

HYDROELECTRICITY INVESTMENT AND DEVELOPMENT COMPANY LTD.

RISK MANAGEMENT FRAMEWORK, 2024

1. Introduction

1.1. Hydroelectricity Investment and Development Company Limited, (hereinafter referred to as “HIDCL” or the “Company”) is a financial institution established under the ownership of Government of Nepal. The main objective of HIDCL is to finance the development of hydropower and renewable energy projects and other related energy infrastructures in Nepal by investing in the form of loan and/or equity in the projects. HIDCL has the mandate of mobilization of financial resources from domestic and international sources into the project financing.

1.2. Background

Risk management is a part of internal governance and management system and procedures involving all areas of the organization. Taking risks is an integral part of financing and banking business. Failure to adequately assess and manage risks may lead to losses endangering the soundness of individual financial institutions and affecting the stability and the reliability of the overall financial system. There is a strong link between good corporate governance and sound risk management. Without proper risk management, the core functions and the operating activities of the company cannot work together to achieve its objectives. It is an essential part of helping the company to grow and promote sustainability and resilience. This document provides background and context to Company’s risk management framework.

1.3. Objective

The purpose of this Risk Management Framework is to establish a comprehensive framework for identifying, assessing, monitoring, and mitigating risks associated with the core business and entire operational activities of the Company.

1.4. Scope

This framework applies to all business units and functions within the Company, covering market risk, investment risk, operational risk, legal and regulatory compliance risk, environmental and social risk, and strategic risk. This framework broadly covers the governance structure, policies and procedures, management systems and reporting mechanism relating to risk management.

2. Governance Structure

2.1. Active Board and Company Management Oversight

2.1.1 Board of Directors

The Board of Directors shall have the ultimate authority to make structural, policy and operational arrangements and oversee to develop appropriate risk management governance within the company. It defines risk appetite and risk tolerance and set risk strategies and is responsible for ensuring that Company management is taking necessary steps to implement those strategies and manage accompanying risks. To ensure appropriate risk management governance in the Company, the Board of Directors shall:

- formulate various policies, rules, regulations, byelaws, guidelines, working procedures and standards,
- review such policies and guidelines periodically,
- defines organizational structure and its role and responsibilities of organizational units and employees, and
- oversee and review the compliance.

2.1.2 Risk Management Committee

There shall be a dedicated board level Risk Management Committee (RMC) composed of board members, CEO and senior officials of the Company. The RMC is authorized for overseeing and guiding the risk management process. The RMC develops and maintains the framework, which enables the Company management to effectively identify, measure, monitor and control risk exposures consistent with the Company's risk appetite. The RMC reports to the Board of Directors on the Company's overall risk profile, including aggregate and emerging risks based on detailed analysis performed by the Company management. The formation and terms of reference of the RMC shall be defined by the corporate governance guidelines of the company.

2.1.3 Company Management

2.1.3.1 Chief Executive Officer

The Chief Executive Officer (CEO) is responsible to transform strategies, operational policies, procedures, and processes into action to ensure effective risk management. The CEO shall be fully accountable to the activities undertaken by the company that could expose it to various risks and to acquire updated knowledge and information of internal and external environment relating to the Company's business. CEO shall possess the necessary knowledge and skills to be able to align the risk levels with the Board's strategies through risk assessment and

treatment. CEO shall monitor and analyse the financial institution's risk profile on an ongoing basis and regularly report it to the Board or a Board level committee for review. CEO management shall also be responsible for regulatory and legal compliance, establishment of effective governance, internal control and the risk culture, internal and external analysis and the review of existing policies and procedures.

2.1.3.2 Senior Management Committee

Senior management Committee is the supportive hand of CEO to establish the appropriate risk management culture within the Company. The senior management Committee shall acquire updated knowledge and information from internal and external sources relating to risk management and shall be reported to the CEO on time. While performing the duty senior management Committee shall be responsible for regulatory and legal compliance relating to the Company business. Senior management Committee shall also be responsible for review of existing policies and procedures and report to the CEO for further proceedings.

2.2. Policies and Procedures

The policy framework of Company operation mentioned in the annexure of Memorandum of Association (MOA) of the Company shall give broader guidelines for risk management. The Board of Directors shall formulate & oversee and Company management shall comply and implement risk management policies and procedures to deal with various risks that arise from the Company's core business and the operational activities. Company management shall prepare a checklist of relevant provisions of prevailing laws relating to Company business and internal policies and procedures to be comply by the Company and shall ensure full compliance of such laws, policies and procedures.

The policies and more detailed procedures shall provide guidance for the day-to-day implementation of the Company's activities with appropriate consideration to the risk strategies in a way to shield the institution from imprudent and unwarranted risks. These policies and procedures shall cover overall activities of the Company such as investment, recovery, treasury management, governance, accounting and financial reporting, financial administration, procurement and assets management, internal control, human resource management, business processes, information system etc. The Company management shall review risk policies, procedures, and limits in a timely manner and submit to Board of Director for approval.

Further, independent assurance from internal audit about the efficiency, sufficiency, and compliance of these policies shall also be obtained. A comprehensive set of the policies, bylaws, procedures and guidelines which is required to ensure the effective risk management

is depicted in Annex I.

2.3. Appropriate Management Information System (MIS)

An effective management information system (MIS) has to be implemented for adequate risk monitoring and reporting. The MIS shall generate key risk indicators in the form of accessible reports in a timely manner, to enable users to monitor the risk levels continuously and inform Company management and Board as necessary or as required. In addition to regular reporting, there shall be a system to address any exceptions observed and procedures regarding measures to be taken to address such deviations.

2.4. Appropriate Business Process & Information and Communication System

Company management shall develop the business process of the Company on the basis of relevant laws, policies, guidelines and best practices and review it in a timely manner. Standard Operating Procedure (SOP) of major activities relating to core business and operation shall define to ensure effective business process. An adequate and appropriate Information and Communication System (ICS) shall be developed to mitigate the operational risk. An appropriate Disaster Recovery Plan (DRP) and Business Continuity Plan (BCP) shall help to manage the ICS risk.

2.5. Comprehensive Internal Controls and Limits

A comprehensive internal control structure shall be in place to help the management be able to contain risks within the level commensurate with the Company's risk appetite, risk tolerance, and strategy. The flow of business processes and the functional responsibility of departmental units shall be determined to ensure the appropriate internal control mechanism, which shall be properly reflected in the organogram of the Company. The internal control system shall be in the form of defined internal system control guidelines and other various policies, guidelines and decisions of the Board of Directors. The internal control system shall enforce the official lines of authority and provide for appropriate separation of duties.

A major part of the internal control structure shall also establish limits such as limits on liquidity, officer limits, and limits on non-performing assets. These limits ensure that the management does not take excessive risks while pursuing business targets. The internal control system shall be adequately tested and reviewed by its internal audit. The coverage, procedures, and findings of the audit regarding the internal controls shall be adequately reviewed by the Audit Committee and any material weakness found should be addressed promptly and appropriately.

2.6. Roles and Responsibilities

The roles and responsibilities for individuals involved in risk management and day-to-day

operations shall be clearly defined in the departmental terms of reference and employees job descriptions approved by the Board of Directors. The roles and responsibilities shall be formulated ensuring accountability and promoting a culture of risk awareness and responsibility throughout the organization. The Company management shall have the responsibility to develop an appropriate system and criteria for appraisal of the performance of each individual employee on the basis of defined job description.

3. Risk Identification

3.1. Risk Categories

Various risk categories including the market risks, investment risks, operational risks, legal and compliance risks, reputational risks, and strategic risks specific to the Company's core business and the operational activities shall be identified.

3.2. Risk Assessment

A robust risk assessment process, incorporating quantitative and qualitative methods to evaluate the impact and likelihood of identified risks shall be implemented and regularly updated to reflect changes in the business environment. The risk assessment process shall be defined in the Company's policies and procedures related to investment, assets management, ICT system, liquidity management and operational activities.

4. Risk Monitoring and Reporting

Key risk indicators tailored to each risk category shall be defined and monitored, including the trigger thresholds and response plans for timely intervention. A structured and periodic reporting mechanism to regularly communicate risk exposure, trends, and mitigation efforts to the Board of Directors, Company management, and relevant stakeholders shall be implemented.

5. Risk Mitigation

5.1. Risk Appetite

Risk appetite is the amount of risk that an organization is willing to take in pursuit of objectives it deems to have value. Risk appetite can also be described as an organization's risk capacity, or the maximum amount of residual risk which will accept after controls and other measures have been put in place. Risk appetite is typically represented by a written document that describes an organization's risk-based decisions. The Company's risk appetite, outlining acceptable levels of risk exposure for each risk category and ensuring alignment with business

strategy and regulatory requirements, shall be defined and formulated in the MOA and AOA of the [Company](#), investment policies and other policies and procedures.

5.2. Risk Mitigation Strategies

Appropriate and effective risk mitigation strategies shall be developed and documented for each identified risk. Strategies may include diversification, transfer, acceptance, reduction and avoidance. Contingency planning and scenario analysis shall also be made to reduce the risk at an [acceptable](#) level.

6. Investment Risks (including Credit Risks)

Investment Risks are the risks associated with the equity and debt investment by the Company. It is the risk that a borrower, investee company or counterparty will fail to meet their obligations according to the agreed terms, resulting in financial and reputational loss to the Company. Given the significant weight of the investment risk in the risk profile of the Company, robust arrangements to manage and control this risk shall be put in place. The effective management of investment risk is a critical component of a comprehensive approach to risk management. Appropriate governance, policy, processes, and internal controls shall be implemented for accepting, managing and monitoring investment risk, on a group and solo basis, in a manner commensurate with the nature, scale and complexity of the Company's activities.

The Company shall have sound procedures for valuing their investment exposures including the consistent provisioning policies. The Company shall have a forward-looking perspective to evaluate if the arrangements in place are adequate to cope with the investment risk they might be exposed to in the foreseeable future.

6.1. Components of Investment Risk Management:

Appropriate governance structure, policies, procedures, guidelines, and control mechanisms shall be put in place considering the key components of the investment risk management system. In addition to this, the Board and Company management's regular oversight and involvement shall also be required at various stages of the organization's business.

The key components to be defined in the Company's policies, procedures and processes for ensuring appropriate investment risk management are as follows:

6.1.1. Appropriate Organizational Structure

The organizational structure shall be designed considering the complexity and diversification of the Company's activities in an appropriate way that it facilitates effective management

oversight and proper execution of investment risk management and control processes. There shall be segregation of duties regarding various investment-related functions, such as assessment, analysis, approval, disbursement, administration, and monitoring. As far as possible, different units shall be established to perform the function of front office and back-office functions. The structure shall ensure that conflicts of interests between these functions are identified, managed and that sufficient checks and balances are in place even if they are within the same unit. Further, in the long run, a separate and independent investment risk management unit independent of the risk-taking units is envisaged.

6.1.2. Investment Risk Strategies, Policies and Procedures

The Board, Company management, Sponsors and/or the Stakeholders of the Company define the investment risk strategies in the Company's constitution, investment policy, other policies, government's strategy, etc. The Investment risk strategy of the Company shall include an assessment of the investment risk profile and statement of the bank's appetite to take investment risk for each activity type, product type (such as equity, debt, guarantee, etc.), economic sector (such as hydropower, solar, other renewable energy, transmission lines, other associated sectors, etc.), geographical location, etc. The strategy shall include the identification of target sectors and overall characteristics that the Company wants to achieve in its investment portfolio, including levels of diversification and concentration tolerances. The investment risk strategy shall also provide continuity in approach and consider cyclical aspects of the country's economy and the resulting shifts in composition and quality of overall investment portfolio.

There shall be policies and procedures in place regarding the information and documentation needed to approve new investments, renew existing ones and/or change the terms and conditions of previously approved investments. The policies and procedures shall include clear provisions regarding approving authority, defining delegations and exceptions or waivers, and their implementation. Delegation of authority shall be clearly spelled out considering knowledge and experience.

6.1.3. Limits and Indicators

To ensure diversification of risks and limit concentration risks, limits on investment exposures shall be set for all relevant activities. They may include, but not limited to:

- Limits on exposure to specific activities or type of products, including off-balance sheet products;
- Limits on single counterparties and groups of connected counterparties, including other banks and financial institutions, domestic and foreign;
- Limits on specific industries and/or economic sectors/ sub-sectors;
- Limits on exposure to types of collateral;

- Limits on exposures to related parties;
- Limits on exposures to geographic regions, river basins;
- Limits on the approving authority.

These limits shall be reviewed and updated periodically. Appropriate early warning indicators shall be defined to signal at an early stage where there is increased exposure to specific components of investment risk, and appropriate response shall be made to these indicators by assessing their probable impact in the investment quality.

6.1.4. Investment Appraisal, Approval and Administration Processes

There shall be policies and procedures in place that shall define the following processes of investment lifecycle:

- Project appraisal and Due diligence
- Assessment, evaluation and review
- Negotiation on terms of financing
- Approval
- Disbursement
- Investment administration
- Monitoring and reporting
- Remedial actions
- Recovery processes
- Provisioning process
- Others as necessary

7. Compliance and Legal Risk

Procedures and action plans shall be established and maintained to ensure compliance with applicable laws, regulations, directives from government entities and regulators, Company's rules and regulations and instructions & decisions of the Board. Regularly review and update compliance policies and procedures shall be made to ensure compatibility with recent changes and developments. Close collaboration with legal experts and policy makers shall be made to identify and manage legal risks associated with investments, contracts, and business operations as and when necessary. The compliance checklist shall be prepared and executed by the Company management, and it shall be reviewed by an independent internal auditor in a regular manner.

8. Environment and Social Risk.

Appropriate environment and social safeguard policy shall be formulated and implemented in

the Company to manage the environment and social risk associated with the Company's investments. The process of evaluation of environmental and social risks shall be defined in the related investment evaluation system and procedures of the Company.

9. Operational Risk

Operational Risk is the risk of direct or indirect loss, or damaged reputation resulting from inadequate or failed internal processes, people and systems or external events. Operational risk has always been inherent to financial institutions and exists in all their activities. Operational risk is a broad field and can be sorted into numerous sub-categories, such as IT risk, outsourcing risk and operational risk in market activities. The major source for operational risk includes inadequate procedures and controls, external and Internal frauds, IT related activities and system failures, damage to physical assets, execution, delivery, and process management.

Company Management should adopt the following policy and strategy for managing operational risk effectively:

- Identification and assessment of the operational risk inherent in all material products, activities, processes and systems,
- A governance structure, effective governance in practice and a decision-making process for operational risk issues,
- A definition of operational risk appetite which is consistent with the risk strategy,
- A documented and effective organizational framework for operational risk management with an adequate segregation of functions between risk-taking units and operational risk controls units and clear assignment of tasks and responsibilities,
- An independent operational risk management function,
- Adequate and effective human and technical resources available for the functions involved in operational risk management and control,
- An effective reporting system,
- Contingency planning for addressing failures due to operational risks.

10. Technology and Cybersecurity Risk

A robust cybersecurity measures to protect sensitive data, prevent unauthorized access, and mitigate the risk of cyber threats shall be exercised. An appropriate IT policy and user policy shall be formulated and executed. Regular cybersecurity assessments and IT audits shall be conducted. Risks associated with technology systems and infrastructure shall be regularly assessed and managed. Appropriate business continuity and disaster recovery plans to minimize the impact of technology-related disruptions shall be designed.

11. Training and Awareness

11.1. Employee Training

Regular training sessions to enhance employees' understanding of risk management principles, policies, and procedures shall be organized. The Company shall foster a culture of risk awareness and responsibility in the organization. Employee training and development system shall be defined through the Company's human resource development policy and plans.

11.2. Communication

Open and effective communication channels shall be established in the Company to facilitate the reporting of potential risks and concerns at all levels of the organization.

12. Effective Date

This Risk Management Framework shall come into effect from the date of approval by the Board of Directors.

13. Continuous Improvement

To ensure its effectiveness in addressing evolving risks and aligning with industry best practices, periodic review and update of the risk management framework and relevant policies and procedures shall be conducted. Further, post-event reviews to analyze the effectiveness of risk mitigation strategies shall be conducted and the lessons learned shall be incorporated into the risk management process.

Annex I: Policy documents related to risk management

