Pubali Bank Limited
Market Discipline-Pillar-III Disclosures under Basel-II
As on 31 December 2010

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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 has been fully practiced by the banks replacing the previous rules under Basel-I. Pubali Bank Limited is maintaining its capital requirements at adequate level by adopting the Risk Based Capital Adequacy Guidelines of Bangladesh Bank in line with Basel II model.

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

i. Minimum capital requirements for credit risk, market risk 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.

Disclosure framework of Pubali Bank Limited

Disclosure includes the following as per Bangladesh Bank guidelines:

• 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

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1. Scope of Application

Pillar III disclosures apply to Pubali Bank Limited on solo /single entity basis. As of 31 December 2010, Pubali Bank has no subsidiary of its own, so capital adequacy requirement framework is applicable on only solo basis. The bank has computed its Capital Adequacy Ratio (CAR) by adopting the following approaches:

Credit Risk: Standardized approach using national discretion, as allowed by Bangladesh Bank guidelines, for:

- Accepting credit ratings as rated by external credit rating assessment institutions (ECAI) for claims on corporate customers;
- Accepting credit risk mitigates (CRM) against the financial securities and guarantees of loan exposures.

Market risk: standardized (rule based) approach;

Operational risk: Basic indicator approach.

2. Assets

The bank categorizes 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) Banking Book Assets: **Taka in million**

SL	Particulars	Detail	Total
	Cash in hand including prize bond		2,431.00
	Balance with Bangladesh Bank		5,844.40
	Balance with Sonali Bank as agent bank of Bangladesh Bank		1,037.00
	Balance with other banks and financial institutions		633.60
	Money at call and short notice		119.50

Taka in million

SL	Particulars	Detail	Total
	Investment:		
	Government	2,290.40	
	Qualifying (Banks etc.)	830.00	
	Others	2,205.40	5,325.80
	Loans and advances / investments	88,599.00	
	Staff loan	507.20	
			89,106.20
	Fixed assets		3,370.30
	Other assets		8,120.20
	Total banking book assets		**115,988.00**
	b) Trading Book Assets:		
	Foreign currency in hand		20.80
	Foreign currency held in Bangladesh Bank		977.60
	Foreign currency with banks and financial institutions		-
	Investment (trading):		
	Held for trading	8,431.70	
	Share of listed company	2,727.30	11,159.00
	Total trading book assets		**12,157.40**

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 periodically reviewed to ensure that they continue to serve their intended purpose and remain in line with local market practice. The major types of collateral 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 bank well, through successive economic cycles and holds good till today. This culture is determined and underpinned by the disciplined credit risk control environment which the bank 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 encompasses the following lending and monitoring processes:

• 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 and exit paths at the disposal of the bank

The bank has also separate Risk and Credit Control unit in place which oversees the 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, for risk grading of the customers, include financial condition and performance, quality of disclosures and management, facility structure, collateral and country risk assessment where necessary. Maximum counterparty / bank exposures are limited to 15 percent (funded) of the bank's capital base as stipulated by Bangladesh Bank and a higher limit accommodation for projects of national importance is considered with specific approval of Bangladesh Bank.

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

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.

Risk weighted assets under credit risk are as below:

Taka in million

SL	Particulars	Detail	Total
i) Total exposure of credit risk			
Funded :			
	a) Domestic	115,731.70	
	b) Overseas	256.50	115,988.20
Non-Funded :			
	a) Domestic	12,603.00	
	b) Overseas	13,820.70	26,423.70
ii) Distribution of risk exposures by claims			
	A. Claims on sovereigns and central banks		-
	B. Claims on other official entities (including CRM)		5,750.10
	C. Claims on banks and securities firms		2,586.70
	D. Claims on corporate (Medium enterprise loans to be shown separately)		54,924.50
	E. Claims included in the retail portfolio & small and medium enterprise (Consumer loan to be shown separately)		18,259.10
	F. Claims secured by residential property		913.10
	G. Claims secured by commercial real estate		1,386.00
	H. Consumer loan		8,636.40
	J. Other categories		-
	Capital market exposure		545.00
	Staff loan		101.40
	Past due loans/NPL		2,910.60
	Off-balance sheet exposure		7,982.60
iii) Credit risk mitigation			
	Claims secured by financial collateral (Exposure)		3,891.20
	Net exposure after the application of haircuts (RWA)		507.10
	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 monitoring guidelines also applies for managing of NPL, loan provisioning review procedure, debt write-off, facility grading, reporting requirements, interest income recognitions. However, the bank's guidelines are more conservative to local regulations for maintaining its capital.

Specific provision on loans and advances as per Bangladesh Bank guidelines

Specific provision on unclassified loans /investments	1%
Specific provision on unclassified loans under consumer loan scheme	5%
Specific provision on special mention account (SMA)	5%
Specific provision on substandard loans and advances/investments:	20%
Specific provision on doubtful loans and advances/ investments:	50%
Specific provision on bad loans and advances / investments:	100%

BRPD Circular No. 5 dated June 05, 2006 also provides scope for further provisioning based on qualitative judgments. Impairment tests on individual assets are done on ongoing basis by applying both quantitative and qualitative assessment, for judging the asset quality and maintaining adequate provision requirements as set out in Bangladesh Bank policy guidelines. If the specific provisions assessed under the qualitative methodology are higher than the specific provisions assessed under the formulaic approach, the higher of the two is recognized in liabilities under "Provisions for loans and advances" with possible movement in the provision charged / released in the profit and loss account.

The provisioning requirements as of 31 December 2010 are as below:

SL	Particulars	Taka in million
	Gross non-performing assets	2,866.20
	Non-performing assets to Outstanding loans and advances	3.22%
	Movement of non-performing assets :	
	Opening balance	2,826.10
	Addition	40.10
	Reductions	-
	Closing balance	**2,866.20**
	Movement of specific provisions for NPAs :	
	Opening balance	754.00
	Provisions made during the period	60.40
	Write-off	(241.50)
	Write-back of recovery	9.70
	Closing balance	**582.60**

5. 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 in place which inter alia covers 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

6. 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 treasury department 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.

Equity Position Risk
The bank holds trading position in equities.

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

SL	Particulars	Taka in million
1.	Interest rate risk	17.50
2.	Equity position risk	1,709.60
3.	Foreign exchange risk	84.10
4.	Commodity risk	-
	Total	**1,811.20**

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 bank stays in line which industry best practice and takes account or lessons learned from publicized operational failures within the financial services industry.

The bank uses the basic indicator approach to calculate its operational risk. **The required capital for operation risk is Taka 944.10 million as at December 31, 2010.**

Regulatory Capitals :

Particulars	Taka in million
A. Tier-I Capital	
Fully Paid-up Capital	4,968.60
Statutory Reserve	4,148.80
General reserve	2,199.60
Total (Tier-I Capital)	**11,317.00**
Deduction	-
Total Eligible Tier-I Capital	**11,317.00**
B. Tier-II Capital	
General Provision	1,512.80
Asset Revaluation reserve up to 50%	1,462.00
Revaluation gain/loss on investment (HFT) up to 50%	0.50
Revaluation reserve for equity instruments up to 10%	677.10

Particulars	Taka in million
PBL Unsecured Subordinated Bond	-
Exchange Equalization Fund	30.00
Sub-Total	**3,682.40**
Deduction, if any	-
Total Eligible Tier-II Capital	**3,682.40**
C. Total Capital	**14,999.40**

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 11.15 percent as against the minimum regulatory requirement of 9 percent. Tier-I capital adequacy ratio is 8.41 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 the Management Committee (MANCOM). The composition of capital in terms of Tier-I, and Tier-II are also analyzed to ensure capital stability and to reduce volatility in the capital structure.

The position of various risk weighted assets is presented below:

SL	Particulars	Taka in million	
A.Credit Risk			**103,995.40**
On-Balance Sheet		96,012.80	
Off-Balance Sheet		7,982.60	
B. Market risk			**20,124.50**
C. Operational Risk			**10,488.90**
Total RWA (A+B+C)			**134,608.80**

Minimum Capital Requirement (MCR) is presented below:

SL	Particulars	Taka in million
	A. Eligible Capital:	
	1. Tier-I Capital	11,317.00
	2. Tier-II Capital	3,682.40
	3. Tier-III Capital	-
	4. Total Eligible Capital (1+2+3)	14,999.40
	B. Total Risk Weighted Assets (RWA)	134,608.80
	C. Capital Adequacy Ratio (CAR) (A4/B)*100	11.15%
	D. Core Capital to RWA (A1/B)*100	8.41%
	E. Supplementary Capital to RWA (A2/B)*100	2.74%
	F. Minimum Capital Requirement (MCR)	12,114.80

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 quarterly 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 (sub risk management units) 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;
- Management Reporting System (MRS) committee has been formed so as to develop centralized management information and reporting system, which meets monthly in order to update the system;
- Training and workshops are regularly being conducted on all core risk areas for developing our internal capacity;
- We have started self rating and inspection in main core risk areas as per SRP guidelines of Bangladesh Bank;

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.