Market Discipline-Pillar-III Disclosures under Basel-II

(Ref. Annual Report-2010) Page No. 62-71

Capital Adequacy under Basel-II

Banks operating in Bangladesh are maintaining capital since 1996 on the basis of risk weighted assets in line with the Basel Committee on Banking Supervision (BCBS) capital framework published in 1988. Considering present complexity and diversity in the banking industry and to make the banks' capital requirement more risk sensitive, Bangladesh Bank, being the central bank of the country has decided to adopt the Risk Based Capital Adequacy for banks in line with capital adequacy framework devised by the BCBS popularly known as 'Basel II'. Bangladesh Bank prepared a guideline to be followed by all scheduled banks from January 2009. Both the existing capital requirement rules on the basis of Risk Weighted Assets and revised Risk Based Capital Adequacy Framework for Banks as per Basel II were followed simultaneously initially for one year. For the purpose of statutory compliance during the period of parallel run i.e. 2009, the computation of capital adequacy requirement under existing rules prevailed. On the other hand, revised Risk Based Capital Adequacy Framework as per Basel II had been practiced by the banks during 2009 so that Basel II recommendation could effectively be adopted from 2010. From January 2010, Risk Based Capital Adequacy Framework as per Basel II have been fully practiced by the banks replacing the previous rules under Basel-I. This has begun an endeavor towards more improved and risk sensitive capital requirement than the previous regulation.

The guideline is structured around the following three aspects or pillars of Basel-II:

i. Minimum capital requirements to be maintained by a bank against credit, market and operational risk;

ii. Supervisory Review i.e., Process for assessing overall capital adequacy in relation to a bank's risk profile and a strategy for maintaining its capital at an adequate level;

iii. Market Discipline i.e., To make public disclosure of information on the bank's risk profiles, capital adequacy and risk management.

Scope of Application

This Risk Based Capital Adequacy framework applies to all banks on 'Solo' as well as on 'Consolidated' basis where-

- 'Solo Basis' refers to all position of the bank and its local and overseas branches/offices;
- 'Consolidated Basis' refers to all position of the bank (including its local and overseas branches/offices) and its subsidiary company(s) like brokerage firms, discount houses, etc. (if any).

Capital Base

Regulatory Capital

For the purpose of calculating regulatory capital requirement, capital is categorized into the following three tiers:

Tier-I Capital

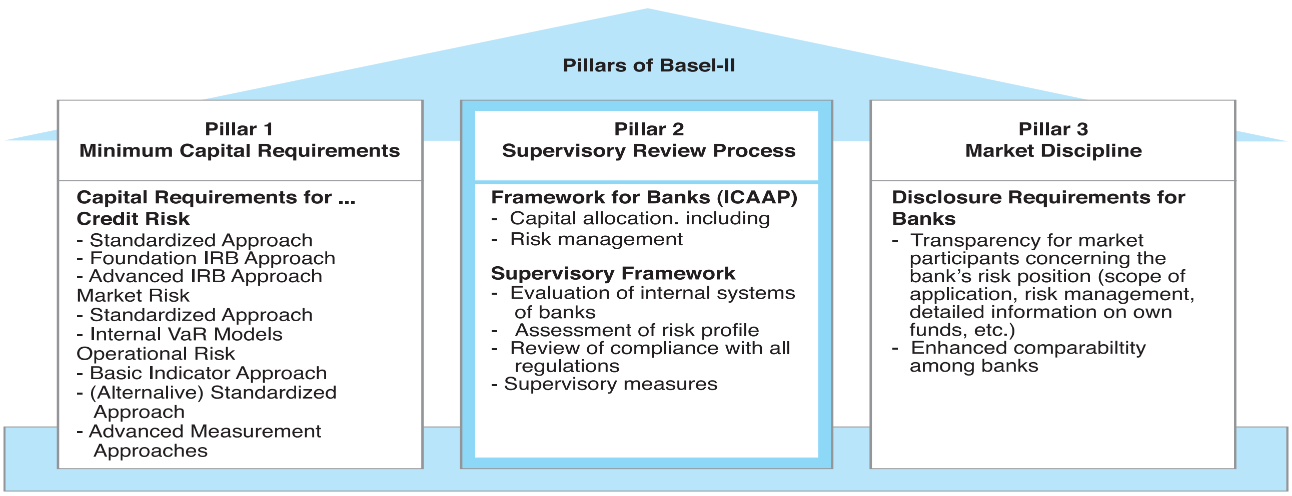
Tier-I capital, also called 'Core Capital', comprises of highest quality capital elements and shall include:

a. Paid-up capital / capital deposited with BB
b. Non-repayable share premium account
c. Statutory Reserve
d. General Reserve
e. Retained Earnings
f. Minority Interest in Subsidiaries
g. Non-Cumulative Irredeemable Preference Shares
h. Dividend Equalization Account

Tier-II Capital

Tier-II capital, also called 'Supplementary Capital', represents other elements which fall short of some of the characteristics of the Core Capital but contribute to the overall strength of a bank and shall include:

a. General Provision
b. Asset Revaluation Reserves
c. All other Preference Shares
d. Subordinated Debt over five year maturity
e. Exchange Equalization Account
f. Revaluation Reserves for Securities
g. Revaluation Reserves for Equity Instruments



Tier-III Capital

Tier-III capital, also called 'Additional Supplementary Capital', consisting of short-term subordinated debt (original/residual maturity less than or equal to five years but greater than or equal to two years) is meant solely for the purpose of meeting a proportion of the capital requirements for market risk.

Conditions for maintaining Regulatory Capital

The computation of the amount of Core (Tier-I) and Supplementary (Tier-II and Tier-III) capitals shall be subject to the following conditions:

- The amount of Tier-II will be limited to 100 percent of the amount of Tier-I capital;
- Fifty percent (50 percent) of Revaluation Reserves for fixed assets and securities shall be eligible for Tier-II i.e. supplementary capital;
- Ten percent (10 percent) of revaluation reserves for equity instruments shall be eligible for Tier-II capital;
- Subordinated debt shall be limited to a maximum of 30 percent of the amount of Tier-I capital;
- A minimum of about 28.50 percent of market risk needs to be supported by Tier-I capital. Supporting of Market Risk from Tier-III capital shall be limited up to a maximum of 250 percent of a bank's Tier-I capital that is available after meeting credit risk capital requirement.

Eligible Regulatory Capital

In order to obtain the Eligible Regulatory Capital for the purpose of calculating Minimum Capital Requirements (MCR), banks are required to make following deductions from their Tier-I capital:

i. Book value of goodwill
ii. Shortfall in provisions required against classified assets
iii. Remaining deficit on account of revaluation of investments in securities after netting off any other surplus on the securities.

Eligible Tier-II capital will be derived after deducting components, if any, qualified for deduction.

Total Eligible Regulatory Capital will be calculated adding the eligible Tier-I, eligible Tier-II and Tier-III capital i.e.,

Total Eligible Regulatory Capital = (Eligible Tier-I Capital + Eligible Tier-II Capital + Eligible Tier-III Capital)

Minimum Capital Requirements (MCR)

a) No Scheduled Bank in Bangladesh shall commence and carry on its business unless it has a minimum Paid-up Capital / Capital deposited with BB (applicable for foreign bank branches) as fixed by BB from time to time.

b) Banks shall also maintain a minimum Capital Adequacy Ratio (CAR) of at least 9 percent of Risk Weighted Assets (RWA) with core capital (Tier-1) not less than 5 percent of RWA. CAR would be derived dividing total Eligible Regulatory Capital by RWA and multiplied by 100.

$$\textbf{CAR} = \frac{\textbf{Eligible Regulatory Capital} \times 100}{\textbf{RWA}}$$

Total Risk weighted Assets (RWA)

Total Risk Weighted Assets (RWA) will be determined by multiplying capital charge for market risk and operational risk by a factor of 11.11 and adding the resulting figures to the sum of risk weighted assets for credit risk i.e.,

Total RWA = RWA for Credit Risk + 11.11 x (Capital Charge for Market Risk + Capital Charge for Operational Risk)

Basel-II provides three approaches of increasing sophistication to the calculation of pillar 1 credit risk capital requirements. The most basic, the standardized approach, requires banks to use external credit ratings to determine the risk weightings applied to rated counterparties, group other counterparties into broad categories and apply standardized risk weightings to these categories. The next level, the internal ratings-based (IRB) foundation approach, allows banks to calculate their credit risk capital requirements on the basis of their internal assessment of the probability that a counterparty will default (PD), but subjects their quantified estimates of exposure at default (EAD) and loss given default (LGD) to standard supervisory parameters. Finally, the IRB advanced approach allows banks to use their own internal assessment in both determining PD and quantifying EAD and LGD.

Capital Charge against Credit Risk

As per Bangladesh Bank's guidelines RWA for Credit Risk includes both Balance Sheet and Off-Balance Sheet exposures. The RWA is again subdivided under Banking Book and Trading Book. For calculating Capital Charge on Market Risk, Trading Book outstanding is used. Risk mitigation techniques including haircut of collaterals and exposures allowed by Bangladesh Bank were also applied for determining the capital requirement.

For Credit risk, banks in Bangladesh adopted Standardized approach as suggested by Bangladesh Bank. According to the standardized approach of Basel-II framework, the risk weight will be based on the risk assessment (hereinafter called credit rating) made by External Credit Assessment Institutions (ECAIs) duly recognized by Bangladesh Bank. Risk weights are based on external rating or a fixed weight that is broadly aligned with the likelihood of counterparty default. Bangladesh Bank has mapped its risk grading (ranging from 1 to 6, where 1 is the highest grading) with that of recognized ECAIs. Where an exposure is secured by guarantee or eligible financial collateral, it may reduce its capital charge by taking benefit of the risk mitigation described in the guidelines of Bangladesh Bank. However, in the absence of credit rating the Risk Weight against loans and advances would be 125 percent.

Capital Charge against Market Risk

Market risk is the possibility of losses of assets in balance sheet and off-balance sheet positions arising out of volatility in market variables i.e., interest rate, exchange rate and price.

Allocation of capital is required in respect of the exposure to risks deriving from changes in interest rates and equity prices in the bank's trading book, in respect of exposure to risks deriving from changes in foreign exchange rates and commodity price in the overall banking activity. The total capital requirement for banks against their market risk shall be the sum of capital charges against-

i. Interest rate risk
ii. Equity position risk
iii. Foreign exchange (including gold) position risk throughout the bank's balance sheet.

Measurement Methodology

As banks in Bangladesh are now in a stage of developing risk management models, BB suggested the banks for using Standardized Approach for credit risk capital requirement for banking book and Standardized (rule based) Approach for market risk capital charge in their trading book.

Maturity Method has been prescribed by Bangladesh Bank in determining capital against market risk. In the maturity method, long or short positions in debt securities and other sources of interest rate exposures, including derivative instruments, are slotted into a maturity ladder comprising 13 time-bands (or 15 time-bands in case of low coupon instruments). Fixed-rate instruments are allocated according to the residual term to maturity and floating-rate instruments according to the residual term to the next repricing date.

In Standardized (rule based) Approach the capital requirement for various market risks (interest rate risk, price, and foreign exchange risk) is determined separately. The total capital requirement in respect of market risk is the sum of capital requirement calculated for each of these market risk sub-categories. e.g.,

a) Capital Charge for Interest Rate Risk = Capital Charge for Specific Risk + Capital Charge for General Market Risk
b) Capital Charge for Equity Position Risk = Capital Charge for Specific Risk + Capital Charge for General Market Risk
c) Capital Charge for Foreign Exchange Risk = Capital Charge for General Market Risk
d) Capital Charge for Commodity Position Risk = Capital Charge for General Market Risk

The methodology to calculate capital requirement under Standardized (rule based) Approach for each of these market risk categories is as follows:

Capital Charges for Interest Rate Risk

A. Capital charges for Specific risk

Capital charge for specific risk against interest related instruments is designed to protect against an adverse movement in the price of an individual security owing to factors related to the individual issuer.

B. Capital charge for General market risk

The capital requirement for general market risk is designed to capture the risk of loss arising from changes in market interest rates. In this regard the capital charge will be calculated on the basis of the following considerations:

i. Bank's underlying trading issues may exist in long or both in long and short position (i.e., related to interest rate derivative/hedge). Where trading issues relate to only long position then total capital charge is to be calculated using the capital.

Capital Charges for Equity Position Risk

a) As with debt securities, the minimum capital standard for equities is expressed in terms of two separately calculated charges the "specific risk" and the "general market risk" for the holdings;

b) The capital charge, for both specific risk and the general market risk charge will be 9 percent.

Capital Charges for Foreign Exchange Risk

a) The capital charge for foreign exchange risk will be 10 percent of bank's overall foreign exchange exposure. The bank's net open position in each currency should be calculated by summing:

   i. the net spot position (i.e., all asset items less all liability items, including accrued interest, denominated in the currency in question);

   ii. the net forward position (i.e., all amounts to be received less all amounts to be paid under forward foreign exchange transactions, including currency futures and the principal on currency swaps not included in the spot position);

   iii. guarantees (and similar instruments) that are certain to be called and are likely to be irrecoverable;

   iv. net future income/expenses not yet accrued but already fully hedged (at the discretion of the reporting bank);

   v. any other item representing a profit or loss in foreign currencies;

b) The overall foreign exchange exposure is measured by aggregating the sum of the net short positions or the sum of the net long positions, whichever is the greater, regardless of sign. The capital charge will be 9 percent of the overall net open position.

Capital Charge against Operational Risk

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

Measurement Methodology

Banks operating in Bangladesh shall compute the capital requirements for operational risk under the Basic Indicator Approach (BIA). Under BIA, the capital charge for operational risk is a fixed percentage, denoted by · (alpha) of average positive annual gross income of the bank over the past three years. Figures for any year in which annual gross income is negative or zero, should be excluded from both the numerator and denominator when calculating the average. The capital charge may be expressed as follows:

K = [(GI 1 + GI2 + GI3) ·]/n

Where-

K = the capital charge under the Basic Indicator Approach

GI = only positive annual gross income over the previous three years (i.e., negative or zero gross income if any shall be excluded)

α = 15 percent

n = number of the previous three years for which gross income is positive.

Gross income: Gross Income (GI) is defined as "Net Interest Income" plus "Net non-Interest Income". It is intended that this measure should:

i. be gross of any provisions;

ii. be gross of operating expenses, including fees paid to outsourcing service providers;

iii. exclude realized profits/losses from the sale of securities held to maturity in the banking book;

iv. exclude extraordinary or irregular items;

v. exclude income derived from insurance.

Gross income = Net profit (+) Provisions & contingencies (+) operating expenses (–) items (iii) to (v) above.

Disclosure of Prime Bank

Disclosure includes the following as per Bangladesh Bank guide lines:

- Scope of Application
- Assets under Banking Book and Trading Book
- Credit risk
- Equity disclosure for Banking Book positions
- Interest rate risk in Banking Book
- Market risk
- Operation risk

1. Scope of Application

The bank has 5 (five) subsidiaries and Basel-II is applied by the bank on "solo" as well as on "consolidated" basis.

2. Assets

The bank has to categorize its assets into the following for calculating risk weighted assets as per Bangladesh Bank guidelines on risk based capital adequacy:

a) Banking book assets

b) Trading book assets

Generally, foreign currency held by bank in Bangladesh and outside Bangladesh, investments (Government securities and shares) under Held for Trading are main components of the trading book. All assets of the balance sheet other than above are lying with banking book.

Banking book assets and trading book assets of the bank as at December 2010 are given below:

a) Consolidated Banking Book Assets:

Taka in million

Particulars	Detail	Total
Cash in hand including prize bond		1,199.50
Balance with Bangladesh Bank		7,458.60
Balance with Sonali Bank as agent bank of Bangladesh Bank		361.50
Balance with other banks and financial institutions		728.30
Money at call and short notice		-
Investment:		
Government	3,038.60	
Qualifying (Banks etc.)	784.70	
Others	982.50	4,805.80
Loans and advances / investments	112,535.60	
Staff loan	1,260.30	
Loans to PBIL for investment in shares	5,041.30	118,837.20
Fixed assets		1741.50
Other assets		1779.50
Total banking book assets		**136,911.90**

b) Consolidated Trading Book Assets:

Taka in million

Particulars	Detail	Total
Foreign currency in hand		71.20
Foreign currency held in Bangladesh Bank		489.10
Foreign currency with banks and financial institutions		668.70
Investment (trading):		
Held for trading	16,351.60	
Share of listed company	1,038.30	17,389.90
Total trading book assets		**18,618.80**

3. Credit Risk

The standardized approach is applied for risk weighting of exposure as per directive of Bangladesh Bank guidelines. It requires banks to use risk assessments prepared by External Credit Assessment Institutions (ECAIs) to determine the risk weightings applied to rated counterparties. As the bank has recently nominated an ECAI for ratings of its exposures and the process is in the early stage, unrated risk weightings were used in most of the cases.

The bank has the guidelines on the acceptability of specific classes of collateral or credit risk mitigation, and determines suitable valuation parameters. Such parameters are expected to be conservative, reviewed regularly and supported by empirical evidence. Security structures and legal covenants are required to be subject to regular review to ensure that they continue to fulfill their intended purpose and remain in line with local market practice. The principal collateral types are as follows:

- Cash
- Gold
- Securities rated by a recognized ECAI
- Debt securities not rated by a recognized ECAI

- Equities (including convertible bonds) those are enlisted and regularly traded in Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE)
- Undertaking for collective investments in transferable securities (UCITS) and mutual funds.

The bank has historically sought to maintain a conservative, yet constructive and competitive credit risk culture. This has served the Group well, through successive economic cycles and remains valid today. This culture is determined and underpinned by the disciplined credit risk control environment which the Group has put in place to govern and manage credit risk, and which is embodied in the formal policies and procedures adopted by the bank. Formal policies end procedures cover all areas of credit lending and monitoring processes including:

- Risk appetite and evaluation of facilities
- Key lending constraints and higher-risk sectors
- Risk rating systems
- Facility structures
- Lending to banks, non-banks and sovereigns
- Personal lending
- Corporate and commercial lending
- Portfolio management and stress testing
- Monitoring, control and the management of problem exposures
- Impairments and allowances.

The bank has also established separate Risk and Credit Control Department which looks after Loan Review Mechanism and also helps in ensuring credit compliance with the post-sanction processes / procedures laid down by the bank from time to time. It involves taking up independent account-specific reviews of individual credit exposures as per the approved lending guideline. Risk department also monitors various credit concentration limits. The bank has in place a risk grading system for analyzing the risk associated with credit. The parameters, while risk grading the customers, include financial condition and performance, quality of disclosures and management, facility structure, collateral and country risk assessment where necessary. Maximum counterparty / group exposures are limited to 15 percent (funded) of the bank's capital base as stipulated by Bangladesh Bank where a higher limit is required for projects of national importance subject to prior approval of Bangladesh Bank.

Past dues and impaired exposures are defined in accordance with the relevant Bangladesh Bank regulations. Specific and general provisions are computed periodically in accordance with the Bangladesh Bank regulations.

Credit Risk Mitigation

The bank has adopted the simple approach for credit risk mitigation under the Standardized Approach where considerations are cash, equity, bank's own FDR etc. collaterals against the exposures to calculate the next exposure with applicable haircut.

Consolidated risk weighted assets under credit risk are as below:

Taka in million

SL	Particulars	Detail	Total
1	**Total exposure of credit risk**		
	Funded		
	a) Domestic	113,948.20	
	b) Overseas	4,889.10	118,837.30
2	Non-Funded		
	a) Domestic	92,801.50	
	b) Overseas	1,112.80	93,914.30
3	**Distribution of risk exposures by claims**		
	A. Claims on sovereigns and central banks		-
	B. Claims on other official entities		54.50
	C. Claims on banks and securities firms		2,478.50
	D. Claims on corporate (Medium enterprise loans to be shown separately)		17,562.00
	E. Claims included in the retail portfolio & small enterprise (Consumer loan to be shown separately)		8,911.60
	F. Claims secured by residential property		12,155.80
	G. Claims secured by commercial real estate		35,727.80
	H. Consumer loan		3,398.40
	I. Medium Loan		7,861.20
	J. Other categories		-
	Capital market exposure		5,041.30
	Staff loan		1,260.30
	SMA		1,741.40
	Past due loans/NPL		1,367.70
	Off-balance sheet exposure		93,914.30
4	**Credit risk mitigation**		
	Claims secured by financial collateral		15,171.70
	Net exposure after the application of haircuts		2859.95
	Claims secured by eligible guarantee		-

4. Specific Provision

The bank follows Bangladesh Bank guidelines regarding loan classification, provisioning and any other issues related to Non Performing Loan (NPL). Bank's internal credit guidelines also directs on managing of NPL, loan provisioning review procedure, debt write-off, facility grading, reporting requirements, interest recognitions. However, the bank's guidelines will not supersede local regulations. Thus, while dealing with NPL, the bank's decision is always complied by local rules and regulations as well as group guidelines which are generally more conservative than the local regulations.

Specific provision on loans and advances as per Bangladesh Bank guidelines

Specific provision on substandard loans and advances/ investments:	20%
Specific provision on doubtful loans and advances/ investments:	50%
Specific provision on bad I loss and advances / investments:	100%

BRPD Circular No. 5 dated June 05, 2006 also provides scope for further provisioning based on qualitative judgments. In these circumstances impairment losses are calculated on individual loans considered individually significant based on which specific provisions are raised. If the specific provisions assessed under the qualitative methodology are higher than the specific provisions assessed under the formulaic approach above, the higher of the two is recognized in liabilities under "Provisions for loans and advances" with any movement in the provision charged / released in the profit and loss account.

SL	Particulars	Taka in million
A	Gross non-performing assets	1,367.70
	Non-performing assets to Outstanding loans and advances	1.23%
B	Movement of non-performing assets	
	Opening balance	1,149.10
	Addition	218.60
	Reductions	-
	Closing balance	1,367.70
C	Movement of specific provisions for NPAs	
	Opening balance	481.10
	Provisions made during the period	120.00
	Write-off	(256.60)
	Write-back of recovery	297.50
	Closing balance	642.00

5. Other Credit Information

Other qualitative and quantitative disclosures are given at notes to the accounts no. 7 of PBL's Financial Statements and Risk Management chapter of this Annual Report.

6. Market Risk

Capital charge means an amount of regulatory capital which the bank is required to hold for an exposure to a relevant risk which, if multiplied by 11.11, becomes the risk-weighted amount of that exposure for that risk.

The bank has a comprehensive Treasury Risk Policy which inter alia coverts assessment, monitoring and management of all the above market risks. The bank has defined various internal limits to monitor market risk and is computing the capital requirement as per standardized approach of Basel-II.

Details of various market risks faced by the bank are as below:

Interest rate exposures

The bank adopts maturity method in measuring interest rate risk in respect of securities in trading book. The capital charge for entire market risk exposure is computed under the standardized approach using the maturity method and in accordance with the guideline issued by Bangladesh Bank.

Interest rate exposures in the banking book

Interest rate risk is the risk where changes in market interest rates might adversely affect a bank's financial condition. The immediate impact of changes in interest rates is on the Net Interest Income (NII). A long term impact of changing interest rates is on the bank's net worth since the economic value of a bank's assets, liabilities and off-balance sheet positions get affected due to variation in market interest rates. The responsibility of interest rate risk management rests with the bank's Asset Liability Management Committee (ALCO). The bank periodically computes the interest rate risk on the banking book that arises due to re-pricing mismatches in interest rate sensitive assets and liabilities. For the purpose of monitoring such interest rate risk, the bank has in place a system that tracks the re-pricing mismatches in interest bearing assets and liabilities. For computation of the interest rate mismatches the guidelines of Bangladesh bank are followed. Details relating to re-pricing mismatches and the interest rate risk thereon are placed to the ALCO regularly. In addition, scenario analysis assuming a 100 basis point parallel shift in interest rates and their impact on the interest income and net profit of the bank are assessed on a quarterly basis and placed to ALCO with proposals for corrective action if necessary. Impact of changes in interest rate is given under Risk Management chapter of this Annual Report (page 83 & 86).

Foreign Exchange Risk

Foreign Exchange Risk may be defined as the risk that a bank may suffer losses as a result of adverse exchange rate movements during a period in which it has been open position, either spot or forward, or a combination of the two, in an individual foreign currency. The responsibility of management of foreign exchange risk rests with the Global Market of the bank. The bank has set up internal limit to monitor foreign exchange open positions. Foreign exchange risk is computed on the sum of net short positions or net long positions, whichever is higher of the foreign currency positions held by the bank. Impact of changes is given under Risk Management chapter of this Annual Report (page 83 & 86).

Equity Position Risk

The bank subsidiary-Prime Bank Investment Limited hold trading position in equities.

The consolidated capital charge for various components of market risk is presented below:

SL	Particulars	Taka in million
1	Interest rate risk	624.60
2	Equity position risk	219.40
3	Foreign exchange risk	62.70
4	Commodity risk	-
	Total	**906.70**

7. 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 reputation risk. It is inherent in every business organization and covers a wide spectrum of issues. The bank manages this risk through a control based environment in which processes see documented, authorization as independent and transactions are reconciled and monitored. This is supported by an independent program of periodic reviews undertaken by internal audit, and by monitoring external operational risk events, which ensure that the group stays in line which industry best practice and takes account or lessons learned from publicized operational failures within the financial services industry.

The bank has codified its operational risk management process by issuing a high level standard like SOP, supplemented by more detailed formal guidance. This explains how the bank manages operational risk by identifying, assessing, monitoring, controlling and mitigating the risk, rectifying operational risk events, and implementing any additional procedures required for compliance with local regulatory requirements. The standard covers the following:

- Operational risk management responsibility is assigned to senior management within the business operation;
- Information systems are used to record the identification and assessment of operational risks and to generate appropriate regular management reporting,
- Assessments are undertaken of the operational risks facing each business and the risks inherent in its processes, activities and products. Risk assessment incorporates a regular review of identified risks to monitor significant changes;
- Operational risk loss data is collected and reported to senior management. Aggregate operational risk losses are recorded and details of incidents above a materiality threshold are reported to the bank's Audit Committee; and
- Risk mitigation, including insurance, is considered where this is cost-effective.

The bank maintains and tests contingency facilities to support operations in the event of disasters. Additional reviews and tests are conducted in the event that any branch of the bank is affected by a business disruption event, to incorporate lessons learned in the operational recovery from those circumstances. Plans have been prepared for the continued operation of the bank's business, with reduced staffing levels.

The bank uses the basic indicator approach to calculate its operational risk. **The required capital for operation risk is Taka 1294.10 million as at December 31, 2010 (Consolidated).**

Capital charge means an amount of regulatory capital which the bank is required to hold for an exposure to a relevant risk which, if multiplied by 11.11 percent becomes the risk-weighted amount of that exposure for that risk.

8. Regulatory Capitals

Tier-I capital of the bank includes Paid-up capital, Non-repayable share premium account, Statutory reserve, General reserve, Retained earnings, Minority interest in subsidiaries, Non-cumulative irredeemable preference shares and Dividend equalization fund. Tier-I capital, also called 'Core Capital' of the bank.

Tier-II (Supplementary Capital) consists of general provision, revaluation reserves for fixed assets, securities and equity instruments, all other preference shares and Subordinated bond.

The use of Tier-III (short term subordinated debt) is limited only for part of the requirements of the explicit capital charge for market risks. The bank does not have any Tier-III capital.

The details of consolidated capital structure are provided as under:

A. Tier-I Capital

	Taka in million
Fully Paid-up Capital	5,776.37
Statutory Reserve	4,391.63
Non-repayable Share premium account	2,241.23
Retained Earnings	3,383.90
Minority Interest in Subsidiaries	-
Total (Tier-I Capital)	**15,793.13**
B. Deduction	
Book value of Goodwill	-
Shortfall in provisions required against classified assets irrespective of any relaxation allowed	-
Deficit on account of revaluation of investment in AFS category	-
Any increase in equity capital resulting from securitization transaction	-
Any investment in TFCs of other banks exceeding the prescribed limit	-
Other (if any)	-
Total deductions	-
Total Eligible Tier-I Capital	**15,793.13**
C. Tier-II Capital	
General Provision	2,333.06
Asset Revaluation reserve up to 50%	125.80
Revaluation gain/loss on investment (HFT) up to 50%	710.28
Revaluation reserve for equity instruments up to 10%	18.05
PBL Unsecured Subordinated Bond	2,500.00
Exchange Equalization Fund	4.52
Sub-Total	**5,691.71**
Deduction, if any	-
Total Eligible Tier-II Capital	**5,691.71**
D. Total Capital	**21,484.84**

9. Capital Adequacy Ratio

The bank has adopted Standardized Approach (SA) for computation of capital charge for credit risk and market risk, and Basic Indicator Approach (BIA) for operational risk. Assessment of capital adequacy is carried out in conjunction with the capital adequacy reporting to the Bangladesh Bank.

The bank has consolidated capital adequacy ratio of 11.69 percent as against the minimum regulatory requirement of 9 percent. Tier-I capital adequacy ratio is 8.60 percent against the minimum regulatory requirement of 5 percent. The bank's policy is to manage and maintain its capital with the objective of maintaining strong capital ratio and high rating. The bank maintains capital levels that are sufficient to absorb all material risks. The bank also ensures that the capital levels comply with regulatory requirements and satisfy the external rating agencies and other stakeholders including depositors. The whole objective of the capital management process in the bank is to ensure that the bank remains adequately capitalized at all times.

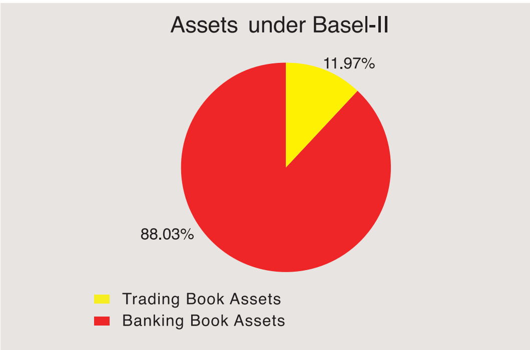
The bank has in place a capital adequacy framework by which the bank's annual budget projections and the capital required to achieve the business objectives arc linked in a cohesive way. Capital requirements are assessed for credit, market and operational risks. The bank's capital adequacy ratio is periodically assessed and reviewed by thy ALCO and reported to Head Office. The composition of capital in terms of Tier-I, Tier-II and Tier-III are also analyzed to ensure capital stability and to reduce volatility in the capital structure.

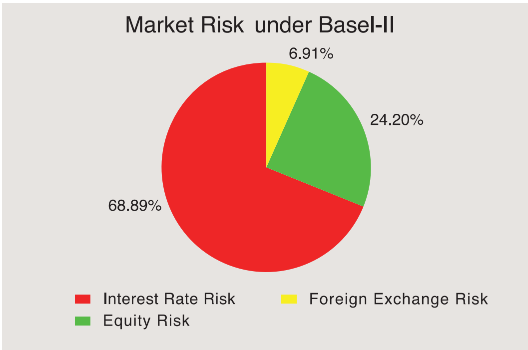
The position of various consolidated risk weighted assets is presented below:

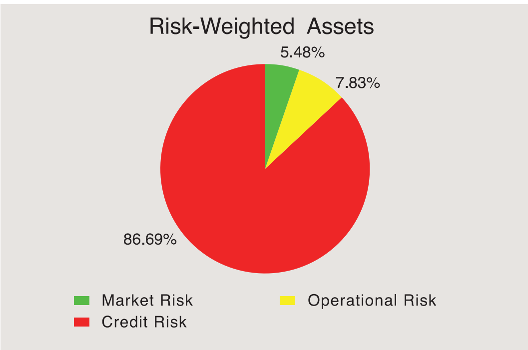
SL	Particulars		Taka in million
A	Credit Risk		159,294.70
	On-Balance Sheet	111,046.30	
	Off-Balance Sheet	48,248.40	
B	Market risk		10,073.80
C	Operational Risk		14,378.40
	Total RWA (A+B+C)		**183,746.90**

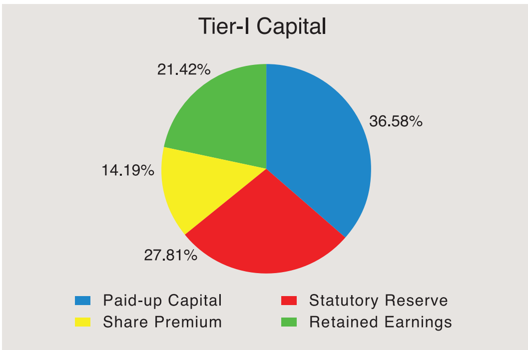
Consolidated Minimum Capital Requirement (MCR) is presented below:

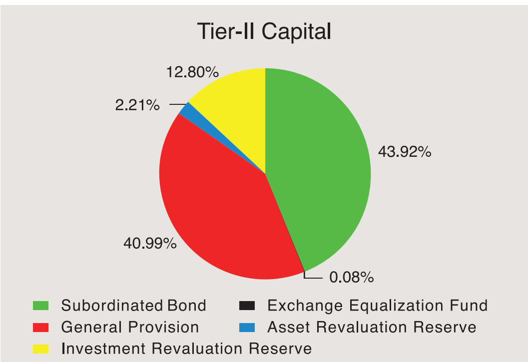
SL	Particulars	Taka in million
A	Eligible Capital:	
	1. Tier-I Capital	15,793.13
	2. Tier-II Capital	5,691.71
	3. Tier-III Capital	0.00
	4. Total Eligible Capital (1+2+3)	21,484.84
B	Total Risk Weighted Assets (RWA)	183,746.90
C	Capital Adequacy Ratio (CAR) (A4/B)*100	11.69%
D	Core Capital to RWA (A1/B)*100	8.60%
E	Supplementary Capital to RWA (A2/B)*100	3.09%
F	Minimum Capital Requirement (MCR)	16,537.22

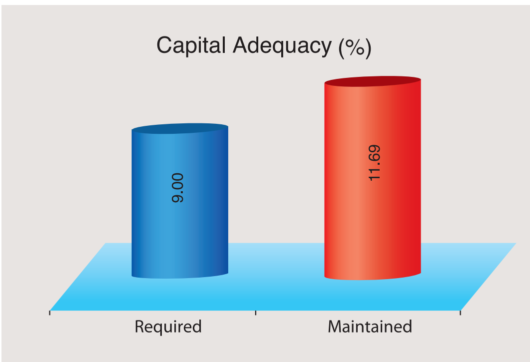












Market Discipline-Pillar-III Disclosures under Basel-II

Risk Management Unit

PBL has formed a separate 'Risk Management Unit' under Chief Risk Officer to ensure following things:

- Designing of organizational structure by clearly defining roles and responsibilities of individuals involved in risk taking as well as managing it;
- Formulation of overall risk assessment and management policies, methodologies, guidelines and procedures for risk identification, risk measurement, risk monitoring, defining an acceptable level of risk, mitigation of all the core risks in line with their respective guidelines provided by Bangladesh Bank;
- Reviewing and updating all risks on systematic basis as necessary at least annually, preferably twice a year, ensuring that adequate controls exist and that the related returns reflect these risks and the capital allocated to support them. The main risk areas will be Balance sheet Risk Management, Credit Risk, Foreign Exchange Risk, Internal Control and Compliance Risk, Money Laundering Risk and IT Risk. The following risks have also to be reviewed:
    - Operational Risk
    - Market Risk
    - Liquidity Risk
    - Reputation risk
    - Insurance Risk
    - Sustainability Risk
- Setting the portfolio objectives and tolerance limits/parameters for each of the risks;
- Formulation of strategies and different models in consistency with risk management policy based on IT Policy and in house IT support which can measure, monitor and maintain acceptable risk levels of the bank;
- Development of information systems/MIS inflow and data management capabilities to support the risk management functions of the bank.
- Ensure compliance with the core risks management guidelines at the department level, and at the desk level;
- The unit will work under bank's organizational structure and suggest to the CEO to take appropriate measures to overcome any existing and potential financial crisis;
- Analysis of self resilience capability of the bank;
- Initiation to measure different market conditions, vulnerability in investing in different sectors;
- The unit will also work for substantiality of capital to absorb the associated risk in banking operation.

Activities undertaken by "Risk Management Unit" since inception and recent approaches

- Risk Management Unit of PBL is currently arranging monthly meeting on various issues to determine strategies in consistency with risk management policy, which can measure, monitor, and maintain acceptable risk level of the bank. Minutes of each meeting is submitted to Bangladesh Bank on monthly basis;
- Besides, Risk Management Paper has also been prepared on the basis of 03 months' monthly minutes addressing different areas of risk and their mitigating tools & techniques guided by the members of Risk Management Unit;
- In order to perform the risk management function smoothly, RMU had invited all the Operational Divisions vide letter to the Head of respective Divisions to form an internal committee along with defined duties of concerned officials. It is to be noted here that due to continuous and successful persuasion, all the Operational Divisions have formulated and established internal risk management committees.

More details about risk management is given under Risk Management chapter of this Annual Report.

Stress Testing

Risk Management Unit (RMU) of PBL has already prepared a stress testing model in line with the Bangladesh Bank's guideline which initially focused on "Simple Sensitivity and Scenario Analysis" on the following five risk factors:

- Interest rate;
- Forced sale value of collateral;
- Non-performing loans (NPLs);
- Share prices; and
- Foreign exchange rate.

The first phase of stress testing based on the financial performance of the bank as of June 30, 2010 has already been furnished and presented to the regulatory authority i.e., Bangladesh Bank and also to the Board of Directors. The result of Stress Testing reflects the strength of this bank to absorb the shocks against all the risk factors. It has been observed that at any level of shocks, the bank will be able to maintain the capital adequacy ratio at the level which is in line with the standard set by Bangladesh Bank.

The next phase of stress testing based on the financial performance of the bank as on December 31, 2010 has also been completed which shows that the bank has adequate capital to absorb minor, moderate and major level of shocks. However, in case of cumulative shocks, some additional capital may be required.

Borrowers' Rating

Borrowers' rating is the offshoot of banks' Capital Adequacy Requirement under Basel-II framework applicable for scheduled banks. Basel Capital Accord-II in respect of Capital Measurement and Capital Standards aligns capital of a bank more closely with the underlying risk a bank undertakes through providing funded and non-funded facilities/guarantees/ commitments to the client/ in favor of client/ counterparty. With a view to smooth implementation of Basel-II Accord, management of our bank had decided to conduct Credit Rating of the Corporate Borrowers through External Credit Rating Assessment Institutes (ECAIs). The management primarily decided to rate the corporate customers.

Since inception, RMU has taken over the mentorship to rate its corporate exposures through ECAIs. RMU has continued its all-out efforts to ensure the timely and proper completion of borrower rating through guidance, series of meetings and written correspondences with the allied stakeholders i.e., different branches of the bank, borrowers and ECAIs. Progress report of the rating completion has already been reported to Bangladesh Bank.

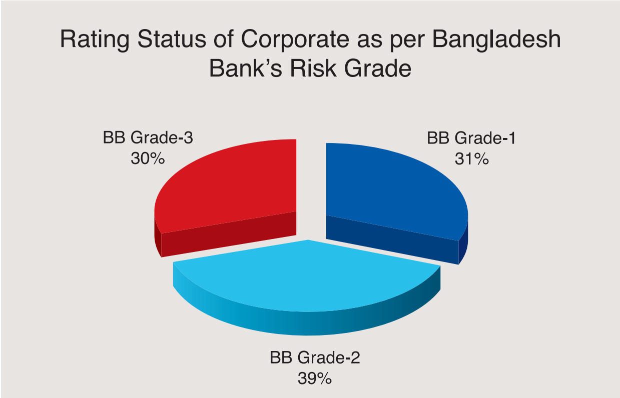
As a result of vigorous effort and continuous persuasion, out of total 332 nos. eligible borrowers of PBL having exposure of Tk 100 million and above, rating of 54 nos. borrowers (16.27 percent of eligible borrowers) has been completed till December 31, 2010. Another 44 nos. borrowers have already signed agreement with ECAIs. It is expected that by the end of the first quarter of 2011, total 98 nos. of our borrowers out of total 332 nos. borrowers will be rated through ECAIs which will cover 29.52 percent of the eligible borrowers.

The rating category of the 54 nos. borrowers of PBL is as follows:

Bangladesh Bank Rating Grade	Equivalent Rating of CRISL	Equivalent Rating of CRAB	No. of Rated Customers of PBL	% of total rated customers
BB Grade-1	AAA, AA+, AA, AA-	AAA, AA1, AA2, AA3	17	31%
BB Grade-2	A+, A, A-	A1, A2, A3	21	39%
BB Grade-3	BBB+, BBB, BBB-	BBB1, BBB2, BBB3	16	30%

Capital Relief through Borrower Rating

Against each individual exposure type, a Risk Weight has been assigned by Bangladesh Bank which is used to measure the amount of regulatory capital that will be required to be maintained against such exposure. According to the standardized approach of Basel-II framework, the risk weight will be based on the credit rating of the borrower prepared by External Credit Assessment Institutions (ECAIs) duly recognized by Bangladesh Bank. Where an exposure is secured by guarantee or eligible financial collateral, it may reduce its capital charge by taking benefit of the risk mitigation described in the guidelines of Bangladesh Bank. However, in the absence of credit rating the Risk Weight against loans and advances would be higher and will increase the requirement of maintaining regulatory capital.



Risk Management Unit, as per the direction of the Senior Management, places top priority on borrower rating as there are opportunities exist to have significant capital relief if rating of all of our corporate exposures can be accomplished. A review of the capital relief (from both funded and non-funded exposure) reveals that till December 31, 2010, we have achieved total capital relief of Tk 1,157.11 million from rated borrowers. Moreover, there is a possibility of achieving total capital relief of Tk 2,032.88 million within March 31, 2011.