

NBFC - Enterprise Risk Assessment

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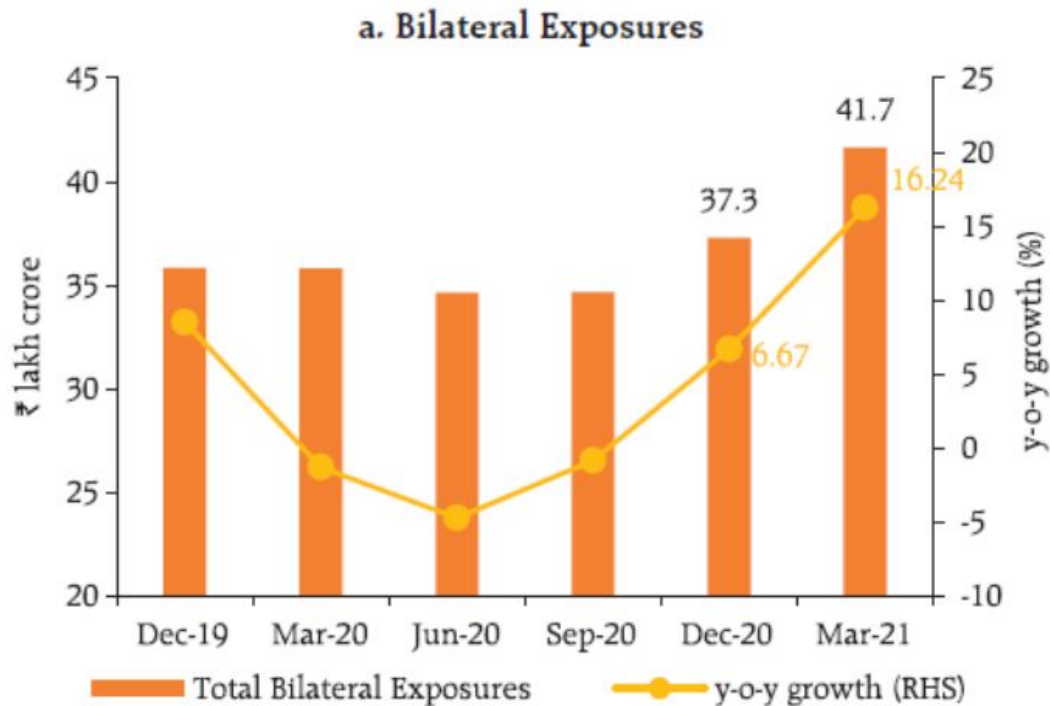


Introduction

NBFC & Systemic Risk



NBFC & Systemic Risk (I/2)



- An NBFC is prone to inherent risks while operating in the financial sector
- NBFC sector has, over the years, evolved considerably in terms of size, operations, technological sophistication and entry into newer areas of financial services and products
- Number as well as size of NBFCs has increased
- Interconnectedness and inter-linkages with banks, capital market and other financial sector entities (eg. MFs) has increased – contagion risk

Source: RBI Financial Stability Report July 2021

NBFC & Systemic Risk (2/2)

- NBFCs are growing more and more relevant to the Indian financial sector; they are the largest receiver of funds followed by HFCs
- Aggregate credit extended by NBFCs stood at 28.5 lakh crores in March 2022 and borrowings form approx. 62.5% of the source of funds
- Net-payable by NBFCs to Financial Sector have grown by 10.2% and for NBFC and HFC together it grew by 10% in past 1 year
- IL&FS has given clear lessons on how NBFC sector can be the one that sets off the domino effect across financial sector
- From being around 12% of the balance sheet size of banks (2010), they are now more than a quarter of the size of banks
- NBFCs were the largest net borrowers of funds from the financial system, with gross payables of ₹12.46 lakh crore and gross receivables of ₹1.62 lakh crore as at end-March 2022. Over half of their borrowings were from SCBs and this share increased further during H2:2021-22 as their reliance on funding by AMC-MFs and insurance companies reduced.

Net Receivables (+ve) / Payables (-ve) by Institutions



Source: Financial Stability Report, June 2022 | In Lakh Crores

Regulatory Response

- Moved to a scale based regulation (SBR) framework
- The SBR framework imposed the following on specified NBFCs
 - Internal Capital Adequacy Process (ICAAP)
 - Compliance Risk Assessment (CRA)
- Risk-based Internal Audit (RBIA) mandated for specific NBFCs

Measure	Applicability
ICAAP	NBFC-ML
	NBFC-UL
CRA	NBFC-ML
	NBFC-UL
RBIA	Deposit taking NBFCs (NBFC-D)
	Non-deposit taking NBFCs (NBFC-ND with asset size > ₹ 5000 crores)



Risk Assessment Methodology

A Scorecard-based Qualitative Methodology



Parameters

■ Inherent Risk

Risks inherent to the NBFC. Inherent risk levels are judged in the absence of risk control and mitigation measures.

■ Risk Event

Occurrence or change of a particular set of circumstances. Risk Event refers to specific event (e.g. breach of code of conduct, breach of data security, etc.) that cause the risk to materialise.

■ Likelihood

The chance of the risk event happening, whether defined, measured or determined objectively or subjectively, qualitatively or quantitatively.

■ Consequence

Outcome of a risk event whether defined, measured or determined objectively or subjectively, qualitatively or quantitatively.

■ Control/ Control Activities

Measures that maintain or modify risk. Controls/ Control Activities include any process, policy, program, practice, or other conditions and/or actions of the Company or any of its personnel which maintain or modify risk.

■ Residual Risk

Risk that is retained in the business after applying the Control measures. Residual Risk levels are determined on the basis of the inherent risk level adjust by the level of control.

■ Line of Business/ Support Function (LoB/ SF)

The business (e.g. Wheels, LAP, LAS, etc) and support functions (IT, HR dept., etc.) of the NBFC.

■ Risk Source

Elements which alone or in combination has the potential to give rise to the risk event (e.g business practice, management, employees, organisation, etc.).

Risk Sources

■ Risk Source

Elements which alone or in combination has the potential to give rise to the risk event.

Illustration

- Organisation related risks
- Management related risks
- Business practice related risks
- Employee related risks
- Customer related risks
- Third party/ outsourced service provider related risks
- Environmental impact related risks
- Social responsibility related risks
- Welfare, Health & safety related risks
- Technology, data security & privacy related risks
- Interpretation related risks
- Others*

* NBFCs operate within a dynamic environment (both internal and external) and the list of risk sources is not static. The risk assessment exercise should identify any additional risk sources or breakdown an identified risk source into more granular sources given their materiality

Inherent Risk - Consequence/ Impact Assessment

Consequence

- Outcome of a risk event whether defined, measured or determined objectively or subjectively, qualitatively or quantitatively

Event	Example	Impact
Legal/ regulatory sanctions, loss of authorisation to operate or enforcement action against Director/ Senior Management	ex. PMLA/ CFT event, suspension of licence, corruption	High
Damage to financial soundness	ex. loss of access to capital markets, suspension of listing	High
Impact on the integrity of the financial system	ex. Bank run (this item can be ignored)	High
Loss of reputation	ex. headline news event	High
Damage to/diminishing of reputation	ex. adverse news report	Medium
Damage to part of organization's business model/ objectives	ex. regulatory change prohibiting loan loaded PPI	Medium
Inability to enforce contracts/ voiding of contracts	ex. Regulatory change voiding certain arrangements (FLDG)	Medium
Major fines, civil claims	ex. major fines, civil claim, class action	Medium
Minor Fines, civil claims	ex. late filing fee	Low

Inherent Risk - Likelihood Assessment

Likelihood

- The chance of a risk event happening, whether defined, measured or determined objectively or subjectively, qualitatively or quantitatively

High

The Risk Event is certain/ almost certain to occur within next 1 year

Medium

The Risk Event is likely to occur within next 1 year

Low

The Risk Event could occur only in remote/ exceptional circumstances

Illustrative basis to assess likelihood –

- Whether there are industry instances of the risk event which leads to any of consequences listed under the Impact Assessment section?
- Whether the risk event has occurred in the past leading to any of consequences listed under the Impact Assessment section?
- The extent to which the function/ process, to which the risk is relevant to, is active in the Company (LoB/ Support Function)
- **Note:** At this stage, likelihood is to be judged without taking into consideration any risk management processes (RMP)/ internal control implemented by the Company

Control - Design Effectiveness

Design Effectiveness -

- Evaluation of 'Design Effectiveness' is used to determine whether the Company's risk management processes/ control, if they are operating as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the Company's risk management objectives.

Illustrative basis to assess Design Effectiveness –

- Whether the Company has a well defined, documented and updated risk management process (RMP) for such inherent risk?
- Whether such RMP has been reviewed and approved at the appropriate level (Board/ RMC/ Senior Management)?
- Whether such RMP has clearly articulated the ownership, accountability, roles and responsibilities of the personnel involved in such risk management process?
- Whether such RMP takes into consideration the organisational environment and all the external environment and dependencies that the RMP is subject to?
- In case risk event has taken place, whether such RMP takes into account the identified root cause and risk remediation processes taken to address such failure?

Control - Implementation Effectiveness

Implementation Effectiveness -

- Evaluation of 'Implementation Effectiveness' is used to determine whether the risk management processes/ controls are performing as designed and the person performing the control possesses the necessary authority and competence to perform the control effectively

Illustrative basis to assess Implementation Effectiveness –

- Whether the RMP have been communicated to the appropriate personnel (any training programs in place)?
- Whether there have been any failures in the last [3/ 5 years] w.r.t. to such inherent risk? Whether remediation processes have been implemented in such cases?
- In cases where remediation processes have been put into place, whether subsequent failure has still occurred?
- Whether there have been any observations from the Company's statutory/ internal auditors with regard to such inherent risk?

Residual Risk Level

- Residual Risk is the risk that is retained in the business, i.e., Inherent Risk adjusted by Control Effectiveness

Residual Risk Scorecard Principle:

- Residual Risk cannot be greater than Inherent Risk
- Where Internal Control Effectiveness covers or exceeds the perceived Inherent Risk, Residual Risk is Low
- Where the gap between Internal Control Effectiveness and Inherent Risk is minimal, Residual risk is Medium
- Where the gap between Internal Control Effectiveness and Inherent Risk is substantial, Residual risk is High

Identification & Assessment Techniques

- Risk identification and assessment including identifying Risk Sources, Risk Events and evaluating their likelihood and consequences may be performed by utilizing certain techniques either singly or in combination
- It should be noted that assessment techniques have their inherent limitations and the assessing team should exercise suitable discretion in applying these techniques including identifying the need to supplement them with workshops and interviews

Identification & Assessment Techniques (Illustrative)

Questionnaire Method

Self-assessment by business and functional heads, and other designated staff associated with the Company's risk management function

Historical Data

Failures of the Company in earlier periods
Industry Reports of risk events and their causes

By linking Objectives/ Strategic Initiatives to Inherent Risks

By examining strategic initiatives and forecasting risks that may arise on their implementation



Illustration

Spreadsheet-based Implementation



Residual Risk Level

■ Illustration

LoB/ SF	Function/ Process	Risk Source	Risk Event	Inherent Risk (ref. Scoring Parameters)	Control Effectiveness (ref. Scoring Parameters)	Level of Residual Risk
Vehicle Loan	Loan: Lead Generation	Management related	Breach of Code of Conduct	HIGH	LOW	HIGH
Vehicle Loan	Loan: Lead Generation	Management related	Conflict of Interest	MEDIUM	LOW	MEDIUM
Vehicle Loan	Loan: Lead Generation	Management related	Inadequate governance over business line/ function	LOW	LOW	LOW
Vehicle Loan	Loan: Lead Generation	Business practice	Mis-selling	HIGH	MEDIUM	MEDIUM
Vehicle Loan	Loan: Lead Generation	Business practice	Inappropriate Marketing Material	MEDIUM	MEDIUM	LOW
Vehicle Loan	Loan: Lead Generation	Employee related risks	Breach of Code of Conduct	LOW	MEDIUM	LOW
Vehicle Loan	Loan: Lead Generation	Employee related risks	Kickbacks/ Bribes	HIGH	HIGH	LOW
Vehicle Loan	Loan: Sanction	Management related	Breach of Code of Conduct	LOW	LOW	LOW
Vehicle Loan	Loan: Sanction	Management related	Conflict of Interest	HIGH	LOW	HIGH
Vehicle Loan	Loan: Sanction	Management related	Inadequate governance over business line/ function	MEDIUM	HIGH	LOW
Vehicle Loan	Loan: Sanction	Business practice	Mis-selling	LOW	MEDIUM	LOW
Vehicle Loan	Loan: Sanction	Business practice	Inappropriate Marketing Material	HIGH	HIGH	LOW
Vehicle Loan	Loan: Disbursement	Employee related risks	Breach of Code of Conduct	LOW	LOW	LOW
Vehicle Loan	Loan: Disbursement	Employee related risks	Kickbacks/ Bribes	LOW	MEDIUM	LOW
Vehicle Loan	Loan: Disbursement	Customer related risks	KYC non-compliance	LOW	MEDIUM	LOW
Vehicle Loan	Loan: Disbursement	Customer related risks	Money Laundering/ Terrorism Finance	LOW	HIGH	LOW
Vehicle Loan	Loan: Disbursement	Customer related risks	Tax Evasion	LOW	LOW	LOW

Calculating Composite Risk Score (CRS)

LoB/ SF	Risk Source	Risk Assessment (Count)				Risk Assessment (%) - RPercent			CRS
		High	Medium	Low	Total Assessments	High (weight = 3)	Medium (weight = 2)	Low (weight = 1)	
Vehicle Loan	Organisation related risks	0	0	0	0	0.00%	0.00%	0.00%	0.00
Vehicle Loan	Management related risks	1	1	13	15	6.67%	6.67%	86.67%	1.20
Vehicle Loan	Business practice related risks	0	1	3	4	0.00%	25.00%	75.00%	1.25
Vehicle Loan	Employee related risks	0	2	8	10	0.00%	20.00%	80.00%	1.20
Vehicle Loan	Customer related risks	1	1	11	13	7.69%	7.69%	84.62%	1.23
Vehicle Loan	3rd party/ outsourced service provider	2	4	19	25	8.00%	16.00%	76.00%	1.32
Vehicle Loan	Environmental impact related risks	0	0	0	0	0.00%	0.00%	0.00%	0.00
Vehicle Loan	Social responsibility related risks	0	0	0	0	0.00%	0.00%	0.00%	0.00
Vehicle Loan	Welfare/ Health & safety related risks	0	4	11	15	0.00%	26.67%	73.33%	1.27
Vehicle Loan	Technology/data security & privacy related	0	3	17	20	0.00%	15.00%	85.00%	1.15
Vehicle Loan	Interpretation related risks	0	0	0	0	0.00%	0.00%	0.00%	0.00
IT Department	Organisation related risks	0	1	1	2	0.00%	50.00%	50.00%	1.50
IT Department	Management related risks	0	1	3	4	0.00%	25.00%	75.00%	1.25
IT Department	Business practice related risks	0	2	0	2	0.00%	100.00%	0.00%	2.00
IT Department	Employee related risks	0	1	3	4	0.00%	25.00%	75.00%	1.25
IT Department	Customer related risks	0	0	0	0	0.00%	0.00%	0.00%	0.00
IT Department	3rd party/ outsourced service provider	0	6	2	8	0.00%	75.00%	25.00%	1.75
IT Department	Environmental impact related risks	0	0	0	0	0.00%	0.00%	0.00%	0.00

Composite Risk Scores per LoB & Risk Source

■ Composite Risk Score (CRS)

Aggregation of risk scores on the basis on Lines of Business/
Support Functions & Risk Sources

LoB/ SF	CRS _{LoB}
Vehicle Loan	8.62
IT Department	14.00

Risk Source	CRS _{RS}
Organisation related risks	1.50
Management related risks	6.20
Business practice related risks	3.25
Employee related risks	2.45
Customer related risks	1.23
3rd party/ outsourced service	3.07
Environmental impact related	0.00
Social responsibility related	0.00
Welfare/ Health & safety related	2.43
Technology/data security & Interpretation related risks	2.48
	0.00

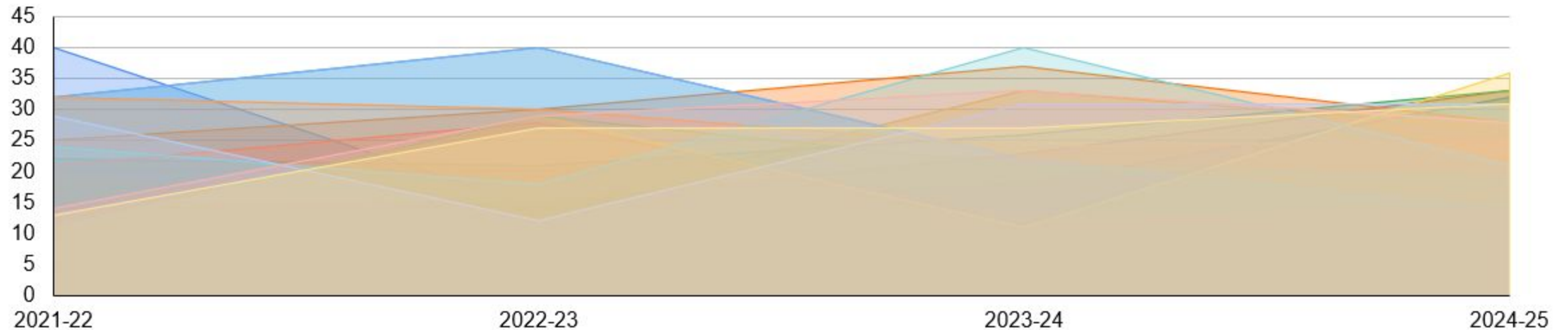
Ranking as per CRS

		CRS _{LOB}	Heatmap
Fund based	Vehicle Loans (Two Wheeler)	27	
	Personal Loans (Gold)	25	
	Commercial Vehicle Loans	16	
	Working Capital Loan	22	
Investments	Equity investment	16	
	Investment in other securities	34	
Non-fund based	Letter of Credit	14	
	Guarantee	36	
Other business	Securitisation/ TLE	50	
Support functions	IT	11	
	HR	45	
	Finance & Treasury	13	
	Accounting & Taxation	14	
	Secretarial	48	
	Legal	13	

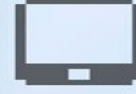


Plotting the CRS Time Series

Risk Scores per Lines of Business/ Support Functions



- Personal Loans (Two Wheeler)
- Personal Loans (Gold)
- Commercial Vehicle Loans
- Working Capital Loan
- Equity investment
- Investment in other securities
- Investment in other securities
- Letter of Credit
- Guarantee
- Securitisation/ TLE
- IT
- HR
- Finance & Treasury
- Accounting & Taxation
- Secretarial



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