RISK MANAGEMENT POLICY

OF

GUJARAT STATE FINANCIAL SERVICES LTD. (GSFS)

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Background

GSFS was established to ease and facilitate financial resources to the state-owned undertakings. To further this objective, the State Government has given mandate to the Company to manage the surplus funds of the state entities and has issued directions from time to time to Government of Gujarat (GoG) entities for placing their funds with GSFS, in order to effectively implement the mandate. GSFS primarily provides these funds as loans to GoG entities only and hence acts as an in-house fund manager to the GoG entities. Thus, the idea of formation of GSFS is to manage funds of GoG entities which results into the circulation of funds within the State Government ambit. With respect to this mandate, it is prudent for GSFS to manage its assets and liabilities in a manner such that it is able to repay its obligations in a timely manner. This is also a statutory obligation as RBI, the regulating agency for NBFCs, has stipulated that NBFCs should have an effective Risk Management Policy as a part of their overall system for effective risk management.

Business Model of GSFS

GSFS has a unique business model in India which creates a win-win situation for GoG entities placing their funds with GSFS, GoG entities taking loans from GSFS and Government of Gujarat. The basic objective of the Company is to manage the surplus funds of GoG entities as per the mandate of State Government. The funds received are primarily provided as loans to other GoG entities at a lower rate as compared to banks/FIs. The business model of GSFS is a unique time-tested model in India which has been in operation since last more than two decades and continues to be so. Some of the salient features of the simple but highly effective business model are as under:

i. GSFS accepts funds from GoG entities as per the mandate of Government of Gujarat, at interest rates which are higher than Banks.

ii. The funds received by GSFS from GoG entities are provided as loans to GoG entities on merit, at interest rates which are lower than Banks/FIs thereby lowering their borrowing costs.

iii. In the event of immediate unavailability of new avenue for loans and to maintain adequate liquidity, GSFS invests these funds in the Liquid/Debt Schemes of approved Mutual Funds and MIBOR linked ICDs with Primary Dealers (PDs) till such time it gets the opportunity to cater the loan requirement of any GoG entity.

iv. GSFS carries out all its functions through a small setup located at a single location with limited number of employees.

v. GSFS does not accept deposits from public nor does it provide any loan to individuals or any private Company. Hence, as the Company operates within the ambit of GoG entities only, its business model does not transmit any risks to the financial market.

vi. The entire mechanism as mentioned above works as per the Credit and Investment Policy approved by Government of Gujarat.

vii. The entire business model of the company runs on the strength of the State Government parentage.

The major assets and liabilities of GSFS consist of the following:

A. Liabilities – Deposits in the form of Inter Corporate Deposits (ICDs) received from GoG entities with tenors ranging from 15 days to 3 years and Liquid Deposit Scheme (LDS) received from GoG entities having tenor less than 15 days.

B. Assets – Deployment of funds as Loans to GoG entities and Money Market Investments.

Objective, Scope and Purpose

The objective of this policy is to ensure sustainable business by way of identifying, measuring, controlling, and reviewing various risks like Liquidity Risk, Credit Risk, Interest Rate Risk, Price Risk, Operational Risk, IT Risk and Compliance Risk.

In order to achieve the key objectives, the Policy establishes structured and disciplined approach to Risk Management, in order to guide decisions on risk related issues enabling the Company to make consistently prudent business decisions.

Types of Risks

1) Liquidity Risk

Liquidity Risk in the context of NBFCs involved in the activity of lending is the risk of inadequate liquidity to further the business. Lack of adequate liquidity or non-availability of liquidity on time hampers the business prospects of NBFCs.

Liquidity Risk Mitigation

Company's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due without incurring unacceptable losses or risking damage to the Company's reputation.

By virtue of the unique business model of GSFS, the supply of funds from GoG entities in the form of ICD and LDS is unanticipated and unregulated but continuous in nature (fresh as well as renewals) on account of budgetary allocations from State Government to GoG entities on year to year basis. It has been the experience of the company that major portion of deposits placed with the company are renewed on maturity**.** The Company deploys sufficient portion of its funds in Money Market instruments which are available at very short notice and can be used to honour even the sudden demands of large repayment from its depositors. The Company closely monitors its liquidity position and manages its receipts and repayments from / to GoG entities in an optimal manner.

The Company has framed Asset Liability Management (ALM) Policy to create an institutional mechanism to monitor the maturity pattern of the various liabilities and assets of the company from time to time. As per the ALM Policy, the Company has a well defined mechanism wherein the Asset Liability Committee (ALCO) has been framed consisting of three Directors including the Managing Director and an Independent Director. There is also an ALM Support Group consisting of senior officials who will be analyzing and monitoring liquidity position of the company and in case of any adverse situation, will report to ALCO. The ALCO will review various MIS reports alongwith the templates stipulated by Reserve Bank of India for reviewing the liquidity and interest rate risk. The ALCO will also review interest rate sensitivity, price sensitivity, stress test on liquidity coverage, structural liquidity position and collateral management position as per the Liquidity Risk Management (LRM) framework of RBI. The ALCO will meet as and when needed depending upon the requirement but atleast once in a financial year.

Process to quantify liquidity costs in the internal product pricing, performance measurement and new product approval process:

As per the business model of the company, it receives funds from Government of Gujarat (GoG) entities as per the mandate of the State Government which directs GoG entities to park their funds with GSFS. Hence, this is the only source of funding for the company. These funds are provided as loans to other GoG entities and remaining funds are invested in the GSGS (Gujarat State Government Securities) and open ended overnight/liquid/debt schemes of Mutual Funds.

The company uses its on-hand balance, its investments in open-ended overnight/liquid/debt schemes of Mutual Funds and fresh inflow of funds from GoG entities for its repayment requirements. Hence, as per the business model, the liquidity requirements of the company are met through internal avenues only and the company does not require to undertake any outside borrowings.

In the absence of any outside borrowing, the process to quantify the liquidity cost of company for internal product pricing and performance measurement is not prescribed.

In case of change in the above business model of the company, the process to quantify the liquidity costs will be considered accordingly and made a part of this policy.

2) Credit Risk

Credit Risk refers to the risk arising from the repayment default by the borrowers of the Institution providing credit.

Concentration Risk arises from the concentration of company's exposure to particular borrowers.

Perspective of Credit and Concentration Risk in context of GSFS

The Policy, while defining the Credit and Concentration risk, takes into consideration the fact that GSFS has a unique business model, wherein as per the State Government directive, GSFS receives funds only from GoG entities. These funds are provided as loans to GoG entities only. Keeping this perspective into consideration, the loan proposals are vetted mainly taking into account the borrower's loan requirement, asset liability mix of GSFS and parentage of the borrower i.e. Government of Gujarat.

Credit Risk Mitigation

GSFS, by virtue of its unique business model and as per the State Government approved Credit and Investment Policy, shall provide loans to only GoG entities but not any private entity or retail segment. As per this business model, the GoG parentage of the loanee company shall be the single most important and deciding factor while giving loans to any GoG entity.

The key element of credit risk mitigation includes a structured and standardized credit approval process wherein the Approval Note of the fresh loan proposal is prepared by including details like profile of the loanee, purpose of finance, available key financials, board of directors, shareholding pattern and other terms and conditions. The Approval Note shall be placed for approval to the Finance Committee of GSFS, which comprises of three Directors of the company who are senior secretaries of the Finance Department. By virtue of their position in Finance Department, these Finance Committee members have the holistic view of the financial positions of loanee entities. The approval of the Finance Committee is a prerequisite condition before disbursement of the loan. Each and every approval of the Finance Committee is to be subsequently placed in the ensuing Board Meeting for ratification by the Board Members.

Concentration Risk Mitigation

The Policy, while assessing the Concentration Risk, considers the unique business model of GSFS as enumerated above wherein the company is allowed to give credit to GoG entities only. Considering this business model, the Reserve Bank of India (RBI) has granted exemption to the company from concentration of credit norms to the extent of exposure to the Government of Gujarat entities.

3) Interest Rate Risk

Interest Rate Risk is the changes in the future cash-flows of a financial instrument on account of changes in the interest rates in the financial markets.

The changes in the interest rates affect NBFCs by way of changes on the NBFCs earnings on account of changes in its Net Interest Income. Interest rates are sensitive to many factors like RBI’s Monetary Policies, inflation, domestic economic indicators, international geo-political situations, global events in financial markets etc.

Products of GSFS in terms of Interest Rate Risk

The liabilities of GSFS majorly constitute of funds received under ICD and LDS from Government of Gujarat entities. Assets constitute of loans provided to other Government of Gujarat entities, Investments in GoG securities (GSDL) & Municipal Corporation Bonds and MIBOR linked ICDs with Primary Dealers (PDs).

The interest rate offered on ICD & LDS and interest earned on Investments in GoG securities (GSDL) & Municipal Corporation Bonds remain fixed during its tenure. Hence, the company has no interest rate risk on these instruments. However, the loans given to GoG entities and the funds placed with Primary Dealers are on floating interest rate basis and therefore, change as per the changes in market interest rate.

Interest Risk Mitigation

With respect to the RBI's Liquidity Risk Management (LRM) Framework, the ALCO will review the interest rate sensitivity based on hypothetical scenarios during its meeting to measure the sensitivity on loans to GoG entities and investment with Primary Dealers. The minutes of the ALCO will be kept before the Risk Management Committee (RMC) for review.

The interest rate on the financial products are to be decided by the Finance Committee from time to time taking into consideration the ongoing interest rate trend, asset-liability position, deposit rates, cost of funds and the fund position of the Company from time to time and after considering GSFS's administrative and other expenditures and nominal savings.

The interest rates on investments with Primary Dealers are linked with the benchmark FBIL-MIBOR rate which is floating in nature. This small investment is strategically kept to avail benefit of highest liquidity it offers. However, due to a very small size as compared to the overall size of Company's assets, the changes in the interest rates on this segment will not have any major impact on the earnings.

4) Price Risk

Price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk).

Products of GSFS in terms of Price Risk

The funds invested in the Liquid/Debt Schemes of approved Mutual Funds constitute usually more than 50% of the total asset size of the company. This investment is exposed to price risk mainly because of changes in NAVs of Mutual Funds, which are marked to market on daily basis as per guidelines of the Regulator. The returns from Liquid/Debt schemes are primarily based on interest rate movement in the financial market which are dependent on various parameters such as liquidity position in the financial market, fiscal and monetary policies of Government and RBI and various other economic and geo-political factors, domestic as well as global, and hence are varying in nature.

The investment in Equity Shares by the company is also subject to price risk on account of changes in the market price of shares on daily basis. The changes in the market price is dependent on various domestic and international factors effecting the Stock Market and the events of the respective companies whose shares form part of the portfolio.

Price Risk Mitigation

With respect to the RBI's Liquidity Risk Management (LRM) Framework, the ALCO will review the price sensitivity based on hypothetical scenarios during its meeting to measure the price sensitivity of investment in Mutual Funds and Shares. The minutes of the ALCO will be kept before the Risk Management Committee (RMC) for review.

The Price Risk for investment in Mutual Funds is mitigated by the company by diversifying its deployment in different Liquid/Debt schemes of empanelled Mutual Funds. The company carries out investment in this avenue strictly as per the norms stipulated in its Credit & Investment Policy which is approved by Government of Gujarat which specifies only certain category of schemes for investment.

The investment in shares is held by the company based on the directions of the State Government in order to strategically retain its shareholding in the respective companies and as a progressive move towards attaining the improvement of CRAR of GSFS. The Company will keep track of the prices of the shares and place it for information at every Board Meeting.

Risks Related to Internal Rate of Return (IRR), Net Interest Margin (NIM) and Earnings and Strategy to manage IRR

As per the business model of the company, it receives funds from Government of Gujarat (GoG) entities as per the mandate of the State Government which directs GoG entities to park their funds with GSFS. Hence, this is the only source of funding for the company. These funds are provided as loans to other GoG entities and remaining funds are invested in the GSGS (Gujarat State Government Securities) and open ended overnight/liquid/debt schemes of Mutual Funds.

Hence, as per the business model, the liquidity requirements of the company are met through internal avenues only and the company does not require to undertake any outside borrowings at market linked rates.

Given the above facts, the company, which runs as per the GoG centric business model, follows the basic objective of providing more benefits to its clientele Government of Gujarat entities instead of pursuing commercial objective. In line with this, the company endeavours to provide better rates on funds received from GoG entities and offers competitive rates on loans provided to GoG entities. Keeping this perspective into consideration, the company shall not target a specified Internal Rate of Return (IRR)/Net Interest Margin/Earnings and shall maintain nominal profit on a sustainable basis.

5) Operational Risk

The Operational Risk refers to the risk of the processes to maintain checks and balances in its operations. Necessary controls are essential to ensure that there are no intentional or unintentional errors that creep into the process.

Operational Risk Mitigation

The Company, in order to mitigate this risk, shall carry out the processes as per its Standard Operating Procedure (SOPs) enumerated for each functions namely, Borrowings, Loans and Advances, Investments, Cash and Bank, Fixed Assets, Financial Reporting and Human Resource. The adherence of SOPs, while performing the internal functions in each of these segments, is ensured by way of Internal Audit of the company.

The Internal Audits are carried out every quarter by the independent audit firm appointed by the Board. The scope of this Internal Audit covers areas of Internal Control, Finance and Accounts, Resource Management, Human Resource Management, Credit Management, Investment Management, Secretarial Management and Statutory Compliance. The Internal Audit also audits the company's adherence to all Statutory and Regulatory guidelines that have been prescribed by RBI and other Statutory authorities. All audit observations of Internal Audits and follow-up actions are presented to the Audit Committee. The Minutes of the Audit Committee are placed in the Board Meeting.

6) IT Risk

Information Technology (IT) is essential to enhance safety, security, efficiency in processes leading to benefits for NBFCs. GSFS acts as a fund manager to various GoG entities and thereby carries out various financial transactions. Hence the role of Information Technology (IT) is of critical importance for the company on account of the steady increase in the size of the company. The significance of the role of IT in the business operations of NBFCs has been emphasized even by RBI.

IT Risk Mitigation

The Company has formed an IT Strategy Committee consisting of 3 members namely, Chief Information Technology Officer (CITO), Director and an Independent Director to carry out review and suggest necessary amendments, if required, for matters related to IT Governance, IT Policy and IT Risk Assessment to ensure an effective IT strategy policy is in place. The Minutes of the IT Strategy Committee will be placed in the ensuing Board Meeting for review.

Company has formulated an AUP (Acceptable Use Policy) wherein different aspects of general IT controls like the desirable and responsible use of company's IT assets by different stakeholders, steps to ensure security and confidentiality of company's data and the remedial rights available with the company in case of breach of AUP have been described.

The Company has embarked upon the process of creating an IT infrastructure wherein it has assigned the task of development, design and implementation of Web Based Integrated Core-Banking/NBFC Solution with Financial Accounting Management Information & Decision Support System to the software developer to upgrade its IT systems and controls. The new IT solution will be able to address the major concerns of RBI related to the IT framework in context to the company.

7) Compliance Risk

GSFS is established under the Companies Act and is also an NBFC in the NDSI (Non Deposit Taking Systemically Important) (Middle Layer) category. Hence the company is subject to compliance of regulations pertaining to Companies Act, accounting, taxation and other laws of India including Reserve Bank of India regulations.

Compliance Risk Mitigation

The Company being a Government Undertaking, is subject to various audits like Internal Audit, Statutory Audit, CAG Audit (Accounts and Proprietary both), Secretarial Audit and inspection by RBI which review the entire functioning of the company in terms of processes, rules, and proprietary aspects. Reports of the audits and inspections are placed in the respective committees/board.