Implementation of Pillar-I (Minimum Capital Requirement) of Basel-II in Bangladesh: A comparative analysis among banks in Bangladesh.

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Agenda

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- **Objectives of the study**
- **Methodology of the study**
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An overview of Basel Accord

- **In 1974, Basel Committee on Banking and Supervision (BCBS) was established.**
- **In July, 1988 BCBS published Basel accord (Basel-I)**
  - global uniformity in measuring capital adequacy
  - Simplified approach to credit risk
  - Assets were classified in five categories according to credit risk
  - Minimum capital requirements is at least 8% of its RWA.

Basel-II

- **In 2004 BCBS published a more risk sensitive framework known as *Basel-II framework.***
  - A new set of international standards for establishing MCR.
  - to develop better risk management techniques in monitoring and managing risks.
  - A comprehensive approach addressing credit risk, market risk & operational risk.
  - Risk sensitiveness achieved through 3 mutually reinforcing pillars.

3 Pillars of Basel-II

Basel-II

Pillar-1

Minimum Capital Requirement (MCR)

- Credit Risk-
  - ✓ Standardized Approach
  - ✓ Foundation IRB Approach
  - ✓ Advanced IRB Approach
- Market Risk-
  - ✓ Standardized Method,
  - ✓ Internal Model Approach
- Operational Risk-
  - ✓ Basic Indicator Approach
  - ✓ Standardized Approach
  - ✓ Adv. Measurement Approach

Pillar-2

Supervisory Review Process (SRP)

- Bank end-
  - ✓ Internal Capital Adequacy Assessment Process (ICAAP)
  - ✓ Risk Management
- Supervisory end-
  - ✓ Evaluation of banks' internal systems (ICAAP)
  - ✓ Assessment of risk profile
  - ✓ Review of compliance with all regulations
  - ✓ Supervisory measures.

Pillar-3

Market Discipline

- Transparency

  -For market participants concerning banks' risk position (scope of application, risk management, detailed information on own funds etc.)
- Comparability

  - between and among the banks within the jurisdiction.

Basel-III

In December 2010 BCBS undertook reforms known as Basel-III Framework-

- To strengthen bank's shock absorbing capacity
- Enhancing banks' capital framework by-
    - Uplifting the quality, consistancy & transparency of the capital base,
    - Widening risk coverage,
    - Supplementing the RBC requirement with a leverage ratio.
    - To commence a global liquidity standard

Objectives of the study

- A comparative analysis in compliance of MCR among the sub-sectors,
- The probable required actions to be taken by the supervisor,
- The possible improvisation of RBCA Guidelines in Bangladesh.
- Challenges in implementing advanced approaches like IRB approach, Internal Model Approach

Methodology of the study:

For the study secondary data collected from Bangladesh Bank.

- Both qualitative and quantitative analysis done
- The capital adequacy framework of BB in light of global standard
- Capital adequacy data of banks has been analyzed for an intra-industry comparison.

Basel implementation in Bangladesh

- In 1991**,** Bangladesh Bank adopted the **liability-to-Capital** approach determining regulatory capital.

- In 1996, Bangladesh Bank adopted the **Basel-I** propositions.
  - MCR at least 8% of RWA with 4% core capital or Tk. 200 million whichever is higher.

- In 2002, capital adequacy regulation was revised:
  - MCR 9% of RWA with 4.5% Core Capital or Tk. 400 million whichever is higher.

Basel-II implementation Scenario in Bangladesh

- **In 2006, BB issued an action plan/road map.**
- **In consequence 2 major tasks were done**

  -Guidelines for recognition of eligible ECAI's- September 2008,

  -Guidelines on RBCA–a Revised Regulatory Capital Framework in line with Basel II- December 2008.

- Banks entered in Basel-II regime fully in January 2010.

- Capital broadly categorized in 3 parts.
  - ➢ Tier-1: Core capital
  - ➢ Tier-2: Supplementary Capital
  - ➢ Tier-3: Additional Supplementary Capital

Basel-II implementation Scenario in Bangladesh

- MCR is now 10% of RWA with 5% core capital or Tk. 400 million whichever is higher (from July 2011).

- BB structured its RBCA guidelines considering all propositions of Basel-II. Calculating RWA following approaches used

  - Credit Risk-*Standardized Approach,*
  - Market Risk-*Standardized (Rule Based) Method*
  - Operational Risk- *Basic Indicator Approach.*

Evaluation of regulation in the context of global standard

BCBS's suggested 25 Core Principles for Effective Banking Supervision.

Capital adequacy principle states –

- *Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks reflecting risks.*
- *Define the components of capital considering loss absorbing ability.*
- *MCR should be higher than Basel requirement for internationally active banks.*

- The MCR of all banks except DFI's is higher in Bangladesh.
- BB has sufficient empowerment to impose required capital on banks and penalty in case of deficiency .

Evaluation of regulation in the context of global standard

- **In several other respects, the local standard does not consistent with the Basel standard-**
  - ✓ *Treatment of commercial enterprises owned by the public sector is more liberal,*
  - ✓ *Banks activities are very broad in nature, but no additional capital requirements address to some potential risks.*
  - ✓ *BB capital adequacy framework does not contain treatment of securitization framework against credit risk.*
  - ✓ *Banks are allowed to include revaluation reserve in Tier-2 capital while there exists no guidelines or specific instruction for revaluations of assets.*
- **Yet, RBCA Guidelines (December 2010) for banks is almost aligned with the Basel standard of capital adequacy. BB has made the alterations where discretion of national supervisors is allowed.**

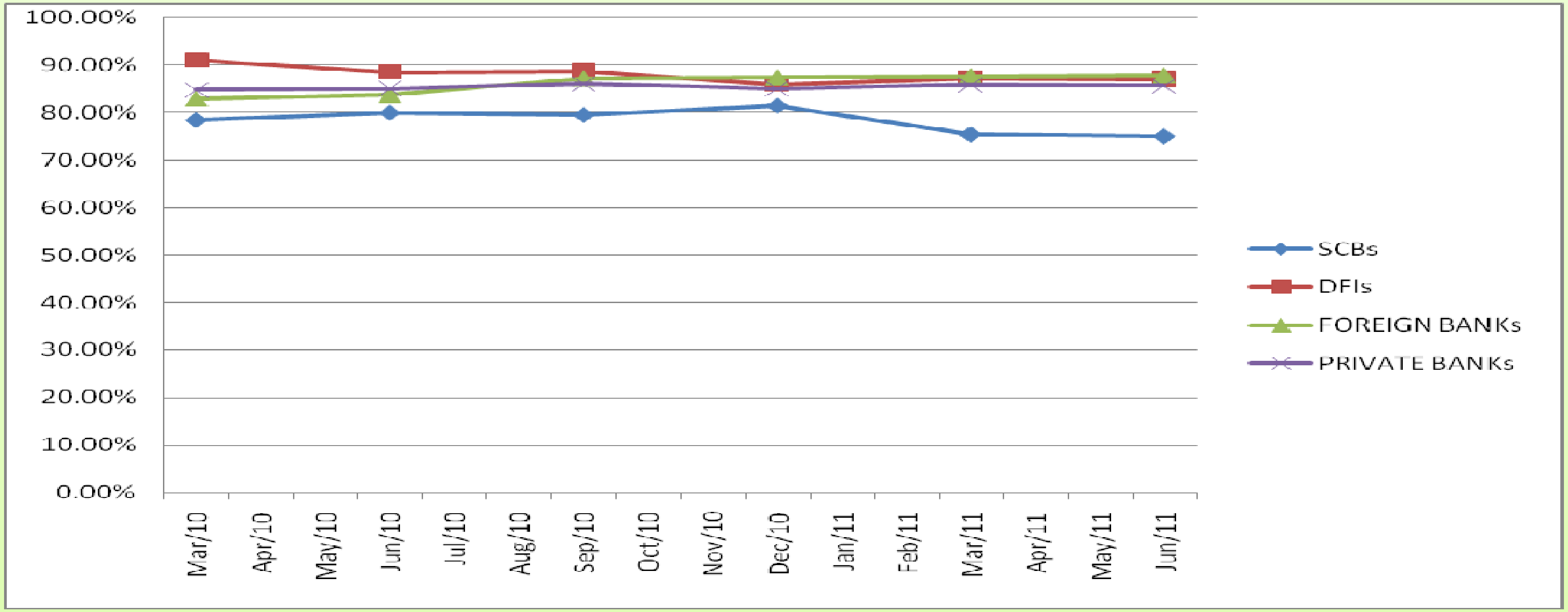
Data Analysis & Findings

Comparative Capital Adequacy Ratio (CAR)

SCBs improved a lot while PCB improved steadily. Foreign banks faced slight fall in the middle recovered later on but the DFIs have experienced worsened situation.

Data Analysis & Findings

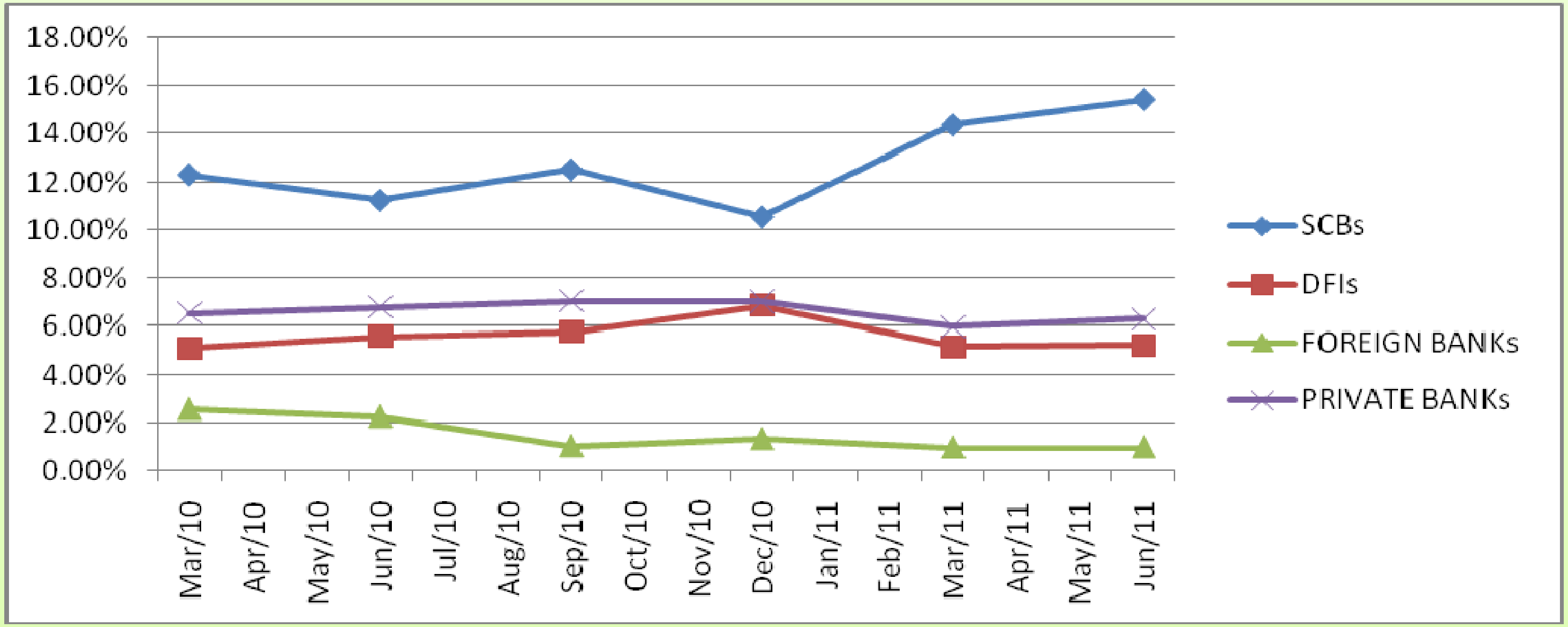
RWA for CR as % of Total RWA



RWA for the whole industry come against CR(75%-91%) implies less market exposure.

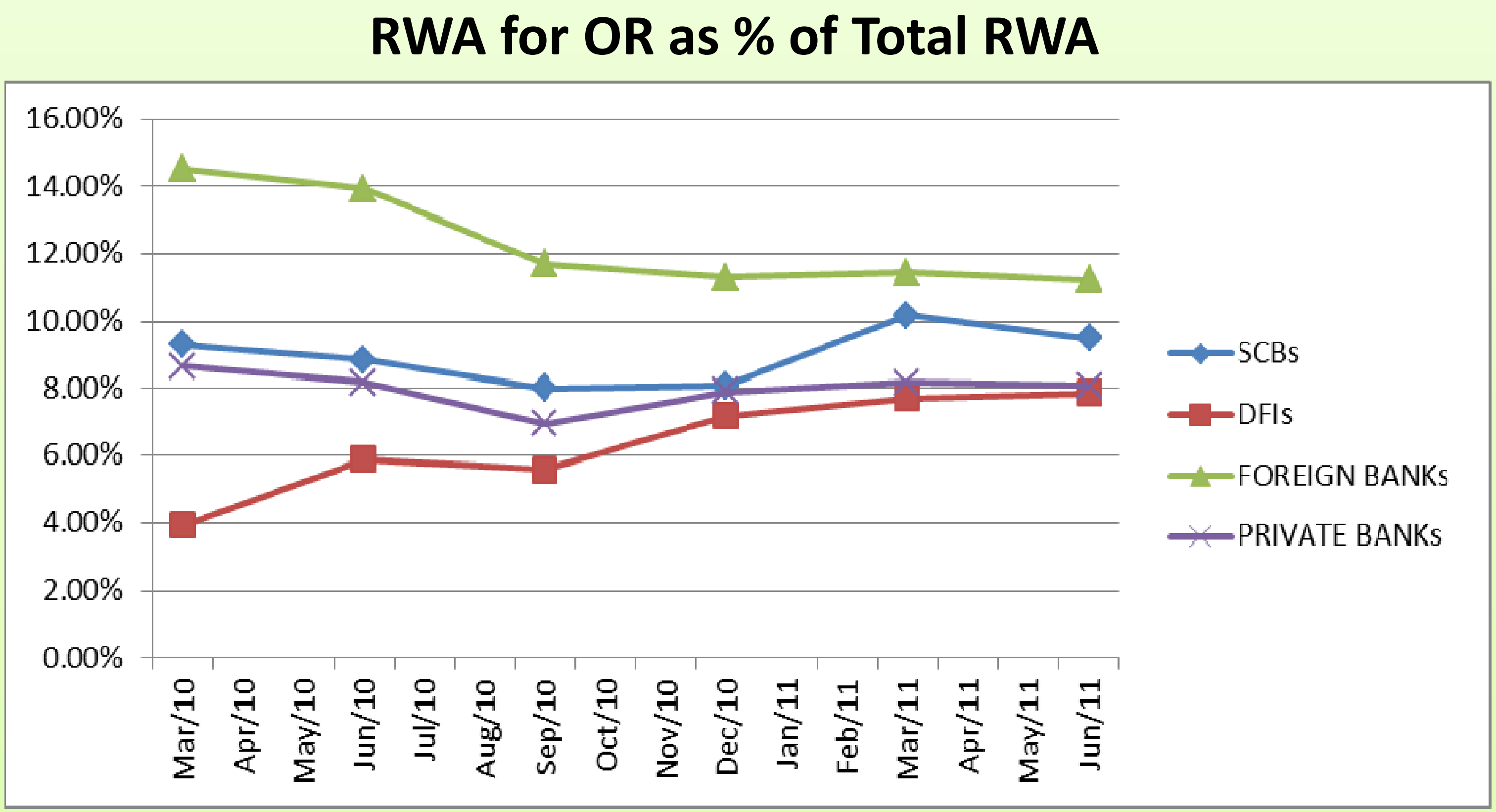
Data Analysis & Findings

RWA for MR as % of Total RWA



RWA for MR are much higher (10.54%-15.46%) for the SCBs in comparison to others and the proportion has been increasing over time.

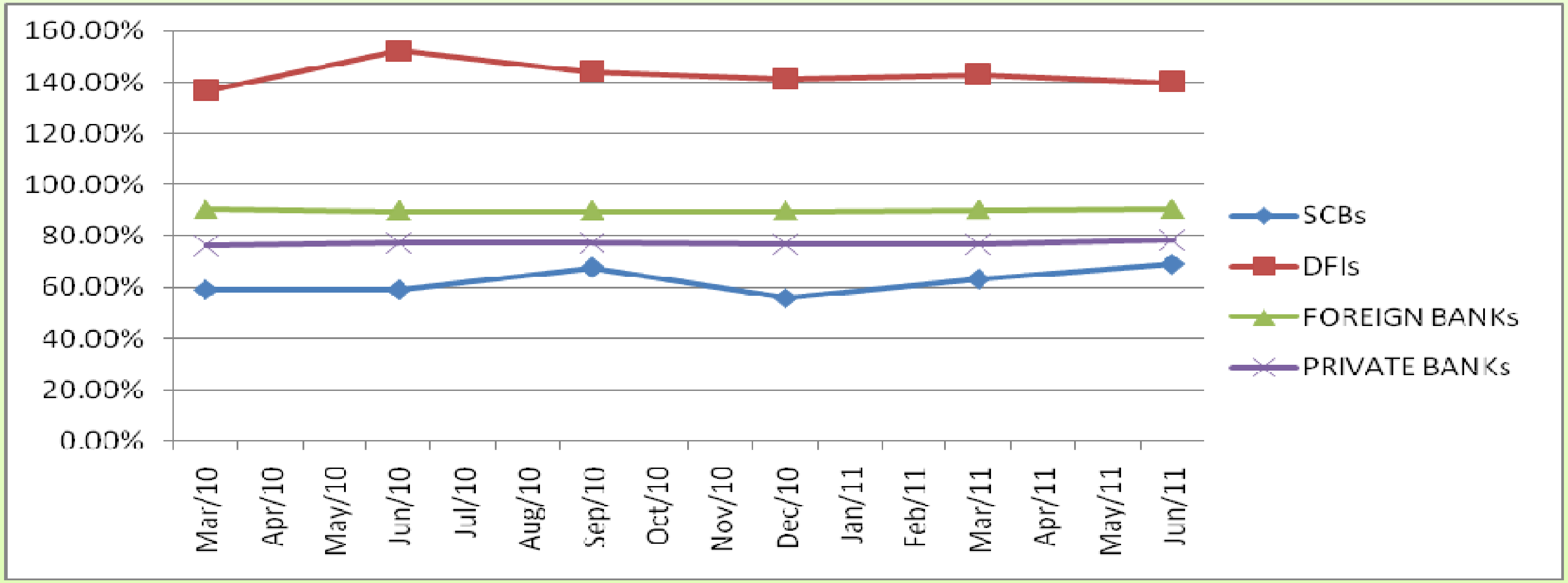
Data Analysis & Findings



RWA for OR steady for all sub sectors which implies the steady movement of their gross profit.

Data Analysis & Findings

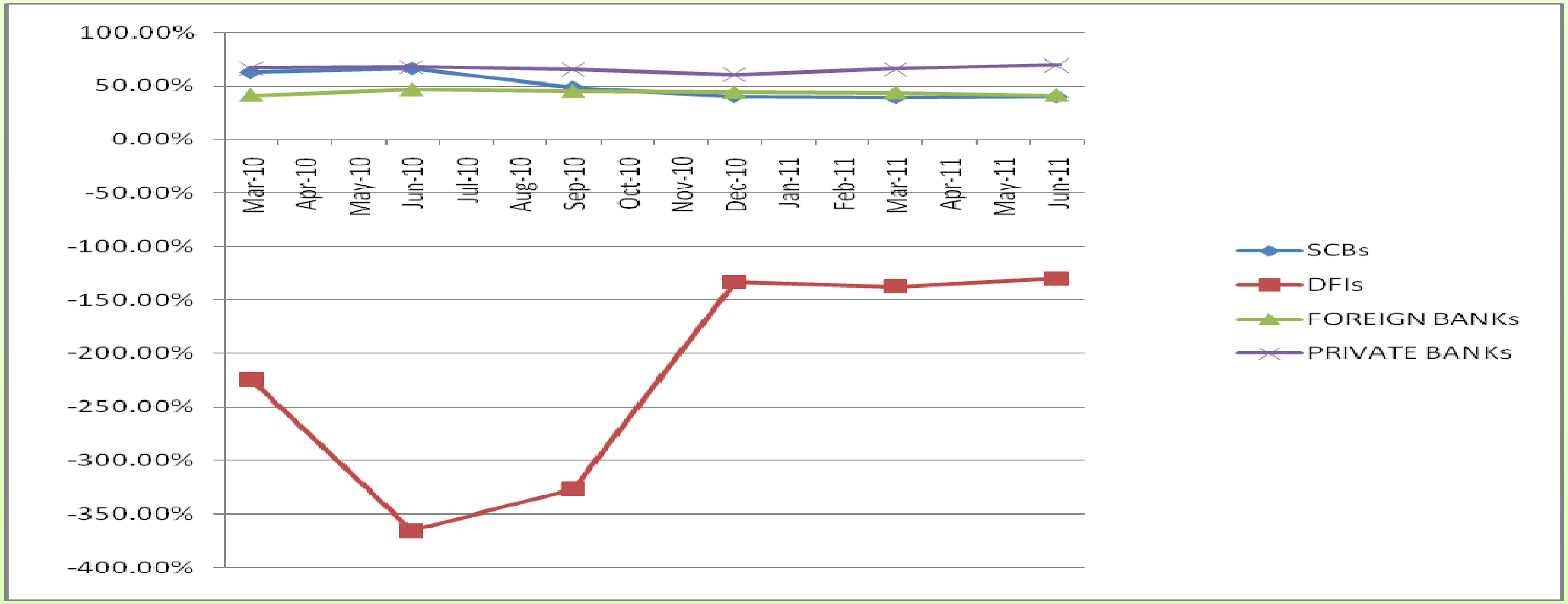
Comparison of Core Capital among banks



Foreign banks have high dependence on the core capital (almost 90%) for their capital base and 75%-80% of the private banks' capital comes from core capital..

Data Analysis & Findings

PUC & Reserve as % of Total Capital



Some PCBs are not over dependent on paid up capital and reserve for their capital composition. Especially foreign banks are highly dependent on paid up and reserve. But DFIs scenario is quite complicated.

Findings

- CAR-SCBs improved a lot while PCB improved steadily. DFIs have experienced worsened situation.
- RWA for the whole industry come against CR(75%-91%) implies less market exposure.
- RWA for MR are much higher (10.54%-15.46%) for the SCBs in comparison to others and the proportion has been increasing over time.
- RWA for OR steady for all sub sectors which implies the steady movement of their gross profit.

Findings

- BB’s main challenge is to prepare banks for Basel accords.
- IRB approach need internal data base,
- Banks are still running under decentralized and less sophisticated IT platform.
- Lack of information on borrower’s business stature, industry information etc. and its data management, storage and processing still remains the major challenge for the banks.

Recommendations & Conclusions

– **Comprehensive and integrated initiatives** should be undertaken by the government and central bank to revive **DFI's** out of the existing situation.

– BB should **align their capital adequacy** regulations properly with the BCP.

- BB should take proper initiative **to preserve and make available real time on-site inspection data**.
- BB should be provided **more empowerment through the Bank Company Act** to be strict in maintaining capital adequacy for all banks.

Conclusions

– Maintaining capital adequacy under apposite and structured risk based assessment is the foundation to build up a resilient banking sector.

- Relevant standards and apt guidelines commensurate to BASEL framework can maximize the benefits of risk management.

- Thus, undesired outcomes of financial turmoil can be mitigated.

Thank you all