuity Management.

The Operational Risk Management Committee also functions as the Business Continuity Management (BCM) Committee, which is responsible for implementation of the Business Continuity Management process and procedures across the Bank. A comprehensive, Board approved, bank-wide Business Continuity Plan has been put in place to ensure continuity of critical operations of the Bank covering all identified disasters.

Operational Risk management, Business Continuity Management and coordination of relevant activities are the responsibilities of the Operational Risk Division of Risk Management Department. The Division is responsible for coordinating all the operational risk management and business continuity planning activities of the Bank, to facilitate achievement of the stated goals and objectives. Activities include building up an understanding of the risk profile, implementing tools related to operational risk management, and working towards the goals of improved controls and lower risk.

The ORM model of the Bank facilitates conducting of Risk and Control Self Assessments, scenario assessments, controls testing, investigation of incidents, issues tracking and development of action plans. Each of these activities can be linked to the other activities in the system, thereby providing an integrated and centralized framework for collecting, managing, and storing information.

The Bank has an internal framework for reporting and capturing Operational Risk incidents. The incidents reported are investigated to assess weaknesses in controls and identify areas for improvement.

The Bank uses an enterprise-wide Risk Management software solution, SAS Enterprise GRC, for management of Credit, Market and Operational Risks. The application automates the management of governance, risk, and compliance (GRC) data, and facilitates the entry, collection, transfer, storage, tracking, and reporting of operational losses, gains, recoveries, and key risk indicators (KRIs) that are drawn from multiple locations across the organization.

It facilitates conducting of Risk and Control Self Assessments, scenario assessments, controls testing, investigation of incidents, issues tracking and development of action plans. Each of these activities can be linked to the other activities in the system, thereby providing an integrated and centralized framework for collecting, managing, and storing GRC information.

The Bank has also framed a whistle blower policy, which is open to employees and vendors for raising their concerns, with full confidentiality, on any fraud, malpractice or any other untoward activity or event.

Since RBI has not prescribed capital charge for Operational Risk for SFBs, the Bank has not computed capital charge for Operational Risk.

### 8.3. AML monitoring as a Risk Management activity

Anti-Money Laundering (AML) initiatives have evolved to be one of the major focus areas for financial institutions, with the widespread prevalence of financial crimes and malpractices. The regulatory controls and compliance requirements in place and the objective of ensuring that the Bank's customer base excludes persons attempting money laundering and other financial crimes, have placed prime importance on the AML programme of the Bank. In view of the increasing importance of this function, the Bank has attached its AML Cell to Risk Management Department.

The AML Cell of the Risk Management Department functions with focus on the following aspects:

- Risk categorisation of customers at the time of account opening, and transaction monitoring along the lines of the risk categorisation of the customers.
- Maintenance of a compliance culture across the organization ensuring that all employees starting from branch staff, understand money laundering risks and the consequences of breaches of the AML norms.
- Effective implementation of the KYC/AML Policy of the Bank ensuring that the Bank is not used for money laundering or terrorist financing activities
- Development and maintenance of a comprehensive AML/ Combating Financing of Terrorism (CFT) programme in line with the regulatory requirements covering systems and controls, training of staff and management oversight and ensure its effective implementation.
- Reporting on cash transactions above the limits specified, transaction involving receipts by non-profit organizations and transactions involving the use of forged or counterfeit currency notes, to the Director, Financial Intelligence Unit- India.

### 9. Information Security Risk Management:

- Robust information and cyber security frameworks are established for securing the IT infrastructure and systems of the Bank. Oversight of Information Security Governance for the Bank is the responsibility of the Information Security Governance Committee (ISGC). The ISGC is a management level committee headed by the Managing Director & CEO. ISGC is the central representative body of senior management from different business functions to provide clear direction and support for Information Security Risk Management initiatives in the Bank.
- The ISGC monitors, reviews, directs and manages the Bank's Information Security Risk Management System within the Bank. This Committee acts as apex committee for handling Information Security risk related initiatives in the Bank, and reports to the Board of Directors through the IT Strategy Committee of the Board and keeps the Board apprised of relevant risks that needs attention.
- The Information Security Division of Risk Management Department is headed by the Chief Information Security Officer, who reports to the Chief Risk Officer directly.

### 10. Risk Management for protecting interests of stake holders

- The ESAF SFB articulates its business strategy and conducts operations within a structured risk management framework, with focus on active management of all financial and non-financial risks faced by the Bank. The Bank endeavours to establish itself as a professionally serious organisation in management of risks, with an ultimate goal of protecting the interests of all its stakeholders, including the shareholders, customers, investors, employees and all others who directly and indirectly deal with the Bank in various areas and geographies of its operations.

- An apex committee of senior executives vets all new products and processes and changes thereto before they are implemented in the Bank for managing the financial and non-financial risks in a manner consistent with its risk appetite.

- The focus and efforts of the Bank in identifying, measuring, monitoring, managing and mitigating risks, and on exercising control on the business and socio-economic environment in which it operates, to the required extent, ensure that all of its valuable stakeholders are protected from any undesirable events, outcomes, sufferings and losses, in the best manner possible.

## 11 Conclusion

The transformation from a Microfinance institution to a Small Finance Bank has brought with it a plethora of opportunities and challenges relating to funding sources, credit delivery and administration, putting in place the required infrastructure, policies and processes, recruitment and training manpower etc. Within one year of commencing operations, the Bank has been successful in diversifying its funding sources and credit delivery as well as putting in place the required systems, policies and procedures. Additional infrastructure facilities are also being put in place and recruitment and training of staff to meet the challenges ahead are progressing. The policies, systems and processes are being regularly improved upon fully complying with the directions and guidelines issued to Small Finance Banks by RBI from time to time.

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