

Asset Liability Management & Liquidity Policy

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1. Introduction

ART Climate Finance (India) Private Ltd (hereinafter “Company”) is a Non-Bank Finance Company registered with Reserve Bank of India. Asset-liability management refers to the process by which a company manages its balance sheet in order to allow for alternative interest rate and liquidity scenarios. In the normal course, NBFCs are exposed to credit and market risks in view of the asset-liability transformations. With liberalisation in Indian financial markets and growing integration of domestic markets with external markets, the risks associated with NBFCs’ operations have become complex and large, requiring strategic management. NBFCs are now operating in a fairly deregulated environment and are required to determine interest rates on loans and advances on a dynamic basis. The interest rates on investments of NBFCs in government and other securities are also now market related.

Intense competition for business involving both the assets and liabilities has brought pressure on the management of NBFCs to maintain a good balance among spreads, profitability and long-term viability. Imprudent liquidity management can put NBFCs’ earnings and reputation at great risk. NBFCs need to address these risks in a structured manner by upgrading their risk management and adopting more comprehensive Asset-Liability Management (ALM) practices than has been done hitherto. ALM, among other functions, is also concerned with risk management and provides a comprehensive and dynamic framework for measuring, monitoring and managing liquidity and interest rate equity and commodity price risks of major operators in the financial system that needs to be closely integrated with the NBFCs’ business strategy. It involves assessment of various types of risks and altering the asset-liability portfolio in a dynamic way in order to manage risks.

Having understood the significance of sound ALM practices, the company proposes to lay down broad guidelines in respect of interest rate and liquidity risks management systems, which form part of the Asset-Liability Management (ALM) function.

2. Objective

The objective of this **Asset Liability Management & Liquidity Policy** is to provide a robust framework for to minimizing risk and ensure the Company's ability to meet all its obligations while maximizing profitability within acceptable risk parameters. The Policy ensures:

- Maintenance of adequate liquidity to meet obligations.
- Prudent management of interest rate and funding risks.
- Compliance with **RBI’s Liquidity Risk Management Framework (2019, as amended)**.
- Long-term financial stability by integrating **ALM with liquidity risk management**.

The ultimate ALM goal is to minimize risk and ensure the institution's ability to meet all its obligations while maximizing profitability within acceptable risk parameters.

3. ALM Function

The initial focus of the ALM function would be to enforce the risk management discipline i.e. managing business after assessing the risks involved. The objective of good risk management systems should be that these systems will evolve into a strategic tool for the company. The ALM process will rest on three pillars:

Pillar	Particulars
ALM Information Systems	o Management Information Systems

	<ul style="list-style-type: none"> ○ Information availability, accuracy, adequacy and expediency
ALM Organization	<ul style="list-style-type: none"> ○ Structure and responsibilities ○ Level of top management involvement
ALM Process	<ul style="list-style-type: none"> ○ Risk parameters ○ Risk identification ○ Risk measurement ○ Risk management ○ Risk policies and tolerance levels

4. ALM Information Systems

ALM has to be supported by a management philosophy which clearly specifies the risk policies and tolerance limits. This framework needs to be built on sound methodology with necessary information systems as back up. Thus, information is the key to the ALM process. There are various methods prevalent world-wide for measuring risks. These range from the simple Gap Statement to extremely sophisticated and data intensive Risk Adjusted Profitability Measurement methods.

However, the central element for the entire ALM exercise is the availability of adequate and accurate information with expedience. Adequate measures will be taken on an ongoing basis to collect accurate data in a timely manner commensurate to the scale of the operations, leading finally to full scale automation.

5. ALM Organisation

- Successful implementation of the risk management process would require strong commitment on the part of the senior management in the company, to integrate basic operations and strategic decision making with risk management. The **Board of Directors** will have overall responsibility for management of risks and should decide the risk management policy of the NBFC and set limits for liquidity, interest rate and equity price risks. The Board of Directors, in their board meetings, will oversee the implementation of the system and review its functioning periodically.
- The **Asset - Liability Committee (ALCO)** consisting of the appropriate members will be created in due course and be responsible for ensuring adherence to the limits set by the Board as well as for deciding the business strategy of the company (on the assets and liabilities sides) in line with the company's budget and decided risk management objectives.
- The **ALM Support Groups** consisting of operating staff should be responsible for analysing, monitoring and reporting the risk profiles to the ALCO. The staff should also prepare forecasts (simulations) showing the effects of various possible changes in market conditions related to the balance sheet and recommend the action needed to adhere to the company's internal limits.
- The ALCO is a decision-making unit responsible for balance sheet planning from risk return perspective including the strategic management of interest rate and liquidity risks. The business and risk management strategy will ensure that the company operates within the limits/parameters set by the Board. The business issues that an ALCO would consider, inter alia, will include product pricing for both deposits and advances, desired maturity profile and mix of the incremental assets and liabilities, prevailing interest rates offered by other peer NBFCs for the similar services/product, etc. In addition to monitoring the risk levels of the

company, the ALCO should review the results of and progress in implementation of the decisions made in the previous meetings. The ALCO would also articulate the current interest rate view of the company and base its decisions for future business strategy on this view. In respect of the funding policy, for instance, its responsibility would be to decide on source and mix of liabilities or sale of assets. Towards this end, it will develop a view on future direction of interest rate movements and decide on funding mixes between fixed vs floating rate funds, wholesale vs retail deposits, money market vs capital market funding, domestic vs foreign currency funding, etc. Post business commencement, the frequency of holding ALCO meetings will be bi-monthly. However, if the need be for a meeting at a short notice, the ALCO can meet at a shorter notice.

6. ALM Process

The ALM process in NBFCs is a formalized, regulatory-driven framework focused on actively identifying, measuring, monitoring, and managing liquidity risk and interest rate risk arising from mismatches between asset and liability cash flows. The scope of ALM function can be described as follows:

- a. Liquidity risk management
- b. Management of market (interest rate) risks
- c. Funding and capital planning
- d. Forecasting and analysing 'What if scenarios'
- e. Preparing contingency plans

The guidelines given in this note mainly address Liquidity and Interest Rate risks.

6.1 Liquidity Risk Management

- Measuring and managing liquidity needs are vital for effective operation of any company. The importance of liquidity transcends individual institutions, as liquidity shortfall in one institution can have repercussions on the entire system. ALCO should measure not only the liquidity positions of the company on an ongoing basis but also examine how liquidity requirements are likely to evolve under different assumptions. Experience shows that assets commonly considered as liquid, like Government securities and other money market instruments, could also become illiquid when the market and players are unidirectional. Therefore, liquidity has to be tracked through maturity or cash flow mismatches. For measuring and managing net funding requirements, the use of a maturity ladder and calculation of cumulative surplus or deficit of funds at selected maturity dates is adopted as a standard tool. The format of the Statement of Structural Liquidity as prescribed by Reserve Bank of India (RBI) may be used for this purpose.
- The Maturity Profile based on ALM - II could be used for measuring the future cash flows of each company in different time buckets. The time buckets, may be distributed as under:
 - i. 1 day to 7 days
 - ii. 8 days to 14 days
 - iii. 15 days to 30/31 days (One Month)
 - iv. Over one month and up to 2 months
 - v. Over 2 months and up to 3 months
 - vi. Over 3 months and up to 6 months

- vii. Over 6 months and up to 1 year
- viii. Over 1 year and up to 3 years
- ix. Over 3 years and up to 5 years
- x. Over 5 years

The negative gaps (i.e. where outflows exceed inflows) in the first two time buckets, viz, '1-7 days', '8 – 14 Days' and '15 -30 Days' should not exceed the prudential limit of 10 per cent of the cash outflows of each time-bucket and the cumulative gap up to the one-year period should not exceed 10% of the cumulative cash outflows up to one-year period.

- As the company does not hold public deposits, all the investment securities would fall in the category of 'non-mandatory securities'. All non-mandatory securities may be kept in buckets of future time frame for the purpose of determining their cash flows based on maturity of such security and intention of holding such security till the time of such maturity.
- The policy note recorded by the company on treatment of the investment portfolio for the purpose of ALM and approved by their Board/ALCO shall be forwarded to the Regional Office of the Department of Non-Banking Supervision of RBI.
- Within each time bucket, there could be mismatches depending on cash inflows and outflows. While the mismatches up to one year would be relevant since these provide early warning signals of impending liquidity problems, the main focus should be on the short-term mismatches viz., 1-30/31 days. Company, however, is expected to monitor its cumulative mismatches (running total) across all time buckets by establishing internal prudential limits with the approval of the ALCO. The mismatches (negative gap) during 1- 30/31 days in normal course may not exceed 15% of the cash outflows in this time bucket.
- The Statement of Structural Liquidity shall be prepared by placing all cash inflows and outflows in the maturity ladder according to the expected timing of cash flows. A maturing liability will be a cash outflow while a maturing asset will be a cash inflow. While determining the likely cash inflows / outflows, company will have to make a number of assumptions according to their asset - liability profiles. While determining the tolerance levels, the company may consider all relevant factors based on their asset-liability base, nature of business, future strategy, etc.
- In order to enable the company to monitor their short-term liquidity on a dynamic basis over a time horizon spanning from 1 day to 6 months, company will estimate their short-term liquidity profiles based on business projections and other commitments for planning purposes. An indicative format ALM - I issued by RBI for estimating Short-term Dynamic Liquidity will be used for the said purpose.

6.2 Currency Risk

The Company does not have any currency risk as of now as there are no transactions entered by the company which will involve currency risk. However, in future, if such transactions are entered, the company will make use of appropriate hedging through derivatives to counter exchange rate risks as they arise.

6.3 Managing Interest Rate Risk (IRR)

- The operational flexibility given to NBFCs in pricing most of the assets and liabilities imply the need for the financial system to hedge the Interest rate risk. Interest rate risk is the risk where changes in market interest rates might adversely affect an NBFC's financial condition.

The changes in interest rates can affect the company in some way. The immediate impact of changes in interest rates is on earnings (i.e. reported profits) by changing its Net Interest Income (NII). The company will manage this risk on NII by pricing loan products at rates that sufficiently cover interest rate risk. The risk from the earnings perspective can be measured as changes in the Net Interest Income (NII) or Net Interest Margin (NIM). Measurement of such risk will be done at the time of deciding rates to be offered to customers. Once interest rate risk is measured by the ALCO, lending rates of the new loans will be finalized accordingly. The interest sensitive assets and liabilities will be clubbed into the following buckets for ascertaining the Gap in individual buckets and the cumulative Gap.

- i. 1 day to 7 days
- ii. 8 days to 14 days
- iii. 15 days to 30/31 days (One Month)
- iv. Over one month and up to 2 months
- v. Over 2 months and up to 3 months
- vi. Over 3 months and up to 6 months
- vii. Over 6 months and up to 1 year
- viii. Over 1 year and up to 3 years
- ix. Over 3 years and up to 5 years
- x. Over 5 years

Cumulative Mismatch as % to Cumulative Outflows for buckets up to one year should be minimum 50% positive.

- The reporting format ALM-3 will be used for computing gaps in each time bucket. Within each time bucket, there could be mismatch depending on interest rate sensitive cash inflows and outflows. The Management Committee, authorized by the Board in this regard, shall set Prudential Limits on Individual Gaps within each time bucket, as defined earlier in this section, considering Total Assets, Earning Assets, Equity or Interest Rate Movements, etc. The Committee will also prescribe prudential limits in terms of Earnings at Risk (EaR) on Net Interest Income (NII). e.g. EaR shock limits $\leq 5\%$ of NII & 10% of Net Worth (for a ± 100 bps rate shock).
- The Company shall adopt a “stock” approach to liquidity risk measurement and monitor certain critical ratios in this regard by putting in place internally defined limits as approved by its Board. The ratios and the internal limits shall be based on an company’s liquidity risk management capabilities, experience and profile. An indicative list of certain critical ratios to monitor as well as their upper limits is as follows:

Ratios	Upper Limit (\leq)
Short Term Liability to Total Assets	5%
Short Term Liability to Long term Assets	10%
Commercial Paper to Total Assets	5%
Non-convertible debentures (NCDs)(original maturity of less than 1 year) to Total assets	5%
Short-term Liabilities to Total Outside Liabilities	50%
Long-term assets to Total assets	90%

6.4 Capital Planning

The company will develop annual rolling 3–5 year business plans / projections, which will include capital plan covering growth, loss absorption, dividend policy, capital actions, and contingency options; linked to business plan and RAS. It is important for the Company to tie-up funding sources while maintaining an acceptable NII spread. Before lending commitments are made, tying up funding sources shall be the role of the Treasury function. In addition to raising of funds, another important aspect of liquidity is also how these funds are safely held till they are disbursed. This is addressed in the Investment policy. The ALM function shall focus on evaluating the cost of funds vis-à-vis market based pricing benchmarks. Additionally, the ALM function will focus on prescribing an equitable mix between long term and short term funding sources to manage structural mismatches and cost of funds.

6.5 Scenario Planning

Regular liquidity stress tests must be conducted, including scenarios such as, sharp increase in NPAs, market funding freeze or withdrawal of credit lines, delay in loan/s repayments. To manage liquidity risk at a cash flow level, this policy envisages adherence to certain gap limits based on dynamic liquidity forecasts. The company will maintain a minimum liquidity buffer of 30 days operating expenses and debt servicing requirements in the form of high-quality liquid assets (HQLA). Maintaining an optimal balance sheet structure and cash flow patterns shall be the key component of the liquidity risk management strategy.

6.6 Liquidity Contingency Management

The ALM exercise shall focus on making available requisite sources of funds in case of contingencies. The contingency planning exercise will also focus on evaluating the impact of contingencies on the cost of funds. Accordingly, the liquidity contingency management strategy will be focused on availability and cost in stressed market conditions. Securitization is another mode of financing for NBFCs, which enables it to convert a pool of assets/loans, into bonds, which are then sold to investors. The company will maintain a Securitization Policy.

6.7 Other Liquidity Monitoring Tools

In addition, the following tools shall be adopted by the Board for internal monitoring of liquidity requirements:

- Concentration of Funding
- Available Unencumbered Assets
- Market-related Monitoring Tools (early warning indicators for liquidity difficulties at the NBFCs)

7. ALM Reporting

Company shall comply with any scale based reporting requirements prescribed by the RBI from time to time. Internal monitoring and reporting:

- **Monthly ALM & Liquidity Report** to ALCO.
- **Quarterly review** by Board of Directors.
- Key ratios tracked:
 - Liquidity Coverage Ratio (LCR)
 - Cumulative mismatch ratios
 - Funding concentration ratios
 - Cost of funds vs. lending yield

8. Policy Review

This policy represents the ALM measures appropriate to the scale of the company. It will be reviewed **annually** and any amendments require Board approval.
