Implementation of Basel Core Principles for Effective Banking Supervision in the context of Bangladesh

by

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ABSTRACT

Bangladesh Bank (BB) is empowered to act as the supervisory authority for all scheduled banks operating in Bangladesh. In order to enforce supervisory activities the objectives, independence, effective legal framework, enforcement powers and Information Sharing System of Bangladesh Bank are laid down in “Bangladesh Bank Order, 1972” & “the Bank Company Act 1991”.

Thus, the first assessment on compliance was carried out by the IMF/World Bank jointly as a part of Financial Sector Assessment Program (FSAP) in October 2002. In October 2006, ‘a self-audit on compliance with Basel core principle for effective banking supervision’ has been conducted by Basel II Implementation Cell of BB. It shows a significant development in compliance with the ‘BCPs’ for Effective Banking Supervision.

“The Bangladesh Bank Order” and “the Bank Company Act” were passed by the parliamentarians in the year of 2003; Bangladesh Bank attained largely compliant status in October 2006 as against Materially Non Compliant in October 2002.

There are certain shortcomings in the 1988 Accord, some of which are mentioned as under:

- The 1988 framework does not make adequate differentiation of credit risk, although the risk is different as the recovery of the two instruments would be different.
- There is no recognition of the term structure of credit risk.
- The current Accord does not give due recognition to the process of reducing credit risk. It also not emphasized more on collateral that has impact in reducing the losses on account of credit risk.
- The first Basel Capital Accord not impose charges against operational risk though it is very important source of risk and can be more devastating than credit risk.

The International Convergence of Capital Measurement and Capital Standards – A revised framework (Basel II) represents a major revision of the international standard on bank capital adequacy that was first introduced in 1988 by the Basel Committee of Banking Supervision (BCBS). It promotes development in risk management and is intended to enhance comprehensive framework for regulatory capital and risk management, a mixture of challenges to both supervisors and banks are anticipated. The New Capital accord is more wide and complex than the ‘1988 accord’. The efforts were to expand a framework that is risk sensitive and includes fresh options for gauging credit and operational risk. In its simplest form, however, this more risk-sensitive framework is only slightly more complex than the 1988 Accord. Moreover, in the New Accord, the Committee is emphasizing the role of supervisory review process and market discipline as essential complements to minimum capital requirements. The elements in the new capital accord comprises with IRB approach and external credit assessments, ‘credit risk mitigation techniques’ and ‘asset securitization’, the treatment of ‘operational risk’, ‘supervisors review’ and the third one is ‘market discipline’.

Objectives of the new capital accord are:
a. It is a further complete approach intended for addressing risk, placing more emphasis on banks’ ‘internal risk methodologies’, ‘supervisory review’ and ‘market discipline’

b. It is a highly sensitive measure to assess the level of risk involved in a banks position and activities.

c. It highlighted the banks that are globally active.

This accord comprises with

- ‘Minimum Capital Requirements’
- ‘Supervisory review’
- ‘Market Discipline’

The ‘Basel II’ accord cannot come on effect until all the three pillars in a row.

At present minimum ‘capital ratio’ that is 8% of total risk weighted assets is already maintained. In the same time new accord will be more comprehensive on holding the industries to ensure hazards.

The minimum total ‘capital ratio’ wills comprises with three parts: “the sum of all risk weighted assets for credit risk, plus 12.5 times the sum of the capital charges for market risk and operational risk”.

Under pillar II, regulators will have the flexibility to need banks to hold excess of ‘minimum capital’. Internal models should be used internally to set limits, measure risks and to allocate economic capital under pillar III ‘market discipline’ encourages high disclosure standards. Basel committee will issue guidance on public disclosure.

The committee anticipates its members to move forward with the appropriate adoption procedures in their respective countries. In a number of instances, these procedures will comprises extra impact assessment of the committee’s structures as well as additional opportunities for explanation by interested parties to be provided to domestic authorities. The committee intends the frame work set out here to be available for implementation as of end of the year 2006. But due to some unavoidable circumstances BB was not able to fully on operation.

The new accord is being circulated to supervisory authorities worldwide to encouraging the supervisors to consider adopting this modified framework at such time as they believe is consistent with their wider supervisory priorities. When the modified structure has been designed to provide options for banks and banking systems worldwide the committee acknowledges that moving toward its adoption in the near future may not be a first main concern for all non G10 supervisory authorities in terms of what is needed to empowering their supervision. When situation is like that, each domestic supervisor should think the benefit of the revised structure in the context of its domestic banking system while developing a timetable and approach to implementation.

Our financial marketplace is not completely efficient. And our banking system still follows the old accord, in convergence with the guidelines of the regulatory authorities. Moreover,
our banking system lacks sufficient expertise to make the new accord effective. But to fit in the changing scenario and to grab the fruit of globalization, our banks must take measures to comply with the *New Basel Capital Accord*. And finally they kicked off the operation in December 2010. Yet we need to wait some times for the operation to move on full throttle.
ACRONYMS

ABCP    Asset Backed Commercial Paper
ADC     Acquisition Development and Construction
AMA     Advance Measurement Approaches
ASA     Alternative Standardize Approach
CCF     Credit Conversion Factor
CCR     Counterparty Credit Risk
CDR     Cumulative Default Rate
CEM     Current Exposure Method
CF      Commodities Finance
CMV     Current Market Value
CRM     Credit Risk Mitigation
DvP     Delivery versus Payment
EAD     Exposure at Default
ECA     Export Credit Agency
ECAI    External Credit Assessment Institution
EL      Expected Loss
EPE     Expected Positive Exposure
FMI     Future Margin Income
HVCRE   High Volatility Commercial Real Estate
IAA     Internal Assessment Approach
IMM     Internal Model Method
IPRE    Income Producing Real Estate
IO      Interest only strips
IRB     Internal Rating Based
LGD     Loss Given Default
M       Effective Maturity
MDB     Multilateral Development Bank
NIF     Note Issuance Facility
OF      Object Finance
PD      Probability of Default
PF      Project Finance
PSE     Public Sector Entity
PvP     Payment versus Payment
QRRE    Qualifying Revolving Retail Exposures
RBA     Rating Based Approach
RUF     Revolving Underwriting Facility
SF      Supervisory Formula
SET     Securitities Financing Transaction
SFT     Securities Financing Transaction
SL      Specialized Lending
SM      Standard Method
SME     Small and Medium sized Entity
SPE     Special Purpose Entity
UCITS   Undertaking for Collative Investments in Transferable Securities
UL      Unexpected Loss
CHAPTER 1
INTRODUCTION

1.1 Introduction

A country’s whole economy is divided into two sectors, i.e. a real sector and a financial sector. The real sector produces goods that can be felt and/or touched and the financial sector supports the real sector in terms of investment. The financial sector constitutes banks, non-bank financial institutions. Banks are those financial institutions that affect money market through accepting deposits and offering credit. Monetary stability and macroeconomic growth cannot be sustained without a sound banking system. ‘Bangladesh Bank’ is the final right of the financial sector being the apex body of monetary and banking structure its role falls into two areas—

- Monetary policy formulation & implementation role
- Supervisory role.

These two roles are interrelated and complement each other and go hand in hand to achieve the desired level of economic growth. The MPD & BRPD departments of Bangladesh Bank formulate the policies and supervising departments and to implement them.

Supervision is the process of inspecting and monitoring the implementation and effectiveness of rules. Supervision seeks to identity the factors that prevent and industry from functioning competitively, and to correct these failure through regulation. It is through supervision indicators of economic instability or trend contradicting monetary policies are identified which facilitates taking necessary precaution and remedial course of actions.

In September 1997, the ‘Basel Committee’ formulated few set of ‘core principles’ for useful banking supervision. In this process IMF and the World Bank provided their support with the Basel Core Principles. These core principles were for making sure of both developed, developing and underdeveloped countries. These Basel core principles ensure banking governance and effective supervisory systems. Though Basel Core Principles are the set of minimum standard but the individual countries may adopt this by modifying them as required, it covers the risk factors and provides flexibility to the supervisors in the volatility of the ever changing market conditions. “The Basel core principles for effective banking supervision” has become the standard for regulators and supervisors.

In Bangladesh, the first assessment on compliance was carried out by the IMF and the World Bank as part of FSAP in 2002. On the basis of that report, a number of corrective steps been taken by the central bank and the government of Bangladesh. In the year of 2006 Basel II implementation cell of Bangladesh Bank arranged a self audit on compliance of Basel Principles. It shows a significant development in compliance with the ‘BCPs’ for its ‘Effective Banking Supervision’.

In the Basel Core Principles there are twenty-five basic principles. The Principles relay on:
Principle 1: Preconditions for effective banking supervision
Principles 2 - 5: Licensing and structure
Principles 6 - 15: Prudential regulations and requirements
Principles 16-20: Methods of ongoing banking supervision
Principles 21: Information requirements
Principles 22: Formal powers of supervisors
Principles 23-25: Cross-border banking

1.2 ‘Bank for International Settlements’ (BIS)

“BIS is a worldwide organization, which fosters cooperation towards monetary and financial stability and serves as the central bank for all of the central banks around the globe. Head Office of is in Basel, Switzerland is one of the oldest financial institute. The BIS activities are mainly:
• an assembly which promote discussion and facilitates decision making process among all the central banks within the global financial community;
• a hub for the financial and economic research;
• a most important counter party for central banks in their financial transactions;
• an agent or trustee in international financial operations and maintains a fair and competitive environment around the world economy.

The BIS operates the Financial Stability Institute (FSI) jointly with the Basel Committee on Banking Supervision to regulate and monitor the banking sectors of different countries. The Group of Ten (G-10), one of the major forums of BIS was originated when 10 member countries of the International Monetary Fund (IMF) together with Switzerland agreed to make resources available for IMF outside their fund quotas under the General Arrangements to Borrow (GAB)”. (“www.bis.org”)

1.2.1 ‘The Basel Committee on Banking Supervision’

According to the Bank for International Settlements- “ For effective banking supervision Basel Committee made a group with the members of different countries. There are also the supervisory authorities of Group of ten countries. Meeting was held at the Bank of International Settlements head office Base, Switzerland, in the year of 1974, December. From there G-10 Governors established a committee on banking supervision for the development of the supervisors around the globe. This forum is for conversation on the basis of supervisory problems. BIS coordinates the sharing of supervisory responsibilities among domestic authorities with the target of ensuring effective supervision of the banks activities worldwide. First step in this issue was the Basel Concordat published in 1983 and 1992 respectively. The committee agreed setup minimum standards for the supervision process according to the globe on the issue of bilateral settlements. Committee also tries to improve the standard of supervision, especially in solvency for soundness and stability of the banks operating across the globe. The first agreement in this regard is known as Basel I Capital Accord. The main aims of this accord were to achieve uniformity of the banks in the form of minimum capital standards. Later on committee has come out with the amendment of new capital accord which one is known as Basel II capital accord. After the recent economic crisis the committee has started to think for a new accord which one will be known as Basel III. In recent past Basel committee pays more attention to supervisory
standards across the globe. In this section the comparison of Basel I and Basel II are going to be discussed.

Some of the Basel Committee documents for managing risk in Banking” (www.bis.org)

1. Core Principles for effective Banking Supervision.
3. Principles for the management of credit risk.
5. Principles for Management and Supervision of interest rate risk.
8. Enhancing Corporate Governance in Banking Organization.

1.2.2 Basel Capital Accord I & II

The Basel Committee announced new capital standards- which often referred to as the Basel Agreement, which one can be applicable to all banking institution across the globe. The first Basel Capital Accord was designed to strengthen the banks in their capital position in the same time to eliminate inequality in the regulatory perspective as well as risk to the banks in off balance sheet commitments they have made in recent years. Basel Agreement on International Bank capital standards is:

\[
\text{Capital Adequacy} = \frac{\text{Total Capital (or Tier 1+ Tier 2 Capital)}}{\text{Total risk weighted bank assets}}
\]

The new accord has been designed because:

1. It affirms promoting safety and soundness and enhancing competitive equality
2. It is more wide-ranging approach to addressing risk, placing more emphasis on banks’ internal risk methodologies, supervisory review and market discipline
3. More sensitive measures of the level of the risk are involved in a banks position & activities.
4. Its focus on internationally active banks

1.3 Statement of the problem

Basel II is mostly a new concept in Bangladesh. This is why there has been limited research or studies conducted to date. I deeply believe that we need to work more on this contemporary issue. Politicians and the central bank have not yet critically evaluated this. That motivates me to conduct this research study. The aim of the study is to bridge the gap in information and to identify any barriers to implementation of the Basel II accord in Bangladesh.
1.4 ‘Objectives’

The objective of the study is to critically evaluate Central Banks’ compliance with ‘Basel core principles’ for ‘effective bank supervision’ & the new Basel Capital Accord and to shed light on the superior features of the Basel II over the Basel I Capital Accord. The following are the specific objectives of this study:

a. To explore an overview of the BASEL Accords and Basel core principles for effective Banking supervision
b. To assess the compliance status of the BASEL core principles of banking supervision in Bangladesh.
c. To review the need of Basel II in place of Basel I Accord and make a comparison between them.
d. To study the implications and impact of Basel Core principles in Banking Supervision in Bangladesh.

1.5 ‘Methodology’

This report is basically the study of evaluation on ‘Basel core principle’ for ‘effective Banking supervision’ in Bangladesh. This report is aimed to supervisory systems of Bangladesh. Data/information was collected from secondary sources. The study had been conducted by extensive review of related literatures available in the library of AIT and Bangladesh Bank collections such as various book, publications, periodicals and journals Bangladesh Bank Order 1972, Banking Company Act 1991, Internet, previous reports, study materials For this purpose, the help from the websites containing information relevant to the study had also been sought. The Bangladesh Bank publications are also collected and consulted.

Only the secondary data had been collected from the publications and websites for the research both from domestic and global sources. Mainly published journals, books, documents and publications of national and international organizations are the vital sources of the information provided in this study. Personal observations have also been made in some cases.

Since the new accord is still in the development and promotion stage, the methods used here in analyzing the thesis are enumerated as under:

**Exhaustive study**: ‘The Basel Committee on Banking Supervision’ released papers on “Core Principles for Effective Banking Supervision”, Basel, 1997 & “International Convergence of capital Measurement & capital standards” a revised framework June 2004”. The intended study is mainly based on these papers and there has been thorough and exhaustive study of the paper to grab the critical views of the proposal. Other supportive documents of the BIS have also been consulted while going on with the study. The committee’s comments and the keynote speeches of many Central Bankers time to time have been taken into consideration while rummaging the study.
Analysis: The New Basel Capital Accord far more critical than that of the existing accord. While going on with the study, several issues came forward. These issues are sometimes completely mathematically derived and for the rest the committee established some rules based on the judgments of the members.

Inference: As previously mentioned, the ultimate objective of the intended study is to critically evaluate the compliance of Basel Core principles and New Basel Capital Accord and its implications in the context of Bangladesh and also finding the link between Core principles and Basel Accord. Henceforth, the attempt was made to see whether the Accord’ and the time duration required for the banks to implement the Capital Adequacy. Bangladeshi Banks could comply with the proposed articles of the ‘New Basel Capital

1.6 Limitations of the study

I have been working in Bangladesh Bank under the Department of Currency Management and Payment systems since my joining in the bank. I have never worked in any departments who work with the Basel. An Employee in other department has very limited access to the data of the organization and has very limited work opportunities and it was not different here for me. Implementation of Basel-II has involvement and coordination of different stakeholders group. I have worked with a single group only. So I have some limitations of data pilling and arrangement. Moreover, practical experience is very different from that of theoretical words.

In this study, related information is collected different published sources. All the data are secondary in nature. There is a little scope for collecting primary data for this study. The data and information collected are qualitative in nature. So there is no scope of mathematical analysis.

The major limitation of the research is that it is completely based on the theoretical features. Other limitations may be enumerated as under:

1. Basel II Capital Accord is still in the phase of improvement and implementation. Henceforth, drawing any abstract decision based on the theoretical aspects only may not make sense.

2. There is no sample of the study since till now no bank has fully gone to the New Basel Capital Accord. For this reason loopholes or the discrepancies in the theoretical context cannot be identified.

3. Moreover, the measures of risk mentioned in New Basel Capital Accord are not universally accepted. And most of the measures are based on the context of the developed countries. Consequently, the New Basel Capital Accord cannot completely adjust with the market scenario of the developing and underdeveloped countries. Henceforth, staying in a country like ours, it is very difficult to presume possibility of implementation and the deviation from the expected outcome of the New Basel Capital Accord
4. One of the most severe drawbacks is the lack of consciousness among the banks in our country. Our banks have not yet started thinking or designing any step to make their asset and liability accounts compatible with the New Accord.

1.7 Organization of the Report

This paper is divided into eleven chapters. The first chapter is the introduction of the report. The second chapter focuses on the literature review and theoretical background of the report. The third chapter gives the History Basel Committee and Rationale of Basel Accord. The Fourth Chapter explains the principles and practices of banking supervision. The sixth chapter shows the compliances of BCPs in Bangladesh. The seventh chapter makes a comparison between ‘Basel I’ and ‘Basel II’. The eighth chapter explains the extent of exposures. In the ninth chapter, the probable implications and impact of the new Accord in Bangladesh are portrayed. The tenth Chapter discusses the capital management practices in Bangladesh. The last and eleventh chapter contains the Recommendations and Conclusions of the report.
CHAPTER- TWO
LITERATURE REVIEW AND THEORETICAL BACKGROUND

2.1 Literature Review

First Capital Accord (Basel I)

In comparison with the two capital Accords, it is essential to start with the first one. “International Convergence of Capital Measurement and Capital Standards” was first published in the year of 1988. Which one was covered primarily credit risk. It located out details of risk based capital framework. In this Accord, the capital adequacy is measured by applying risk weights with different assets & the amount of capital to the risk weighted assets. The document sketched how different asset classes were weighted as per to their riskiness. Weights were classified in five different categories – ‘0%, 10%, 20%,50% & 100%’. OECD government debt or cash as an example has 0 or low weight, bank loans get 20% as it is fully secured by the mortgages, for residential property it is 50%. Claims on the private sector or others associated outside the OECD with an outstanding maturity of over one year given weights to 100%”. (www.bangadesh-bank.org.bd)

Two basic objectives were there on Committee's work, number one, the framework should served to make stronger the soundness and continuity of the international banking system. In the same time to modify the framework in a fair and consistent way the banks according the globe in the light of accessible way. The committee also notices the original proposals that the banks should be functional with as much consistency as possible in the level of the country.

In increasing the framework described in this document the Committee sought to arrive at a set of principles which were theoretically sound at the same time emphasized more on meticulous features of the current supervisory & accounting systems in any single member countries. It is suppose to be believed that the objective had been achieved. The framework offered for a middle period so that the obtainable situation in different countries could be reflected in flexible measures to let time for change.

In some aspects the framework is allowed in favor of a level of nationwide caution where it was relevant. The consequences of the differences on all over the ratios are very much negligible. However it’s in the mind of the committee to have consistency so set up a certain standard for the international banks. In the same time local authorities might set different standard for their own.

In the case of ‘Basel I’ the emphasis was on the factors that are taken in to consideration was assessing banks strength. Basel I mostly concern on credit risk where as other risks, like ‘interest rate risk’, ‘Investment risk’ also needs special attentions by the ‘supervisory authority’ for assessing overall capital adequacy. Basel committee already scrutinizes probable move toward these risks, which ultimately emerged the new Accord (Basel II). There are many things relied on the quality of a bank’s assets. For ‘Capital and
Provisioning’ Basel committee is closely monitoring the banks provisioning policies. Committee sought to promote meeting policies in this regard as in other regulatory issues. “The Committee had therefore finished that capital, for supervisory purposes, should be distinct in two Tiers in a way which would have the consequence of requiring minimum 50% of a bank's capital base to consist of a core component included of equity capital and in print reserves from post tax retained earnings (Tier 1). The supplementary elements of capital should be admitted into Tier 2 up to a quantity equivalent to that core capital”. “BRPD circular No-05/2006 ’A review of Basel, Akther 2007”)

The New Capital Accord (Basel II)

After formulating some sorts of capital rules by the Basel committee, the committee apprehended that there are some new things to add for sound and effective banking systems across to the globe. In the year of 1999 committee arranged a meeting with having all the interested and influential parties related to the field. The committee published “Consultative paper on a new capital adequacy Framework”, as an outcome of the meeting. The committee expects comments from all corners related to the industry. They were given opportunity to comments on this issue by the end of March 2000.

‘The Basel Committee’ realized bank’s capital ratio by the risk weightings as mentioned in the first Capital Accord, were not at all times a good pointer of its financial condition. The new capital framework is designed to advance the method regulatory capital reproduce original hazard that consists of 3 pillars:

- Pillar one develop and expand 1988 standardized rules of 1988. These rules describe external credit rating system.
- Pillar two- Supervisory review of capital adequacy. That one is for making sure of banks position. It is essential for the supervisors to make sure bank has capital adequacy more the 8%.
- Third pillar is called ‘market discipline’. To ensure high disclosure, improve the market player’s function in encouraging the banks to hold sufficient capital.

Pillar one is all about open capital charges of the treading book. Committee has intended interest on specific charges to mitigate Interest rate risk of the banks. “ The Basel Committee found that equity capital and reveal reserves form Tier 1 capital, & the accord needs internationally lively banks to have bare minimum 4% Tier 1 capital and 8% sum capital in association to risk-weighted assets. By the end of 1998 Basel Committee clarified to original capital tools should be limited to a highest 15% (Tier 1 capital) & issue to a variety of circumstances. For enhancing transparency, BIS conceived the idea that banks ought to infrequently in public reveal every part of ‘Tier 1 capital’ & its major themes. ‘Tier 2 capital’ is the supplementary resources and comprises additional form of reserves & mixture debt capital supplies”.

In the very next year Basel Committee declared that it recognized other forms of netting for capital adequacy purposes. Risk associated with certain off balance sheet items also projected a new formula for add-on’s, which obtained into relation the risk lessening outcomes of netting possible exposure .
The level of NPLs reproduces the degree to which banks are able to do one of their basic functions, that is, bring together the money they lend. As there may be different causes for an increase in NPLs, a high level of NPLs approximately commonly indicates serious problems in the banking sector. Net interest margin can be interpreted as a measure of the efficiency of banking sector performance, as it indicates the cost of banking intermediation that requires to be paid by banks’ customers” -(“‘Guidelines on Risk Based Capital Adequacy’ Published by Bangladesh Bank’ 2010, page-1-3”)
CHAPTER-THREE
HISTORY AND RATIONALE OF THE NEW BASEL ACCORD

3.1 ‘History of the Basel committee & its membership’

The Basel committee is formed by the central-banks. In fact, Governors of the ten countries who are known as Group ten in the year of 1974. There are four working group under this committee and usually meets four times a year.

Basel Committee's associates are from different countries among the world. The practice is that Central Banks represents on behalf of the countries. The present chairman is Mr. Stefan Ingves, Governor of Sveriges Riksbank and is replaced with Mr Nout Wellink on 1 July 2011.

There isn’t any decision making power given to the committee, even any right to void. It works to formulate standards for the supervisors, necessary guideline, provide advocacy to the best practices according to the best practice of individual countries. The committee also appreciates the approaches are similar with other countries without effecting interest of its members supervisory techniques.

Committee has obligation to report towards the governs of the central banks, nominated executives from the member countries. Try to collect support for its necessary initiatives on the financial aspects. One of the great concerns of the committee is to eliminate the gaps across the globe on supervisory coverage in search of two essential ideologies: No overseas banking organization ought to get away supervision. And the supervision be supposed to be sufficient. For attaining this “committee has published a long series of documents since 1975.

In the year of 1988, the Committee decided to set up a capital measurement system which one will commonly known as the Basel Capital Accord. It provides for the success of a credit risk measurement framework with a minimum capital standard of 8% by the end of the year 1992”. (www.bis.org)

From then this formula has been adopted by most of the countries in the world. June 1999, Committee comes out with an application for a modified Capital Adequacy structure of three pillars: “a) minimum capital requirements b) supervisory review of an organization c) internal assessment process and capital adequacy”; as well as efficient utilization of disclosure to create tough ‘market discipline, as a complement to managerial efforts.

After 2008 financial disaster, Committee have adopted a improvement program to deal with the education of the disaster, which carries on the bank sector development known by the Pittsburgh meeting of the G20 group. Mutually, the new ‘international standards’ to deal with both firm specific and broader systematic risks have been called as “Basel III”.

“In January 1996, Committee issued Market Risk development to the Capital Accord, which one began from end of 1997, a significant features of this modification is, an option to a
steady measurement method, banks are permitted, subject to rigid quantitative & qualitative ethics, to utilize inner value-at-risk models as a source for calculating market risk capital requirements.

June 1999, Committee comes out with an Idea for a new capital adequacy framework to change the 1988 Accord, and that has refined in the existing years, finishing in the release of the New Capital structure on the year of 2004.”


The new accord is based with three pillars. Pillar one is capital requirements, second one organizational supervisory review, finally internal assessment process that is disclosure for making strong market discipline. These three things are necessary pillars of a successful capital framework.

One of the major functions of the Committee is endorsing sound supervisory standards internationally intensified. In this context and in close association with many non-G10 supervisory bodies, the Committee in the year of 1997 promotes a set of core principles for effective banking supervision. That provided a comprehensive plan for an effective supervisory system. There are number of steps have been taken to encourage countries to put into practice the “Core Principles”, including the establishment of a Liaison group comprised of both G10 and non-G10 countries. For this reason as a first step to full implementation, an evaluation of the current condition of a country's compliance with the Core Principles should take place. To ease implementation and appraisal, the Basel Committee in the year of 1999 developed the Core Principles Methodology. Since then the Committee has been reviewing the Core Principles and the Methodology in close partnership with the assessors and with non-G10 supervisors. The revised versions of the two papers were published in October 2006.


3.2 Weaknesses of Basel I and Rationale of New Basel Accord

The world’s financial system and situation is far more complicated than ever before. Risks have been come out with different shapes and have arisen in the different marketplace. Which one is destroying the attempt for level playing field for all the players in the financial market. “Security and reliability in today’s Banking system can be accomplished only by the mixture of effective bank level management, market discipline and supervision. Basel One accord focused on the total quantity of bank capital that is very important in decreasing risk for the bank in liquidation & the possible cost of a bank’s fall down for depositors. By making on this, new structure means to get better security and reliability in the financial system by insertion more stress on banks own internal control and management the supervisory review process, & market discipline. Although the new structure highlights mainly on internationally active banks, its underlying principles are anticipated to be fit for application varies level of complexity and sophistication”. (Guidelines on Risk Based Capital Adequacy” Bangladesh Bank, December 2010, 51”)
An amendment was introduced in the year of 1996 that pointed on trading risks & permitted a few banks & financial institutions for the first time to use their own systems to measure their ‘market risks’.

There are certain drawbacks in the 1988 Basel Accord; some of them are mentioned as under:

- The ‘1988 Basel framework’ does not make adequate differentiation of credit risk, as there are only four risk weights of 0%, 20%, 50% & 100%. The risk weight applied for AAA Company is the same as that for a corner shop although the risk profiles of the two vary substantially. A junior bond and a senior bond held in banking book would receive the same risk weights, although the risk is different as the recovery of the two instruments would be different.

- There is no appreciation of the term ‘structure of credit risk’. ‘Capital charges’ are set at the same level irrespective of the ‘maturity structure’ of a credit exposure. This approach overlooks that there is greater risk of default for the longer period.

- The present rules do not recognize the portfolio diversification effects for credit risk when at the same time recognizing it for market risk under the internal VAR models of banks. As a result the present rules can represent a false picture of the riskiness of an organization. As an example, two institutions with the same capital adequacy under the current rules can have very different levels of credit risks due to diversification effects that are ignored under the Present rules.

- The present rules distort the credit risk pricing, as margins do not reflect the differences between different degrees of default risk, different seniority of instruments or differences in the terms of an exposure.

- Present Accord does not give due appreciation to the credit risk mitigation practices & does not familiar with the part collateral can play in reducing the losses on account of credit risk.
CHAPTER- FOUR

BCPS FOR EFFECTIVE BANKING SUPERVISION & ITS COMPLIANCE IN BANGLADESH

4.1 Requirements for ‘effective banking supervision’

“Principle 1: An effective banking supervision ….. such information should be in place”.

Description: The Bangladesh Bank, was formed under a Presidential order which one is known as Bangladesh Bank order, 1972(BBO 1972). BB has the complete responsibility of supervision and regulation of banks inside the country. The Bank Company Act 1991 Provides Bangladesh Bank the power puts down the regulations relates with the banking laws & supervision. In the Bangladesh Bank order 1972 the basic purpose of the Bangladesh bank is mentioned, which is “to supervise the monetary and credit system with a view to ensuring the stability of prices”.

Other than, Article 7 of Bangladesh Bank orders records purposes to be used in carrying out these objectives, and to standardize and supervise their actions. In article 31 of the BCA 1991 mentions that Bangladeshi Central bank have the full authority to provide banking license or even cancel those licenses as per the authority given to them. in the manner specified by law. Article 16(3) of the BBO 1972 expresses that the BB is in charge for regulating foreign exchange operations in Bangladesh.

Assessment:

(1) Bangladesh Bank (Central Bank of Bangladesh) is the sole supervisor of banks in Bangladesh. The rules, regulations and laws provide sound functions of banks and let them to set minimum standard in establishing and implementing the laws that are currently not in use. Section 44 of the Bank Companies Act, 1991 vests powers in Bangladesh Bank for inspection of books of any banking company at any time.

Compliance Level: Compliant.

“Principle 1 (2): Each such agency should have operational independence and adequate Resources”.

Description

The Bangladesh Bank Order 1972 provides operational sovereignty to Bangladesh. BB is also autonomous of other agencies in implementing its objectives.

Assessment: Generally these principles are already compliant. More over training opportunities are also occurring in a regular basis for the employees of the central bank.
Compliance Level: Compliant.

“Principle 1 (3): A appropriate ….. its ongoing supervision”.

Description
The BB has given the sole authority to give license for an institution interested to do banking business also have the authority to revoke license are vested with Bangladesh Bank (Article 31 of BCA 1991). Article 77 of the BCA 1991 also mentioned the BB’s obligations to 1) distinguish banks as in debt & commencing insolvency measures. Also the same time making options concerning reorganization of banks.

Assessment
The existing rules and regulations are proven sufficient enough for issuance and cancellation of banking licenses. Prudential rules permits Bangladesh Bank to changes, even for this reason Bangladesh Bank need not to take prior approval from the parliament. Bangladesh Bank has the legal authority to seek all sorts of information needed from the schedule banks when needed.

Compliance Level: Mainly Compliant

“Principle 1 (4): An appropriate legal ……………………… Concerns”.

Description
Bangladesh Bank Order 1972, article 7 and article 44 of Banking Company Act 1991 allowance authority to the Bangladesh Bank to regulate and supervise their activities.

BB has the authority to issue directives for the banks in particulars under section 45 of BCA 1991in the public interest or in the sake of banking policy.
Article 77 mentions BB’s liability by regard to distinguishing banks as insolvent & commencing insolvency actions, plus construction decisions concerning restructuring of banks.

Assessment: An appropriate lawful arrangement is in place for the central banks to take attainment as desirable beside banks, & the central bank emerges to use these authorities as required. Qualitative judgment is permitted, Bangladesh Bank, by commandment, has the right to admission bank proceedings, & there is a wide range of permits accessible by regulation.

Compliance Level: Largely Compliant however could be improved through implementation.

“Principle 1 (5): A proper legal framework for…………….. legal protection for supervisors.”

Description :The Banking Company Act is provided for plain protection to the supervisors under section 122.
Assessment: Existing Banking laws provides sufficient protection to the supervisors.

Compliance Level: Compliant.

“Principle 1 (6): preparations ……………………………………. in place”.

Description: As There is no formalized accord between the BB and other agencies to share and access information on a regular basis. Supervisors may share some information among them maintaining confidentiality.

Compliance level: Mainly compliant.

4.2 Licensing and Structure

“Principle 2: The allowable …………………………. far as possible”.

Description: The jargon banking company is clearly mentioned in Section 5 (O) of the BCA 1991. The acceptable activities for banking company are undoubtedly defined and scheduled in Section 7(1) of the BCA Section 7(2) prohibits a banking company from moving on any form of business other than that referred to in subsection (1). Section 8 of banking company Act-1991 restrictions the use of word “bank” or any of its derivatives and Section 9 of banking company Act-1991 forbids certain forms of trading.

Compliance Level: Compliant

“Principle 3: The licensing ………………………………….. should be sought”.

Description

The licensing criteria are mentioned in Section 31 of the BCA 1991. BB has formulated policy/rules for the capital adequacy. These rules are followed by all licensing banks inside the border.

Compliance Level: Mainly Compliant

“Principle 4: Bank supervisors ……………………………other parties”.

Description:

- In Section 14 and 14A of BCA 1991 provide guidelines regarding this principle.

- Statement should be given in this regard, if it is found false, all shares of the concern shall be cancelled.

Assessment: The Bangladesh Bank made constructive efforts to comply with this core principle.

Compliance Level: Compliant

“Principle 5: Banking supervisors must …………………………… effective supervision”.

Description:

Schedule Banks are allowed to set up auxiliary plus important venture simply in business which is endorsed under section 26 of the BCA, 1991.
Compliance Level: Compliant.

4.3 Prudential Regulations and Requirements
Capital adequacy

‘Principle 6: Banking supervisors ………………….. Accord and its amendments’.

Assessments
1. According to the “Asian Tribune article” - “Bangladesh Adopt BASEL II capital adequacy requirement and risk-based capital adequacy ratio is now 9%”.
2. According to BB report “The private and foreign commercial banks maintained capital adequacy ratio of 9.5% and 24.6 % respectively, as on December 2005”.
3. Bangladesh Bank BRPD circular No. 01 dated 8th January, 1996; “Capital adequacy takes account of different degrees of credit risk & covers both on and off balance sheet transactions.”

Minimum Capital Standard:
Each and every bank has to maintain a minimum portion of capital beside risk weighted assets which one is not less than 10%. Along with them minimum 5% is in from core capital & this compulsion will have to be reach by the end of 2007. Nevertheless, minimum capital requirements for all scheduled banks will be “Tk.100 core as per BCA, 2003”. The Banks having shortfall of capital ‘have to meet minimum 50% by the end of March 2004 and the rest by March, 2005’.

Compliance Level: Mainly Compliant.

Principle 7: A necessary ………….. investment portfolios.

Assessments
1. According to section 29 of BCA, 1991, Central Bank has the right to determining policies regarding advances by banks and also given the responsibility to lead in this regard.
2. Core Risk Management Guidelines on five major risks e.g. a) Credit Risk Management b) Foreign Exchange Risk c) Management Risk d) Asset-Liability risk e) Internal control and compliance risk anti-money laundering have been maintained by the Bangladesh Bank .

Compliance Level: Compliant.

(ii) Asset quality and adequacy of loan and loss provisions and reserves

“Principle 8: Banking supervisors ……………………………. loss reserves”.

Assessments
1. The Bangladesh Bank has given complete guideline ‘on income recognition, asset classification & provisioning, complete both on and off balance sheet items in line with worldwide standards’.
2. Bangladesh Bank determines the loan classification criteria on the basis of purpose and qualitative judgment According to Circular No.05 June 05, 2006 provided by BRPD.
Compliance Level: Compliant.

(iii) ‘Concentrations of risk and large exposures’

“Principle 9: Banking supervisors ………………………………… related borrowers”.

Assessments
Inspecting officers of BB must be satisfied that all the banks have MIS (Management Information Systems) through that executives of the particular bank(s) can highlights and focus. The supervisors also setup the limits to control bank exposures to single/individual or group/associate borrower

1. Prudential standards have been approved evenly in respect of procedures of foreign branches or in domestic lending to person/group borrowers at 15% and 35% (in case of secured and easily salable) of the bank’s capital funds beneath the section 27(3) of BCA, 1991. The banks may set up nominal exposures with the prior approval of the concern board. They might also settle down internal aggregate limits of exposure to various sectors under the part of loan policy.

Compliance Level: Compliant.

Connected lending:

“Principle 10: To prevent …………………………………….. or reduce the risks”.

Assessments

1. Under section 27 of the BCA loans and advances are prohibited to the directors related to the bank or any other concern related to the banks or associates or sponsors. Therefore, Bangladesh Bank has published guidelines to make sure about the liability beneath non-funded based facility starts on the bank.
2. According to Section 45 of Bank Companies Act, there are some limitations of providing linked lending to the Directors of commercial banks.
3. It is not yet clear that the BB rigorously scrutinizes “interconnected” lending. Nonetheless, a Credit Information Bureau (CIB) exists which is a central base housing of large loans, past due and classified loans. It seems that selectively, banks are not allowed to extend additional credit to defaulting borrowers. The trustworthiness of information forwarded to the system is not clear, nor is the practice of credit.

Compliance Level: Largely Compliant

Country and transfer risk

“Principle 11: Bank supervisors …………………………………such kind of risks”.

Assessments

1. Schedule banks of Bangladesh those are operating abroad needs to follow guideline/instructions from Bangladesh Bank. There are also restrictions from the central banks on group of countries in some specific risk categories subject to the maximum ceiling.
2. Rules for investment outside of Bangladesh by banks, permission of Bangladesh Bank is a must according to BRPD circular no. 1/96.

Compliance Level: Largely compliant

Market risk management

“Principle 12: Supervisors need ……………………………………… if wanted.”

Assessments
1. Bangladesh bank has the authority under section 49 of the Banking Company Act, 1991 to impose detailed boundary and/or precise charge on market risk exposures as part of the common to provide guidelines to banks on any feature of their functioning.
2. Bangladesh Bank already imposed chargers on the field of market risk. According to BRPD circular no. 2/95 “Market risk in investment portfolio are strongly forbidden through quantitative restrictions”

Compliance Level: Mainly compliant

Other risk management

“Principle 13: Supervisors should …………………………….. against these risks”.

Assessment
1. Bangladesh bank has published guidelines for in place of effective Asset- Liability management (ALM) SYSTEM. Every bank must have an Asset – Liability Committee (ALCO), chaired by the chief executive Officer/ Managing Director or the Executive Director of the concern bank.

2. Liquidity risk management:
Schedule banks operating inside the country are required to maintain CRR and SLR as per section 36(1) of Bangladesh Bank order, and section 24(2a) of the Banking Company Act, 1991 correspondingly.

3. Interest Rate Risk Management:
All the Bangladeshi Schedule banks measures their interest rate applying conventional gap analysis methods and by the sophisticated methods where it’s feasible.

4. ‘Currency Risk Management’:
The banks have to assign 100% risk weight to its open position limit in foreign exchange. As well, they need to fix the combined & individual limits for each and every currency authorized by Bangladesh Bank. They are obligatory to accept value at risk associated with forward exposures. The Bangladesh Bank always checks currency risk from first to last a monthly statement on maturity & situation for together on & off balance sheet substance in foreign exchange operation.

Compliance Level: Largely Compliant
Internal controls

“Principle 14: Bank supervisors have ………………………. and regulations”.

Assessment
1. Bangladesh bank has published a set of guide line for the commercial banks. BB has increased their inspection and audit system to boost up the supervisory review more strong. To avoid fraud and forgery and cash flows in accounts BB has introduce internal control system.

Compliance Level: Largely Compliant

Know-your-customer

“Principle 15: Supervisors ought to ……………………………. Criminal elements”.

Assessments
1. Inside Bangladesh, KYC (know your customer) is introduced from the very beginning. For every individual or group or institution needs to fill the KYC form to open an account. There are few more things are also important like photograph, National ID Card etc. for ensuring identity of the client
2. Anti-Money Laundering Act 2002 has been passed in the parliment very recently.

Compliance Level: Compliant

4.4 ‘Methods of Ongoing Banking Supervision (Principles 16-19)’

“Principle 16: There should ……………………………. off-site supervision”.

Assessment
(a) Bangladesh Bank introduces on-site inspection and off site inspection for supervisory review. Bangladesh Bank also introduces CAMEL ratings since 1995. The domestic banks of Bangladesh were rated on CAMEL model.
(b) There are two separate departments were established in Bangladesh Bank for the supervision and examination purposes:
    Department of Off-site Supervision (DOS); and
    Department of Banking Inspection (DBI).
(c) To ensure stability in supervision, Bangladesh Bank also commences targeted evaluations of particular collections at control site, for observing inspections for follow-up or else appraise of chosen areas of concern. On-site Branch level inspection is conducted by DBI of BB to ensure the compliance of rules and regulations as introduced by BB time to time and through other BRPD circulars.
(d) Under the Section 44 of the BCA, 1991, Bangladesh Bank is authorized to send one or more supervisors at any time to any banking company to examine their records and accounts.

Compliance Level: Largely Compliant

“Principle 17: Supervisors …………………………………. institution's operations”.

Assessments
Bangladesh Bank constantly related with the bank management. Senior Executives of BB usually meet with different bank management annually. They also discuss with the issues related with the on and off site inspection. CAMEL ratings are also discussed on the meeting for their necessary actions.

**Compliance Level: Mostly compliant**

**Principle 18: Supervisors ………………………………………. consolidated basis.**

**Assessments**

(a) According to section 36 and 51 of the Banking Company act, 1991, Bangladesh Bank has been authorized to receive statutory and prudential reports from different banking companies for effective off-site supervision.

(b) Bangladesh Bank can compel penalties for incorrect information produced by the commercial banks as per the Banking Company Act, 1991.

**Compliance Level: Largely Compliant**

**Principle 19: Supervisors should ……. of external auditors.**

**Assessments**

(a) Under the section-39 of the BCA, 1991, a person properly qualified under the Bangladesh Chartered Accountants Order, 1973 shall audit balance sheet & PL account arranged by the banking company. The Bangladesh Bank has authorized to order for special audit for specific and certain areas for a specific period (Section 39 (1) of BCA, 1991). According to section 40 of BCA, 1991, the accounts and balance sheet with the auditor’s report have to be accepted by the board of directors or by the share holders in the AGM are to be submitted to Bangladesh Bank. For the case of public sector banks (NCBs), the Ministry of Finance appoints the Auditors.

**Compliance Level: Largely Compliant**

“**Principle 20: An ………………………………………. on a consolidated basis”.**

**Assessment:** This rule is not yet applicable for Bangladesh bank.

**Compliance Level: Not Applicable.**

4.5 Information Requirements (Principle 21)

“**Principle 21: The bank supervisors …………………………… reflect its condition”.**

**Assessments**

(a) Bangladesh Bank is trying to increase the level of transparency as well as disclosures in the yearly accounts of the schedule banks. These all are mentioned in the section 38 of the Banking Companies Act, 1991.

(b) BB reserves the legal right to compel fines to the external audit companies whenever it deems necessary (Section 39 of BCA, 1991). BB should also exercise the right to determine the eligibility of external auditors and state such auditors disqualified whenever it deems essential.

**Compliance Level: Largely Compliant**
4.6 Formal Powers of Supervisors

“Principle 22: Supervisors of …………………………………….. Recommend its revocation.”

Assessments

The Bangladesh Bank is authorized and has the legal right to issue or cancel directives for all schedule banks and also the right to revoke orders given earlier. This legal right is important because Bangladesh Bank on behalf of Government to protect ultimate user’s right. Supervisors of Bangladesh Bank also enjoys a wide range of freedom in inspection from the power vested under section-36, Section-46, Section-47 and Section 31 (5) of Banking Company Act. Bangladesh Bank also has the legal authority to impose penal measures against those schedule banks who violets the rules under the section-64 and 77 respectively from Banking Company Act 1991.

Banks that are failed to meet capital adequacy, restraint on increasing branch, increase of asset & setting up of subsidiaries are imposed. Central Bank has the legal right to limit announcement of dividend by any schedule banks for corrective measure. Problem Banks Monitoring Section in the Department of Off-site Supervision (DOS) has been established to monitor the banks with CAMEL ratings of 4 and 5.

Compliance Level: Compliant

4.7 Cross-border banking

“Principle 23: Supervisors of bank …………………………………… ventures and subsidiaries”.

Compliance Level: Compliant

Principle 24: A vital component …………………………………… supervisory authorities.

Compliance Level: Materially non-Compliant

Principle 25: Supervisors of banking ………………………... consolidated supervision.

Assessment

For particular off site monitoring, banks need to supply returns of all overseas branches after every quarter. The portions that are operated in abroad must have to follow the regulations provided by the central bank for monitoring this off site supervision is always active. They schedule bank also need to follow the host countries all sorts of formalities.

The official supervises foreign countries; need to call on the host country supervisory officials to share their views while inspect. Also for the case of inside the territory, BB follows the rules and regulations; if they are found Ok then the license can be produced.

Compliance Level: Compliant

4.8 Assessment of Compliances

A joint assignment of the World Bank and the IMF assessed the strengths, potential vulnerabilities and key development opportunities in the Financial Sector of Bangladesh under Financial Sector Assessment Program (FSAP) in October 2002. The team found the weaknesses that should be taken into account to pass up potentially destabilizing conditions that may cause for financial sector vulnerabilities. The side also advised reform measures to
develop a sound, well-organized moreover steady monetary system. In demanding, the assignment assessed the following areas of financial sector based on different criteria:

(i) Monetary Policy
(ii) Financial Policy
(iii) Compliance of Basel Core Principle (BCP) for Effective Banking Supervision
(iv) Principles of Securities Regulation
(v) Core Principles for Payment System, and
(vi) Anti-Money Laundering and Financial Terrorism

Then Bangladesh Bank, Government and the Securities and Exchange Commission have initiated substantial authoritarian plus managerial steps to expand efficiency & competitiveness of the fiscal sector. Main measures were taken based on FSAP report and other events were taken broadly in the light of worldwide best practices.

In a recent progress, Bangladesh Bank has formed 4(four) committees comprising of high officials of relevant departments to reassess the status of financial sector in terms of the standards set by the World Bank and IMF in the FSAP report. When most of the studies are under process, Basel II Implementation Cell has carried out an assessment of the extent of Compliance of BCP for Effective Banking Supervision. It can be taken to the consideration that compliance of BCPs needs providing a firm foundation for the ultimate completion of Basel Accord II. For instance, principles like 1(3), 1(4), 1(6), 5, 6, 7, 8, 9, 10, 12, 13, 14, 15 and 23 are straight connected with ‘Basel Accord II’. Nonetheless, findings of comparative rank of banking segment in terms of fulfillment of BCPs are shown below:
Table-1: Overall self assessment as per self audit October, 2006

<table>
<thead>
<tr>
<th>Basel Core Principles (BCPs)</th>
<th>October, 2002&lt;sup&gt;124&lt;/sup&gt;</th>
<th>October, 2006&lt;sup&gt;125&lt;/sup&gt;</th>
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<tbody>
<tr>
<td></td>
<td>C</td>
<td>LC</td>
</tr>
<tr>
<td>Principle 1(1) Objectives</td>
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<td></td>
</tr>
<tr>
<td>Principle 1(2) Independence</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Principle 1(3) Legal Framework</td>
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<td></td>
</tr>
<tr>
<td>Principle 1(4) Enforcement of Powers</td>
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<tr>
<td>Principle 1(5) Legal Protection</td>
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</tr>
<tr>
<td>Principle 1(6) Information Sharing</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Principle 2 Permissible Activities</td>
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<td></td>
</tr>
<tr>
<td>Principle 3 Licensing Criteria</td>
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<td></td>
</tr>
<tr>
<td>Principle 4 Ownership</td>
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<td></td>
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<tr>
<td>Principle 5 Investment Criteria</td>
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<td>Principle 6 Capital Adequacy</td>
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<td>Principle 7 Credit Policies</td>
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<tr>
<td>Principle 8 Loan Evaluation and Loan Loss Provisioning</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Principle 9 Large Exposure Limits</td>
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<td></td>
</tr>
<tr>
<td>Principle 10 Connected Lending</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Principle 11 Country Risk</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Principle 12 Market Risk</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Principle 13 Other Risk</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Principle 14 Internal Control and Audit</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Principle 15 Money Laundering</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Principle 16 On-site and off-site Supervision</td>
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<tr>
<td>Principle 17 Bank Management Contact</td>
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<td>Principle 18 Off-Site Supervision</td>
<td>✓</td>
<td></td>
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<tr>
<td>Principle 19 Validation of Supervisory Information</td>
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<tr>
<td>Principle 20 Consolidated Supervision</td>
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<tr>
<td>Principle 21 Accounting Supervision</td>
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<tr>
<td>Principle 22 Remedial Measures</td>
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<tr>
<td>Principle 23 Globally Consolidated Supervision</td>
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<tr>
<td>Principle 24 Host Country Supervision</td>
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<tr>
<td>Principle 25 Supervision Over Foreign Banks’ Establishments</td>
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</tr>
<tr>
<td>Total</td>
<td>1</td>
<td>7</td>
</tr>
</tbody>
</table>

Overall Assessment: Largely Non-Compliant
Largely Compliant

C= Compliant, LC= Largely Compliant, MNC = Materially Non Compliant, NC = Non Compliant, NA= Not Applicable

<sup>125</sup> Assessed by WB, IMF
<sup>126</sup> Assessed by BASEL II Implementation Cell, BRPD, BB
CHAPTER- FIVE

‘OVERVIEW OF THE NEW BASEL CAPITAL ACCORD’

In essence this chapter deals with an overview of the ‘New Basel Capital Accord’ in a condensed form and the discussion has touched all the applicable terms under ‘the New Basel Capital Accord’. However among these terms, credit and operational risk has given a greater emphasis; henceforth, these two parts have been elaborately covered in Chapter Eight.

5.1 Overall Capital
The Internal ratings-based IRB approach might be depending of an institutions loan portfolio. As well as quality distribution of financial institutions and their portfolio to use of credit risk avoidance techniques. Current data’s related to this elements are partial, It seems additional works relevant with the IRB approaches if necessary.
Overall level of capital would be steady with wrapping the fundamental risk at a balanced height of assurance & offered that a humble incentive to accept classier risk management techniques.

5.2 Description of the Framework

5.2.1 ‘Scope of Application’
In the ‘New Basel Capital Accord’ has recognized the necessity of the key players and their relevance with the new Basel accord. After expansion of Basel I capital accord (1988), the banking activities have been enlarged and also it expansion complexity of corporate ownership.

There are also different practices for finding combined level where capital adequacy supplies are applied. It is also necessary to define plainly new Basel Accord for the banking industries.

Banks have more and more extended their operations not only in the banking sectors but also in the other areas of trade, commerce and finance. They are like securities, insurance etc. for increasing their efficiency the Accord of Basel taken all the things under great concern and consideration. However there are some examples that are not fit with it also like some certain securities and some other financial bodies that are regulated by others.

5.2.2 Pillar 1: Minimum Capital Requirements

Minimum aggregate capital ratios will be made with three parts according to the ‘new capital accord’. the total amount of all risk weighted assets for credit risk plus 12.5 times the total sum of the capital charges for marketplace hazard and operational risk.\textsuperscript{6}
Total capital (unchanged) 

\[
\text{Credit Risk} + (12.5 \times (\text{Market risk} + \text{Operational Risk})) = \text{Bank’s capital ratio (minimum 8%)}
\]

“Assume a bank has $875 of risk weighted assets, a market risk capital charge of $10 & an operational risk charge of $20, the denominator of the total capital ratio would equal $875+[(10+20) \times 12.5]$ or $1,250$.

The first pillar covers authoritarian capital requirements for the market, credit & operational risk. Certain the variety of underlying assumptions needed, the better and more risk-sensitive action can be achieved through the supervisory review process rather than through minimum capital requirements” ("www.rbi.org.in")

5.2.3 Credit Risk

Credit risk is based on counting the ‘risk weighted asset’ under ‘Standardized methods’ and the ‘IRB approaches’. All the information’s and definitions are provided by the BIS is discussed bellow for the better understanding are:

1) ‘Standardized Approach’
   Standardized approach is the key element of the New Accord. This approach is a modification to the 1988 Accord’s approach to credit risk where assets are assigned risk weights. To advance risk sensitivity without making the standardized approach overly difficult, there are several risk weights on external credit assessments.

   (a) ‘Greater risk differentiation’
      There is an alteration of the treatment of banks’ exposures to sovereigns, banks and corporate bodies in an effort to improve the risk sensitivity of the standardized approach

   (b) ‘Operational requirements’
      As it is mentioned elsewhere in the framework, operational requirements are an necessary complement to minimum capital requirements. In the standardized approach, national supervisors will not allow banks to assign risk weights based on external assessments in a mechanical approach. Banks might elect to use a subset of the ECAI assessments deemed eligible by their nationwide supervisor, though the assessments must be functional consistently for both risk weighting and risk management purposes. This condition is intended to limit the probable for external credit assessments to be used in a manner that results in reduced capital requirements but is conflicting with sound risk management practices

   (c) ‘Treatment of credit risk mitigation techniques’
      “Credit risk mitigation narrates to credit risk that is reduced by some means, for example, by security, credit derivatives, guarantees, or netting agreements. In the New Basel Capital Accord for recognizing credit risk mitigation techniques suggests a choice of approaches that hits different balances between simplicity and risk sensitivity.
The actions of credit risk mitigation in the standardized approach and in the organization IRB approach are designed to be steady. In the advanced IRB approach, moreover, the treatment of such systems will place greater emphasis on internal assessments. In addition, recognizing that credit risk mitigation can offer rise to operational risk and other risks, there are lowest operational standards for all approaches. A brief content of the new credit risk mitigation framework is provided below.

(d) ‘Collateral’
In common, banks will be permitted to recognize cash; a defined range of debt securities issued by sovereigns, public sector entities, banks, and securities firms and corporate; certain equity securities traded on recognized exchanges; certain UCITS and units in mutual funds; and gold. The straightforward approach to collateral usually uses the substitution approach employed in the 1988 Basel Accord. The explanation of collateral is narrower than in the comprehensive approach and dealings are subject to more stringent operational requirements. On the whole, the simpler approach will generate higher capital requirements on collateralized transactions rather than the comprehensive approach.

(e) ‘Guarantees and credit derivatives’
For a bank to get any capital relief from the receipt of credit derivatives or guarantees, the credit protection must be straight, open, irrevocable and unconditional. When these circumstances are met, banks may distinguish credit protection provided by sovereigns, banks and securities firms and corporate (including insurance companies) with an external assessment of “A” or better.

The “double default” effect can decrease the credit risk to which a bank is subject if there is a little correlation between the default probabilities of the obligor and the guarantor.

(f) ‘On-balance-sheet netting’
On-balance-sheet netting banking book will be acceptable subject to certain operational standards. Its scope will be narrow to the netting of loans and deposits to a single counter party.

(g) ‘Residual risks’
Maturity mismatches and currency mismatches are explicitly concentrated on the New Accord. Mismatches may apply to all forms of credit risk mitigation methods. Hedges with a maturity less than that of the underlying exposures will be known provided they have a residual maturity of one year or more.

2) ‘Internal Ratings-Based Approach (IRB)’
(a) Background
Major Key elements of the IRB approach are discussed below:

The IRB approach offers a similar action for corporate, bank and sovereign exposures, and a separate framework for retail, project finance and equity exposures. In support of each exposure class, the treatment is based on three main basics: risk components, where a bank may use either its own or standardized supervisory estimates; a risk-weight function which
changes the risk components into risk weights to be used by banks in calculating risk-weighted assets; and a set of least requirements that a bank must meet to be eligible for IRB action.

Total compliance with these lowest amount requirements, including disclosure, jointly with supervisory review of such compliance, is basics to a bank’s ability to make use of the IRB structure. Exclusive of these, it would not be possible to rely on banks’ internal estimations. Adherence to the least requirements of the IRB approach will need some banks to improve their existing risk management systems. Banks are encouraged to begin this procedure now. The accomplishment of the IRB approach may present confronts for some supervisors, given its importance on bank-specific rationale and supervisory review.

The following sections outline the proposed IRB treatment for the six broad exposure classes.

(b) ‘Corporate, Sovereign and bank exposures Risk Components’

The IRB framework for business, sovereign and bank exposures builds on current best practice in credit risk measurement and management. As mentioned above, the structure is based on the estimation of a number of key risk components. Banks’ internal actions of credit risk are based on assessments of borrower and transaction risk. The majorities of the banks base on their rating techniques on the risk of borrower default & assign a borrower to a rating grade. Bank would then calculate the probability of default (PD) associated with the borrowers in each of these internal grades; this PD guess must represent a conservative view of a long-run average (pooled) PD for borrowers assigned to the rating in question.

In the advanced approach, the bank will have the chance of estimating the LGD of an exposure, subject to meeting other, more precise minimum requirements for LGD estimation. In this approach, the range of appropriate collateral is not restricted. On the other hand, banks will still be required to judge the risks, which the limitations in the foundation approach are designed to address. For that reason, the supplementary minimum requirements are considerably more precise than those required of banks using foundation methodologies.

The capital obligation (K) for a defaulted exposure is equivalent to the greater of zero and the differentiation between its LGD and the bank’s best approximation of expected loss. Risk weighted asset amount for the defaulted exposures is the product of K, 12.5 & the EAD.

‘Risk weighted assets’

IRB risk weights are articulated as a single constant function of the PD, LGD and in some cases, M, of an exposure. This role provides a mechanism by which the risk apparatus outlined above are changed into regulatory risk weights. This approach does not rely on supervisory determined risk weight containers as in the standardized approach. As an alternative, it allows for greater risk differentiation and accommodates the different rating grade arrangements of banking institutions.
Minimum Requirements

Being qualified for IRB approach the bank must comply a full set of minimum requirements, equally at the beginning and on an continues basis. These requirements ensure the reliability and credibility of a bank’s rating system, methods and its estimation of the risk components that will serve as the origin for regulatory capital. Largely categorized, the minimum requirements for the foundation IRB approach mentions the following:

(a) Meaningful differentiation of credit risk;
(b) Completeness and integrity of rating assignment;
(c) Oversight of the rating system and processes;
(d) Criteria of rating system;
(e) Estimation of PD;
(f) Data collection and IT systems;
(g) Use of internal ratings;
(h) Internal validation; and
(i) Disclosure (requirements described under Pillar 3).

(c) ‘Retail Exposures’

IRB approach has been considered for retail that is separate from that for the corporate portfolio – with respect to the inputs, the risk weight structure and the minimum requirements. This regard, an objective definition of retail exposures is required.

Risk Components

A significant difference between corporate and retail portfolios lies in the way banks differentiates risk. For the case of retail exposures, the use of a fixed rating scale and the assignment of borrower ratings are much less then common. Fairly, on the basis of borrower, transaction/product and other characteristics, banks commonly split the portfolio into “segments” made up of exposures with comparable risk characteristics.

The IRB approach to retail builds on this and other industry practices. Therefore, banks will be obligatory, for IRB purposes; to group retail exposures into internally determined sectors in accordance with a set of least requirements. The appraisal of risk components will be made at the section level rather than at the rating grade level, as is the case for business exposures.

Risk weights

Risk weights must be a function of PD and LGD. For the banks using the EL approach mentioned above, a system is developed by which such estimates can be interpreted into the PD/LGD risk weight function. As retail portfolios are distinguished by a high number of low-value exposures, there will be no alteration to reflect concentration of lending to a borrower (or linked group of borrowers) in the retail structure.

Minimum requirements

With corporate exposures, adherence to least amount requirements is necessary to ensuring the integrity and reliability of internal rating systems and predictable loss data. While many
necessities draw on the corporate requirements, others reflect the particular characteristics of retail portfolios.

Risk weights may be assigned based on the following formula:

Correlation (R) = 0.15

Capital requirement (K) = LGD × N[(1 − R)^-0.5 × G(PD) + (R / (1 − R))^0.5 × G(0.999)] − PD × LGD

Risk-weighted assets = K × 12.5 × EAD

Capital requirement (K) for a defaulted exposure is the same to the greater of zero and the difference between its LGD and the bank’s best estimate of probable loss. The risk-weighted asset amount for the defaulted exposure is the product of K, 12.5, and the EAD.

**Qualifying revolving retail exposures**

Risk weights are defined based on the following formula:

Correlation (R) = 0.04

Capital requirement (K) = LGD × N[(1 − R)^-0.5 × G(PD) + (R / (1 − R))^0.5 × G(0.999)] − PD × LGD

Risk-weighted assets = K × 12.5 × EAD

The capital requirement (K) for a defaulted exposure is equal to the greater of zero and the difference between its LGD and the bank’s best estimate of expected loss. The risk-weighted asset amount for the defaulted exposure is the product of K, 12.5, and the EAD.

**Other retail exposures**

For other retail coverage’s that are not in default, risk weights are measured based on the following function, which allows correlation to vary with PD:

Correlation (R) = 0.03 × (1 − EXP(-35 × PD)) / (1 − EXP(-35)) + 0.16 × [1 − (1 − EXP(-35 × PD))/(1 − EXP(-35))]

Capital requirement (K) = LGD × N[(1 − R)^-0.5 × G(PD) + (R / (1 − R))^0.5 × G(0.999)] − PD × LGD

Risk-weighted assets = K × 12.5 × EAD

Major Key aspect of the treatment for retail exposures is risk segmentation. Banks and other institutions will be required to segment their portfolio to ensure that each risk section contains exposures whose risk characteristics are rationally homogenous.
(d) Project Finance Exposures

The main topics include (a) the unique loss allocation and risk characteristics of project finance lending. In particular, the relationship between predictable and unpredicted losses differs from that seen in corporate exposures, and PD, LGD and EAD are more extremely correlated; and (b) the limited accessibility of data for use in quantifying key risk characteristics and in validating banks’ approximation.

(e) Equity Exposures

There is a new capital action of equity exposures will require particular care in its development and completion, including transitional arrangements and, where suitable, the need to grandfather some types of investments.

(f) Granularity adjustment

The ‘granularity’ adjustment would be functional to the total risk weighted assets at the consolidated bank level. Based on the allocation of its exposures and LGD estimates within (and across) its internal grades, a bank may calculate an adjustment to risk-weighted assets to reflect the degree of granularity relative to a standard reference portfolio.

(3.) ‘Asset securitization’

There is a conventional securitization involves the legal or economic transfer of assets or obligations by an originating organization to a third party, classically referred to as a “special purpose vehicle” (SPV). An SPV issues asset-backed securities, which are argues against specific asset pools.

(a) Operational requirements

A meaning of a “clean break” – to recognize when the issuing bank removes securitized assets from its balance sheet – is necessary for purposes of risk-based capital requirements. Wherever these criteria, explained more completely in The New Basel Capital Accord, are met, the assets should be measured effectively removed from the bank’s balance sheet for purposes of calculating a regulatory capital charge for the clear risk.

(b) Disclosure requirements

Banks are required to disclose publicly certain quantitative and qualitative information’s. In the New Basel Capital Accord sketches required disclosures that have to be made by originating banks, sponsoring banks and SPVs recognized by banks. Numerous of the proposed disclosure requirements reflect the level of information presently disclosed to the market.
5.2.4 Operational Risk

(1) ‘Minimum capital requirements’
Banks have to address the operational risk in some business lines in the standardized approach and use the inside measurement approach for others. Nevertheless, once the bank has an standard method for use in the more advanced approaches; it will not be acceptable to choose to revert to a simpler method for treating operational risk.

(2) Continuum of approaches
The crucial Indicator Approach links the capital charge for operational risk to a solitary pointer that supplies as a substitute for the banks on the whole risk exposure. For instance, if gross income is acknowledged as the indicator, each bank will preserve capital for operational risk equal to a fixed proportion (“alpha factor”) of its gross income. The Internal Measurement Approach allows entity banks meeting more precise supervisory standards to rely on internal data for regulatory capital reasons. Banks will gather three data inputs for a particular set of business lines and risk types: an operational risk exposure indicator plus data representing the probability that a loss event occurs and the losses given such events.

(3) The “floor” concept
According to the New Basel Capital Accord will limit the decrease in capital held for operational risk when banks shifts from the standardized approach to the internal measurement approach by setting a floor, under which the required capital cannot fall. The commission has reviewed the need for the subsistence and level of the floor two years after the implementation of the New Accord.

(4) “Operational risk management standards”
In case of use the internal measurement approach, banks will require to demonstrate compliance with a number of standards.

(5) On-going work
In addition to increasing calibration of the operational risk charge, the Committee will carry on to explore ways of improving the risk sensitivity of the operational risk structure. It will include work on a risk profile index in the internal extent approach, a loss distribution approach, and the acknowledgment of risk mitigation techniques – all of them are discussed in the Supporting Document.

(6) Pillar 2: “Supervisory review process”
In the second pillar of the new framework is planned to make certain that every bank has smooth internal processes in place to review the sufficiency of its capital based on a careful assessment of its risks. Supervisors will be liable for assessing how banks are assessing their capital adequacy requirements comparative to their risks, as well as whether banks are suitably addressing the relationship between verities of risks. In doing so, supervisors will illustrate on, among other considerations, their knowledge of best practices across organizations.
It is also important way in which Pillar 2 of the new capital accord interacts with the necessities of the more superior methods in Pillar 1, in particular those of the IRB framework for credit risk. Supervisors must make sure that banks on an on-going basis are meeting these necessities.

1. Four key principles of supervisory review

The Basel Committee has acknowledged four key concepts of supervisory review, which are elaborated below. These ideologies complement the widespread supervisory guideline that has been developed & published by the team.

‘Principle 1: Banks should have a procedure for assessing their overall capital in relation to their risk profile and a policy for maintaining their capital levels’.

A sound capital adequacy assessment process should comprises policies and procedures considered to ensure that material risks are captured; procedures for connecting the bank’s strategies and level of capital to risk & internal controls, evaluations and audit to make sure the integrity of the overall administration system. The accountability for the organization and maintenance of this process rests with management.

In continuation of evaluating this process, bank authority should remain watchful of the exacting stage of the business cycle where that is operating. Therefore, bank authority has to carry out precise, future looking stress testing which identifies events of changes in credit and capital market conditions that could unfavorably impact the bank.

Principle 2: Supervisors ought……………………………………… of this process.

Evaluating a bank’s internal capital assessment process, supervisors ought to consider several relevant factors. These factors comprises the consequences of sensitivity analyses and stress tests carried out by the bank and how they relate to the bank’s capital; the degree to which bank management has provided for unexpected actions in setting capital levels; and whether the target capital levels are properly reviewed and checked by senior management.

Principle 3: Supervisors should…………………………………….. the minimum.

Supervisors have several way of ensuring that the individual banks are operating with sufficient levels of capital. The supervisor may, among other options, target capital ratios or define type above bare least regulatory capital ratios for marking the capitalization of the bank.

Principle 4: Supervisors be supposed ………………….. maintained or restored.

Supervisors should consider a verity of options if they become worried about a bank is not fulfilling the requirements professionally which one is outlined in the supervisory principles earlier. These procedures may include increasing monitoring, create restriction on dividend payments. The bank need to prepare and implement a satisfactory capital preservation plan and the bank need to move up additional capital instantly. Supervisors have the discretion to use the apparatus best suited to the situation of the bank and its operating environment.
2. Supervisory review of compliance with the minimum standards

In order for certain inside methodologies, credit risk mitigation techniques and asset securitizations to be acknowledged for regulatory capital purposes, banks will need to meet a number of necessities, including risk management standards and disclosure. In exacting, banks will be required to disclose features of their internal methodologies used in calculating minimum capital requirements for credit and operational risk. As part of the supervisory review process, supervisors have to ensure that these circumstances are being met on an on-going basis. The Committee envisions that monitoring a bank’s compliance with such supervisory standards can be accomplished through several means, including on-site examinations or inspections, off-site review and open discussions with management. In the same time, adoption of these advanced approaches will likely require considerable enhancements to current supervisory reports. It will also need that supervisory and examination staff has sufficient experience and training to exercise judgment in the appropriate areas.

3. Other aspects of supervisory review

In adding to these four key principles, there are other aspects of the supervisory review process. These comprise accountability and transparency of the supervisory review process and the action of interest rate-risk in banking book.

(a) Supervisory transparency and accountability

The supervisors should need to be careful on their obligations in an extremely transparent and accountable manner.

(b) Interest rate risk in the banking book

As a part of this second consultative package, the Committee has amended its principles in the year of 1997. It was for the management of interest rate risk. Interest rate risk is a potentially significant risk, and one that merits capital. It is mainly appropriate to treat interest rate risk in the banking book beneath Pillar 2 of the New Accord. However, supervisors who consider that there is sufficient homogeneity within their banking populations about the nature and methods for monitoring and measuring this risk could set up a mandatory minimum capital requirement.

(c) ‘Pillar 3: Market discipline’

The third major component to capital adequacy is market discipline. Significant disclosures by banks inform market participants, facilitating effective market discipline. Disclosure requirements and recommendations are discussed below:

The New Capital Accord anticipates that banks will be allowed to use internal methodologies to calculate capital requirements for credit risk and operational risk.
Agreed the influence of internal methodologies on the capital requirements established, The comprehensive disclosure is vital for market participants to understand the relationship between the risk profile and capital of an institution, and therefore its soundness. The use of these internal approaches is contingent upon a number of criteria, including appropriate disclosure. Also in the area of credit risk mitigation techniques and asset securitization, in order for banks to reap the capital benefits, they must fulfill certain disclosure requirements to provide adequate information to markets about the impacts of these techniques and transactions.

An important step in enhancing the recommendations under Pillar 3 is to embed them in an adequate bank management process, as described in the following principle:

“Banks should have a formal disclosure policy approved by the board of directors. This policy should describe the bank’s objective and strategy for the public disclosure of information on its financial condition and performance. In addition, banks should implement a process for assessing the appropriateness of their disclosure, including the frequency of disclosure.”

Pillar 2 states a similar principle with regard to the assessment of risk and capital, and such a principle will serve to make stronger the status of the disclosure recommendations. While a bank does not comply with the disclosure recommendations under Pillar 3, the Committee anticipates a supervisory response aimed at remedying these circumstances. The strength of this response should depend on the scenery, implications and duration of non-compliance. A spectrum of responses is available to supervisors, ranging from “moral suasion” through dialogue with the banks management to reprimands or financial penalties. Many supervisors do not have any direct legal authority with regard to accounting and disclosure, measures in this area would, at least initially, often have to be restricted to pressure through moral suasion. But, to the extent that certain disclosure recommendations are recognized in International Accounting Standards, the enforceability of the standards will be very much superior.

The disclosure of a significant amount of information would be used for internal management purposes. While suitable disclosures are necessary for the operation of market discipline, it does not desire to require disclosure of proprietary information or to place an redundant burden on the industry.

5. ‘Transitional Arrangements’
   (a) Transition Period Regarding the Overall Implementation of the Accord

The New Basel Accord will apply to all globally strong and active banks at each tier within a banking group. Three year transition period beginning from the date of implementation for applying full sub consolidation will be supplied for those states where this is not a requirement at present.
(b) Transition Period Regarding the ‘Internal Ratings-Based Approach’
The full and instant adherence to certain data-related bare minimum requirements may not be possible for banks with otherwise well-managed and sophisticated credit risk management systems at the time of implementation of the revised Accord.

6 “When multiplying by 12.5, the bank creates a numerical link between the calculation of the capital obligation for credit risk, where the capital charge is based on the risk-weighted assets and the capital requirements for operational and market risks, where instead the capital charge itself is calculated directly”.
CHAPTER- SIX

COMPARISON OF THE BASEL CAPITAL ACCORDS

6.1 Basel Agreement

On behalf of United Sates Federal Reserve Board and representatives of eleven other Developed countries proclaimed preliminary agreement on new capital standards—often referred to as Basel Agreement—which one will be applicable to all banking industries and relative authorities. The Basel capital accord helps leading banks to make strengthen capital positions.

Capital adequacy ratio under the Basel Agreement on International Bank capital standards is:

\[
\text{Capital Adequacy} = \frac{\text{Total Capital (or Tier 1+ Tier 2 Capital)}}{\text{Total risk weighted bank assets}}
\]

6.2 The New Basel Capital Accord

Basel I accord was not found full proof. After taking place new issues, committee had to think something new concerning this. Here is a description given by Council of Mortgage Lenders form UK mentioned that, “The first Basel Accord has been replaced by a new accord, Basel II. The new accord has been introduced to keep pace with the increased sophistication of lenders' operations and risk management and overcome some of the distortions caused by the lack of granularity in Basel I. Lenders had been able under Basel I to reduce required capital in ways that did not reflect lower real risk (in what has become known as regulatory capital arbitrage). The intention is that Basel II will align required minimum capital more closely with lenders' real risk profile.”

6.2.1 Purpose

1. Affirms promoting protection with reliability & enhancing competitive parity
2. Objectives:
   a. Extra complete approach to deal with the risk, insertion more significance on banks' inner risk methodologies with supervisory review & market discipline
   b. Additional open measures of the height of risk concerned in a banks situation and activities.
   c. Spotlight on internationally dynamic banks
6.2.2 Three Pillars: ‘Capital, Supervisory Review, Market Discipline’

The ‘New Basel capital accord’ is based on three pillars. Until otherwise the three pillars all are in a row the Accord will not be complete.

6.2.2.1 Pillar One: “Minimum Capital Requirement”

1. Minimum requirement 8% ratio of capital to risk weighted asset is conserved. However, the new Basel Capital Accord will be extensive on a combined basis to bank holding companies to make sure hazards/risks within the complete banking society are measured. The minimum total capital ratios are based on three different components. Total risk weighted assets for credit risk + 12.5 times the sum of the capital charges for market risk & operational risk. The equation represents roughly as follows :

\[
\text{Total capital (unchanged)} = \frac{\text{Bank’s capital ratio (minimum 8\%)}}{\text{Credit risk} + (12.5 \times (\text{Market risk} + \text{Operational risk}))}
\]

“Credit Risk”

1. New Basel accord has two main features. They are (1) standardized approach which one is hypothetically similar with former approach yet more risk sensitive. Another one is IRB (Internal Rating Based) approach.

a. For the case of ‘standardized approach’, bank allocates a risk-weight beside every asset & off-balance sheet point. Following that bank then generates a figure of risk weighted asset values .

b. Risk weights are sophisticated by referring to a rating in black and white by an external credit assessment institution that meets rigorous standards, instead of being based on the broad category of borrower .

i. “There ought not to be, on average, a net enlarge or reduce in minimum regulatory capital, complete of operational risk .

ii. Bank and its administrators are liable for external credit assessment. As well as the caliber of the produced ratings.

(“Guidelines on Risk Based Capital Adequacy’ Bangladesh Bank, December 2010”
iii. In IRB approach banks would use their personal approximations of borrower creditworthiness to evaluate credit risk in their portfolio, subject to severe methodological and disclosure standards.

- The creditworthiness estimates are interpreted into estimates of potential upcoming losses, which together with other inputs establish the minimum capital requirements.
- Under the "foundation" approach to IRB, supervisors provide the other inputs.
- According to the "advanced" approach, banks with sufficient internal capital allocation processes supply the other input.
- This approach supplementary correctly reflects a bank's individual risk profile.

The objective is to ensure a adequate capital requirement to address risks, but also to push banks to move from the standardized approach to the IRB.

“Operational Risk”

1. “It covers the danger of straight or indirect loss occurring from inadequate or unsuccessful internal processes, public, and systems or from outside events.

2. Expect operational risk to comprise around 20% of in general capital requirements.

3. In this case three models proposed:
   - Basic indicator – in general uses single indicator for total activities of a bank.
   - Standardized – For different business unit uses of diverse indicators.
   - Internal measurement – for determining required capital schedule banks use internal loss data”. (www.bis.org)

6.2.2.2 Pillar Two: “Supervisory Review Process”

1. The banks have flat internal risk assessment procedure in place to assess the adequacy of the capital must ensured by the supervisors.

2. For the supervisory review process there are mainly four principles.

3. With the connection in the risk profile Banks be supposed to have a procedure to assess their overall capital.

4. Supervisors may take any necessary action if they are not satisfied with assess of the banks internal capital adequacy assessment and approaches.

5. Supervisors need to ensure banks operating in side the territory must have minimum regulatory capital ratios and also holds capital excess of the minimum.
6. In the very beginning supervisors need to take necessary steps to prevent capital going down from minimum level and to support the risk characteristics of a specific bank.

7. The compulsion of exact capital necessities are left to administrators as of the considerable disparities in the character of the risk & the procedures for observing it.

8. Banks internal assessment systems are renowned as the primary tool for measuring interest rate risk.

9. Precise concentration ought to be paid to banks whose economic value would turn down by additional 20% of Tier 1 and tier 2 capitals as a consequence of a 200-basis point adjust in rates.”

(www.bis.org)

6.2.2.3 Pillar Three: Market Discipline

1. Main objectives of this pillar are to make the market strengthen by enhancing disclosures by banks. The disclosures should be significant and affect to ensure the market better by the market main players.

2. Banks capability to use the additional complimentary inside methodologies to settle on capital requirements will be reliant on their fulfillment by the smallest disclosure necessities.

3. The disclosure necessities spotlight on four parts:

   - Scope of the new capital requirements' application to the disclosing bank;
   - Composition of capital (the nature, components and features of capital);
   - Risk exposure evaluation and management process - covers credit, market, operational and interest rate risk and risk mitigation systems;
   - Capital adequacy - capital ratios & factors impacting on its capital adequacy position and economic capital allocations.
6.2.2.4 Documentation
New Basel accord based with copy of the Accord and seven other supporting documents elaborating on the subsequent features of the Accord:

- The Standardized Approach to Credit Risk
- The Internal Ratings-Based Approach
- Asset Securitization
- Operational Risk
- Supervisory Review Process (Pillar 2)
- Principles for the Management and Supervision of Interest Rate Risk
- Market Discipline (Pillar 3)

6.3 Assessment between Basel-I and Basel-II
A Comparison of the Changing Rules for International Regulation of Bank Capital

Features of Basel I Rules (as formally adopted in 1988):

- Identified the principal types of capital that are satisfactory to regulators (including Tier 1 and Tier 2 capital) and was the first recognized capital standard to take into account risk exposure from off-balance sheet items.
- Focused first and fore mostly upon credit risk or default risk intrinsic in the assets on a bank’s balance sheet and among off-balance sheet items, with market risk exposure from shifting interest rates, currency, and commodity prices added later.
- Determined individual bank’s capital requirements using same method and the same set of risk weights (a “one size fits all” approach).
- It is functional to the same least capital requirements to all banks in participating countries.

Features of Basel II Rules (programmed for implementation in full force in 2006 or rather later):

- Offers greater sensitivity to arbitrage and improvement in the financial market place, which demands more flexible bank capital rules than Basel I permitted.
- Recognizes that similar banks have different risk exposures, may have to utilize different methods to assess their own unique risk exposures, and may be subject to different capital requirements (including different rules for large versus small banks).
- Widens the types of risk considered in shaping capital requirements and establishes minimum capital requirements for credit, market, and operational risks. The outcome of this and other changes is to Basel II is significantly extra risk sensitive than earlier accord.
- Needs each bank to develop in-house risk-management models and stress tests for reviewing its own degree of risk exposure (VAR or Value at Risk) under a range of different market place scenario.
- Needs each bank to resolve its own capital requirements based on its own calculated risk exposure, subject to review for “reasonableness” by regulatory bodies.
- Endorses greater public disclosure of each bank’s true financial situation so that greater market discipline is applied to bank’s professed to be on excessive risk.

Basel II is additional than just a description of a capital to asset ratio. It also adds in two additional components resulting in three commonly reinforcing pillars:

1. A revised approaches for calculating the capital to asset ratio;
2. Supervisory review standards for reassuring capital adequacy;
3. Market discipline from first to last public disclosure.

The minimum capital to risk-weighted asset requirement of 8% remains as usual. The numerator that describes the acceptable types of regulatory capital (i.e., tier one and tier two capital) is also mainly unchanged. The core modifications in Basel II are to the denominator that defines risk-weighted assets.

http://www.cml.org.uk/cml/policy/issues/721
CHAPTER- SEVEN

CAPITAL MANAGEMENT PRACTICES IN BANGLADESH AND IMPLICATIONS OF NEW BASEL CAPITAL ACCORD

7.1 Capital Management Practices

Inside Bangladesh, the commercial and scheduled banks had to follow the capital-to-liabilities approach before 1996, according to the guiding principle of the Banking Regulation & Policy Department of Bangladesh Bank. New provision for measuring the capital adequacy of banks on risk weighted assets replacing the capital to liabilities approach were commenced with the BRPD circula-1 dated 08-01-1996. The amended policy on capital sufficiency considers various levels of credit risk & enclosed both on & off-balance sheet items. The following sections largely outline the outstanding features of those practices with important modifications made from time to time by a few new instructions have been issued for banks compliance:

1. Definition of Capital
   Capital might be segregated into two different tiers. They are known as tier 1 and tier 2 for better supervisory reason. Tier one capital which one known as core capital comprising with the maximum quality capital elements. For Tier 2 which one is known as Supplementary Capital in changes of other ingredients which reduce short of some of the individuality of the core capital other than add to the generally strength of a bank. The elements of core capital & supplementary capital are shown in the Annexure-1.

2. Minimum Capital Standards
   During the amendment of the Bank Company Act, 1991 in 2007, the level of least capital obligation for each bank has been elevated to Taka 200 crore from Taka 100 crore. Moreover, each bank must preserves a ratio of capital beside risk weighted assets not less than 10% with at least 5% in tier 1 capital & this obligation had suppose to be attain by December, 2007. Afterward on the final guide line it was mentioned:
   a) In Bangladesh no schedule banks are allowed to carry on its business without having minimum capital requirements prescribed by the central bank as per section 13 of ‘Bank Company Act, 1991’.
   b) Banks have to maintain minimum CAR “on a ‘Solo’ basis as well as on a ‘Consolidated’” basis as per instruction(s) given by BB from time to time.
   c) Banks have to maintain at least 50% of required capital as Tier 1 capital.

3. Risk-weighted Assets
   ‘Balance sheet’ and ‘off balance sheet items’ are measures according to their relative risk factors. Right now there are four categories of risk measurements they are ‘0%, 20%, 50% and 100%’. Bangladesh Bank guidelines provide that off balance sheet transactions need to change into balance sheet equally assessing the capital adequacy prior assessing a risk weight.
Commercial banks of Bangladesh have been following the guidelines set by the Bangladesh Bank time to time in addition Bangladesh Bank monitors whether the commercial banks comply with the rules of the game accordingly.

All these guiding principle and circulars made by Bangladesh Banks follow the general principles of the 1988 Basel Accord. The banks are upholding the capital adequacy according to the norms determined by the Basel Committee in 1988.

7.2 Implication of the ‘New Basel Capital Accord’

‘The new Basel Accord’ before come on effect was expected to have far reaching propositions. Commercial Banks may create awareness on credit risk and higher reliance on advance risk management tricks through both the merger and acquisition. Basically the underdeveloped nations are thriving on the structural issues and their banks are acting like financial intermediaries. They need some flexibility in their approaches.

The new Basel Capital Accord is quite complex in its view of sophistications & over the coming years, move limited supervisory wealth away from directly supervision towards completion of these precise suggestions. As a result of the previous point, this difficulty of the New Basel Capital Accord would persist huge skill, which the schedule banks may find tough to obtain. Because of the enlarged flow of property to capital regulation, the bank capital may see as a remedy for prevention of bank failure. As well as supervisory oversight in respect of other bank-specific strictures might become general. More over it is in the belief that enough capital would keep banks protects from failure. Finally, amplified dependence on external rating agencies may lead the banks to loosen its own credit rating models and place explicit liability on administrators to take such organizations into their authoritarian fold.

Capital sufficiency highlights on the whole risk weighted capital planned to protect the depositors from the probable shocks of losses that any banks may face. That will help absorbing major financial risks (such as credit risk, foreign exchange risk, interest rate risk and risk linked with off-balance sheet operations). The Banks that are operating in Bangladesh have to uphold a least capital adequacy ratio (CAR) not less than 10% of their risk-weighted assets (RWA) with at least 5% in core capital or Taka 2.0 billion, either one is higher. Shortfall, if any, in the CAR has to be fully met by a certain date, as guided by Bangladesh bank.
Table: 7.1 Capital Adequacy Ratio (CAR) by type of banks (Percent)

<table>
<thead>
<tr>
<th>Type of Banks</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>NCBs</td>
<td>5.25</td>
<td>4.36</td>
<td>4.24</td>
<td>4.06</td>
<td>4.48</td>
<td>-1.14</td>
<td>-0.84</td>
<td>-0.37</td>
<td>0.53</td>
</tr>
<tr>
<td>FCBs</td>
<td>15.81</td>
<td>18.39</td>
<td>16.84</td>
<td>21.38</td>
<td>22.62</td>
<td>24.44</td>
<td>24.64</td>
<td>26.00</td>
<td>22.86</td>
</tr>
<tr>
<td>Total</td>
<td>7.37</td>
<td>6.69</td>
<td>6.65</td>
<td>7.37</td>
<td>8.61</td>
<td>6.93</td>
<td>7.11</td>
<td>7.34</td>
<td>8.02</td>
</tr>
</tbody>
</table>


Table 10.1 demonstrates that as on 31 December, 2006 the PCBs and FCBs supported CAR of 9.67% & 23.02% correspondingly. Though the CAR of NCBs carries on remaining under the bare minimum authoritarian CAR owing to their high NPL and ongoing losses; but the DFIs managed to overcome the boundaries of the regulatory requirement marginally.

Now the following table shows the statistic of the net Non Performing Loans (NPL) ratios by type of banks:

Table: 7.2 Net NPL Ratios by type of banks (Percent)

<table>
<thead>
<tr>
<th>Type of Banks</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Q1</td>
<td>Q2</td>
</tr>
<tr>
<td>NCBs</td>
<td>30.1</td>
<td>28.06</td>
<td>17.56</td>
<td>13.23</td>
<td>18.28</td>
<td>22.89</td>
</tr>
<tr>
<td>DFIs</td>
<td>48.0</td>
<td>32.75</td>
<td>22.97</td>
<td>22.61</td>
<td>22.56</td>
<td>21.36</td>
</tr>
<tr>
<td>PCBs</td>
<td>10.5</td>
<td>7.96</td>
<td>3.35</td>
<td>1.75</td>
<td>1.63</td>
<td>2.09</td>
</tr>
<tr>
<td>FCBs</td>
<td>-0.3</td>
<td>0.03</td>
<td>-1.47</td>
<td>-2.16</td>
<td>-2.23</td>
<td>-2.66</td>
</tr>
<tr>
<td>Total</td>
<td>22.6</td>
<td>18.07</td>
<td>9.79</td>
<td>7.15</td>
<td>8.59</td>
<td>8.21</td>
</tr>
</tbody>
</table>

The most important sign used to recognize harms by asset quality in loan portfolio is the part of gross and net NPLs to whole assets and whole advances. Overseas Commercial Banks have the lowest percentage while DFIIs have the highest of NPLs. The proportion of NPLs to whole assets of all the banks shows a rising trend whereas its turn down from a peak of 22.6% in the year of 2002. The NCBs and DFIIs keep on to have very elevated NPLs regularly unpaid to substantial loans supplied by them on deliberations commercial and under directed credit programs, particularly through the ‘70s and ‘80s. Poor assessment and inadequate follow-up and supervision of the loans provided by the NCBs and DFIIs in the past finally caused in massive booking of pitiable quality assets which keep on weight the portfolio of these banks. In addition, the banks were unenthusiastic to write off the historically bad loans as of poor quality of underlying collaterals and to avoid any possible legal complications due to loopholes in legal framework. Revival of NPLs though demonstrates some symbols of development, frequently as of the events in use with observe to inner reformation of these to fortify their loan revival instrument and recovery drive initiated in recent years. The spirit of the ‘New Basel Capital Accord’ lies in the growth of asset quality through better risk management. ‘The New Basel Capital Accord’ has devised clear rules and mathematical derivatives to measure the associated risk and its exposure linked with the asset. Hereafter, the creation of a loan or asset will automatically be adjusted by the magnitude of capital requirement in the new accord. The statistic over shows that the FCBs are evidently ahead in terms of complying with the New Basel Capital Accord since they have got a very good credit standing their internal management is also quite capable of handling the matters independently and with sufficient expertise. The PCBs are the average and they must work hard to come in line with the New Basel Capital Accord. The very vulnerable situation lies with the NCBs and the DFIIs. At this point, the ‘New Basel Capital Accord’ is a compulsory theme to relate, the absence of which will lead to the ultimate damage of the national organizations.

Bangladeshi commercial Banks used to follow the age-old traditional Lending Risk Analysis (LRA) approach to evaluate the risks till 2005. But from 2006 Credit Risk Grading Manual is introduced to evaluate the risks.

The Credit Risk Manual developed by Bangladesh Bank is mostly qualitative and strict. It is an extensive process although it is not a full-proof measure of risk and credit exposure. The risk grading under CRM is given bellow:
<table>
<thead>
<tr>
<th>Risk Rating</th>
<th>Grade</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Superior – Low Risk</td>
<td>1</td>
<td>Services are fully protected by cash deposits, government bonds or a counter assurance from a top tier global bank. All security documents should be in place.</td>
</tr>
<tr>
<td>Good – Satisfactory Risk</td>
<td>2</td>
<td>Borrower repayment capacity is strong. The borrower ought to have outstanding liquidity and low leverage. The company should show strong earnings, cash flow and a sound track record. All necessary security documents should be in place. Collective Score of 85 or greater based on the Risk Grade Score Sheet</td>
</tr>
<tr>
<td>Acceptable – Fair Risk</td>
<td>3</td>
<td>Financial condition is almost sound though may not be able to face major continued setbacks. These borrowers may not be as strong as Grade 2 borrowers, still exhibits consistent earnings, cash flow and have a good quality track record. These assets should normally secured by acceptable collateral (1Schrage over stocks/debtors/equipment/property). Borrowers should have sufficient liquidity, cash flow and earnings. A collective Score of 75-84 based on the risk grade scorecard.</td>
</tr>
<tr>
<td>Marginal – Watch list</td>
<td>4</td>
<td>Grade 4 assets deserve more attention to the conditions affects borrower in the economic environment. Borrowers having an above average risk due to strained liquidity, higher leverage, poor cash flow and/or inconsistent earnings. Benefits can be downgraded to 4 if the borrower face a loss, loan payments routinely falls past due, account conduct is reduced, or other untoward factors are present. A collective Score of 65-74 on the risk grade scorecard.</td>
</tr>
<tr>
<td>Risk Rating</td>
<td>Grade</td>
<td>Definition</td>
</tr>
<tr>
<td>------------------</td>
<td>-------</td>
<td>-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Special Mention</td>
<td>5</td>
<td>Having potential weaknesses that need management’s close concentration. If don’t corrected, these failings may worsening of the repayment prediction of the borrower. Facilities ought to be reduced to 5 if sustained declining in financial condition is noted (consecutive losses, negative net worth, excessive leverage), if the loan payments remain due for 30 to 60 days, of a significant application or claim is lodged against the borrower. Full repayment of facilities is still expected and interest can still be taken in to profit. A combined score of 55-64 based on the risk grade scorecard.</td>
</tr>
<tr>
<td>Substandard</td>
<td>6</td>
<td>Financial condition is fragile and the ability to repay is doubtful. These weaknesses can hamper to the full recovery of loans. It could be downgraded to 6 if loan payments remain past due for 60-90 days. If the customer desires to create a lender group for debt restructuring purposes the operation has ceased trading or any indication suggesting the winding up or conclusion of the borrower is discovered. This is not yet considered non performing as the correction of the lacking may result in an improved condition, same time interest can still be taken into profits. A total score of 45-54 based on the risk grade scorecard.</td>
</tr>
<tr>
<td>Doubtful</td>
<td>7</td>
<td>Repayment of principal and interest is doubtful and the possibility of loss is very high. The asset is not yet classified as loss though due to particularly factors yet not been identified such as litigation, liquidation process of capital injection. If loan payments remain past due more than 90 days interest income must be taken into suspense (non-accrual). Provisions for loan and loss may be raised against unrealizable amount of benefits. The provisions of adequacy must be reviewed at least quarterly for all non-performing loans, and the bank be supposed to follow lawful options to implement security to obtain repayment or discuss an appropriate loan rescheduling. For all the cases Bangladesh Banks CIB report is required. An Average score of 35-44 based on the risk grade scorecard.</td>
</tr>
<tr>
<td>Bad/Loss</td>
<td>8</td>
<td>Long outstanding and no progress in obtaining repayment more than 180 days past due or in the final stages of wind up/ liquidation. The recovery possibility is poor and lawful options have been pursued. Process of liquidation or realization of security may be expected.</td>
</tr>
</tbody>
</table>
CHAPTER-EIGHT

CONCLUSION AND POLICY GUIDELINES

8.1 Conclusion

One of the great ways to understand the strong point of the regulatory framework of a financial system is implementation status of Basel Core Principles (BCPs). It can be declared that World Bank, IMF & Bangladesh Bank have assessed the rank of the Bangladeshi banking segment in terms compliance of Basel Core Principles. The particulars are shown below:

Financial Sector Assessment: Compliance of Basel core principles for effective banking supervision

Compliance of BCPs requires a rock-hard base for the ultimate implementation of the new capital Accord. Ever since the ‘New Accord ‘needs considerable preceding risk management practices for the banking sector, Central Bank already issued 5 special guidelines on 5 core risk areas in the year of 1993, which one gave a basic base for the flat accomplishment of ‘the new Basel accord’.

A combined mission of the World Bank and the IMF reviewed the strengths, potential vulnerabilities and major development opportunities in the Financial Sector of Bangladesh under Financial Sector Assessment Program (FSAP) in October 2002. The team recognized the weaknesses that should be taken into consideration to avoid potentially destabilizing situations which may cause for financial sector vulnerabilities. The group also suggested reform actions to develop a sound, well-organized as well as steady monetary system. The assignment assessed the following regions of financial sector based on different criteria:

- Monetary Policy
- Financial Policy
- Compliance of Basel core principle for effective banking supervision
- Principles of Securities regulation
- Core Principles for Payment System
- Anti-Money Laundering and Financial Terrorism

Afterward Bangladesh Bank, Government and the Securities and Exchange Commission have begun significant authoritarian plus supervisory steps to get improved competence with competitiveness of the monetary sector. Actions were taken based on FSAP statement and other measures were taken largely in light of international best practices. In a current move, Bangladesh Bank has formed 4(four) different committees comprising of high officials of relevant departments to reconsider the status of financial sector in terms of the standards set by the World Bank & IMF in the FSAP statement. Whereas most of the studies are under process, Basel II Implementation Cell has passed out an assessment of the extent of Compliance of BCP for Effective Banking Supervision. It can be taken in to consideration that compliance of BCPs requires providing a rock-solid foundation for the ultimate
implementation of Basel Accord II. For example, principles 1(3), 1(4), 1(6),5,6,7,8,9,10, 12, 13, 14, 15 and 23 are straight linked with Basel Accord II.

Therefore, the first appraisal on compliance was carried out by the IMF/World Bank together as a part of Financial Sector Assessment in October 2002. In their assessment the IMF/World Bank suggested, "The legislation should be amended to limit the powers of the Government to intervene in the operation of bank supervision and to increase the Bank's Autonomy." On the basis of that statement, a number of corrective measures have been undertaken by the Bangladesh Bank and the Government. In the year 2006, a self-audit on compliance with ‘Basel Core Principles for effective Banking Supervision’ has been carried out by Basel II Implementation Cell of Bangladesh Bank. That shows a significant progress in compliance with the BCPs for ‘Effective Banking Supervision’.

In October 2002 the IMF/World Bank side also suggested that a) BB should have full authority to act on bank license applications and should publish the criteria to be used for determining application for bank licenses and b) The Act should be modified to ensure that shareholdings in banks that exceed 5% are allowed only when approved by BB. As per suggestion, the related clause of Bangladesh Bank Order 1972 has been modified and BB now has full power to act on bank license applications. Criteria have also been set for determining application for bank licenses. The shareholding in banks by any person/family/company except by the Government is limited to 10%. BB is now evaluates as mostly compliant, as against materially non compliant in 2002. Moreover, findings of comparative status of banking section in terms of fulfillment of BCPs are exposed below:

<table>
<thead>
<tr>
<th>Basel Core Principles (BCPs)</th>
<th>October, 2002</th>
<th>October, 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principle 1(1) Objectives</td>
<td>C</td>
<td>C</td>
</tr>
<tr>
<td>Principle 1(2) Independence</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 1(3) Legal Framework</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 1(4) Enforcement of Powers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 1(5) Legal Protection</td>
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<td></td>
</tr>
<tr>
<td>Principle 1(6) Information Sharing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 2 Permissible Activities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 3 Licensing Criteria</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 4 Ownership</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 5 Investment Criteria</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 6 Capital Adequacy</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 7 Credit Policies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 8 Loan Evaluation and Loan Loss Provisioning</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 9 Large Exposure Limits</td>
<td></td>
<td></td>
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<tr>
<td>Principle 10 Connected Lending</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 11 Country Risk</td>
<td></td>
<td></td>
</tr>
<tr>
<td>principle 12 Market Risk</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 13 Other Risk</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 14 Internal Control and Audit</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 15 Money Laundering</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 16 On-site and off-site Supervision</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 17 Bank Management Contact</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 18 Off-Site Supervision</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 19 Validation of Supervisory Information</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 20 Consolidated Supervision</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 21 Accounting Supervision</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 22 Remedial Measures</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 23 Globally Consolidated Supervision</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 24 Host Country Supervision</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principle 25 Supervision Over Foreign Banks’ Establishments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>17</td>
<td>10</td>
</tr>
<tr>
<td>Overall Assessment</td>
<td>Largely Non-Compliant</td>
<td>Largely Compliant</td>
</tr>
</tbody>
</table>

C=Compliant, LC= Largely Compliant, MNC = Materially Non Compliant, NC = Non Compliant, NA = Not Applicable
details the revisions in the New Accord, which spots on advanced risk and capital measurement techniques, the most important force for imposing the new law’s requirements, the Basel Capital Accord's risk management philosophy, and describes how it is supposed to handle all sorts of risks within financial arenas.
Basel II is more than just a description of a capital to asset ratio. It also incorporates two supplementary components resulting in three reciprocally reinforcing pillars:

1. A revised methodology for calculating the capital to asset ratio;
2. Supervisory review standards for assuring capital adequacy;
3. Market discipline through public disclosure.

The lowest amount capital to risk weighted asset requirement of 8% remains unchanged. The numerator that describes the satisfactory types of regulatory capital (i.e., tier one and tier two capital) is also largely unchanged. The core modifications in Basel II are the denominator which defines risk-weighted assets.

The existing Basel Capital Accord is intended to be functional to all financial institutions in the same manner: a “one size fits all” approach. Basel II provides three different dimensions that can be used to obtain a risk weighting of assets. The purpose is that this will provide better assessments of risk and make the resulting capital ratios more significant.

The Standardized approach needs fixed risk weightings to be applied to different types of assets. The collateral range and credit risk mitigation tools that can be utilized to reduce the associated risk of an asset has been expanded to include guarantees and credit derivatives.

The Internal Ratings Based (IRB) approach allows financial institutes to use its own internal assessments of major risk drivers when weighting its assets and consequently determines its own risk-weights within absolute floors. The IRB approach has two alternatives:

☐☐The IRB Advanced Approach gives a financial institutes more independence to use its own systems to set risk weightings. For these instance financial institutes required to meet stringent at least standards set up by the committee. To maintain a control environment through the institution can display the relevance of its experience. In realistic terms, a financial institution will be likely to have in place sophisticated modes and process that facilitate it to collect, store & to utilize loan & loss and probability of default statistics over the time in a statistically rigorous manner.

Basel II suggests substantive changes to the action of credit risk through introducing specific risk weightings for different credit products that should be included in the calculation of the capital ratio. In adding, a calculation of operational risk is also included within the denominator of the capital ratio for the very first time. The risk weightings in the standardized approach include:

☐☐Retail loans - 75% risk weighting
☐☐Mortgages - 35% risk weighting (reduced from previous 50%)
☐☐Revolving credit - 15% risk weighting
☐☐Operational risk - 15% of average gross income

A significant innovation of the standardized approach is that loans measured past due are risk weighted at 150%, if not the financial institution holding the debt has already set aside specific provisions.
Regulation Authority in Australia, many European countries and parts of Asia and South America already applied this capital standard. In adding, many Canadian provinces follow either the Basel Capital Accord or a partially modified version. A wide number of national regulators, including those in developing countries, are keen to adhere to international best practice and are currently considering the proposals of the Basel Committee.

**Basel II and plan for its Implementation**

The G-10 nations have already determined to apply the Basel II by 2006 when other nations need three more years to come on effect from 2007. Worldwide popularity and demand of Basel core principles has decided to ensuring relocation to Basel II in non-disruptive manner. Bangladesh Bank has accepted a consultative approach and starts operating since December 2008. BB is also getting informed from the financial institutions quarterly since December 2008.

A committee has been formed in consist with Bangladesh Bank and Chartered Accountant farms with providing sufficient power. There is also a coordination committee is also been formed. Finally BB started its full operation of new Accord since 01 January 2010. But in this stage still BB needs supports from NCBs, PCBs, and Commercial Banks. Still the modified strategy on capital sufficiency takes account of different level of credit risk & wraps both on and off balance sheet transactions.

**Implementation of Basel II in some major countries:**

- **European Union**: Target of implementation by January 1, 2007 : SA/BLA
- **USA**: Implementation by January1, 2009 : IRB
- **Australia**: Implementation by January1, 2008

*Source: Akhtar(2004)*

In complete conditions, with the assistance of Basel II banks can hold less capital. For applying IRB approaches all the banks or the institutions needs to prove the supervisors an advance level of data modeling capabilities. In response banks likely to hold even lower stage of capital. An apprehension is that since bigger banks will be able to meet the know-how and agendas needed to use the IRB approach then they will be capable to grasp comparably fewer capital than minor firms like to credit unions which pose partial systemic risk to fiscal systems.

**8.2 The ‘New Basel Accord' in Bangladesh**

Banks may be developed an easy and standardized approach on the basis of internal rating system. Which one is applicable to those banks that are not internationally active. As a part of this process ranges of standardized risk weights are 0%- 150% for the internationally active banks. Supervisors may chalk out, such ratings with Slandered Probability of Default on the basis of collective data from nominated banks. As a leader of rating systems banks need to develop and improve the strength of the IRB approach.
As a result, the New Basel Capital Accord primarily functional to all globally active banks. In addition, a basic standardized approach, as advised earlier, may be developed for additional banks as fine as countrywide supervisors should to have decision of put into practice the new Basel Accord.

The focusing purpose of the Basel II is to making sure of competitive equality & provides a balanced degree of stability in function. It is necessary that all supervisors, around the world must have a common definition of internationally active and significant banks.

In this instance, all banks with cross-border business exceeding a certain percentage of their whole business may be defined as globally active banks. Significant banks may be defined those banks with complex structures and their market share in the total assets of the local banking system exceeds a universally accepted market share. In this regard supervisors inside the country have reserves the right to describe the comprises quality of an international bank and a significant bank . Every single supervisor may be required to declare the criteria adopted for defining globally active and significant banks in its authority through the Basel Committee. The criteria, when certified, be supposed to be accepted by supervisors in other authorities and by global agencies .

Cross-holdings of equity and other regulatory investment bodies as well required to be rational to conserve the consistency of the fiscal arrangement as well as reduce the adverse effect of systemic risk and contagion.

The Basel Committee may consider prescribing a substance limit up to which cross holding of capital & other authoritarian investments could be allowed and any surplus investments over the limit would be removed from total capital.

As a result, such of the ECAs that reveals openly their risk scores, rating process and method & subscribe to the publicly disclosed OECD methodology & qualify for use by domestic supervisors would only be entitled for use in assigning preferential risk weights. Among all the financial institutions Banks are strongly supervised and regulated entities. But for the sick and problem banks needs more on site and off site supervisions as well as strong prudential standards. That’s why the risks in the interbank coverage are not equivalent with other corporate. This is the reason that’s why banks need tailor maid action for claims. Basel committee provide the supervisors staying inside the country legal rights to allot minor risk weight to the experiences to the sovereign of integration, depreciation in domestic currency & supported in the currency.

Henceforth, the IRB approach can be applicable to the banks that are active across the globe within the time line proposed by the Basel Committee. It is proposed a simplified standardized approach for assigning preferential risk weights based on internal ratings of banks may be developed. Focusing to observe with the minimum standards suggests by the Basel Committee for IRB Approach. In this move toward, consistent risk weights, as an alternative continuous function of PD, Loss Given Default and Exposure at Default in the range of 20% to 150% could be allocated subject to mapping of these ratings based on the
force of the ranking systems & the standard PD predictable by the supervisor on the basis of pooled data from selected banks.

When, worldwide active banks might require to track the IRB approach, here is a basic consistent approach may be developed for added banks. Bank lending in the emerging markets for productive purpose are sufficiently collateralized with various types of assets. The suggestion of past dues for more than 90 days might be restrictive. Domestic supervisors might have the authority on collateral consideration the greater range of collateral against securing the assets. And that could be done to avoid regulatory arbitrage.

Consequently, domestic supervisors should have authority in defining the exposure classes that is corporate, retail sovereign, project finance etc.

The highest degree of operational risk arises from complexity of operations; the group might believe the learning on operational risk through the references to observe the rate of losses, correlation by means of credit and market risks, operational risk etc.

Until a scientific procedure of measuring the operational risk is being deployed, Basel committee might proposed a minor capital charge on the gross income or a certain percentage of current capital requirements over the underlying risk profile. For the ‘outliers’ bank local supervisors may given the authority to prescribe charge in higher capital.

The proposals to authorization regular disclosures on in sequence, focus of time decay, would craft simple market players in taking conversant decisions.

Three years have been provided as transition period which began from the date of completion for complete sub-consolidation. In the same time a three year transition period has also been provided for foundation of IRB approach. Within this period the requirements may be relaxed although the regulatory body expects to ensure sound IRB approach within the time frame.

The time provided by the authority may be sufficient for the foreign banks operating in Bangladesh but for others it may need more time.

Thus, if not suitably modified, the implementation of the New Basel Accord in its current format would result in major increase in the capital charge for banks, particularly in the emerging markets.

8.3 Recommendations

The total banking system plays a vital role in an economy by funding enterprises, pooling risks, making payments and mobilizing savings. The task of supervisory bodies to make sure that banks operate in a sound manner and the capital they holds and reserves are adequate to bear the risks that may arises in their trade. Tight, strong and effective banking supervision system offers a public good that may not be completely provided in the market place in the same time. With effective macroeconomic policy, is complex to financial stability in a
specific country. If the cost of bank supervision is high then the cost of poor supervision proved higher.

The following recommendations are made in the context of Bangladesh:

- Supervision function of Bangladesh Bank should be strengthened for effective supervision. Supervisor must be careful so that nothing happens like the collapse of the Oriental Bank Limited recently.
- Supervisors of Bangladesh Bank must have to understand the nature of investment that bank are incurring. In the same time they have to ensure the risks taken by the banks are being sufficiently managed.
- It is essential for the supervisors to make sure that the banks have suitable wealth to undertake hazards, having adequate capital, skilled and strong management, efficient monitoring systems & every other accounting record.
- It is significant & essential for the national legislators that they could give urgent thought to the changes important to make sure that principles can be applied in all material respects.
- A serious effort is needed to bring the Bangladesh Bank supervisory standards up to the level indicated in the core principles.
- Bangladesh Bank’s autonomy and ability to act on ownership changes needs to be further strengthened through legislation and practices.
- Bangladesh Bank should issue guidelines to set “Ethical Standards” by commercial banks.
- Deposit insurance system should be made more effective.
- This deserves infusion of market participants in the decision process.

*For Oriental Bank, it was almost bankrupt, which forced BB to take full control and authority of the bank. Whereas the BB was taking into consideration a number of options, it finally decided to take over the bank’s responsibility. Previously, some of the non banking financial institutions became almost bankrupt due to not having proper management, but never a scheduled bank came on the closer of bankruptcy before.

Oriental Bank got the license in 1987. From the very beginning that bank fell into trouble due to its insider lending, poor management and corruption. In the year of 1994 Bangladesh Bank enlisted seven problem banks and Oriental bank was one of them. Six other banks come out from problem banking already but Oriental bank continued as the only problem bank and its situation was deteriorating day by day.

In December 2001 Oriental banks total loss stood at Tk 86.34 crore which climbed up to Tk 450 crore by March 2006. At the end of March 2006 overall capital deficit stood at Tk 877 crore.

In side Bangladesh only four out of 48 schedule banks have provisional shortfall. Among them Three of the banks have a provisional shortfall below Tk 60 crore, while Oriental's shortfall stood at Tk 322 crore in March 06.

The bank has to incur a huge loss to maintain statutory liquidity ratio (SLR) with Bangladesh Bank and paid high interest in the call money market. Other than this its deposit growth has also been declining. Throughout its last working calendar year its deposit growth fallen by 3% in compared with the previous year.

The central bank brought the issue to the governments notice that the situation of Oriental banks bad performance. Matter of sorrow that political considerations always refrained the government from providing Bangladesh Bank the signal for taking necessary action against the problem bank”.

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