DISCLOSURE ON CAPITAL ADEQUACY & MARKET DISCIPLINE

Capital Adequacy Ratio:

The Capital Adequacy Ratio (CAR) measures the amount of capital any financial institution retains compared to its risk and risk weighted assets. It determines how effectively any financial institution can sustain in case of a reasonable amount of loss or how efficiently it can protect the organization against probable financial risks. The CAR is important to shareholders because it is an important measure of the financial soundness of a financial institution.

Two types of capitals are measured with the CAR, first the tier 1 capital which can absorb a reasonable amount of loss without forcing the bank to cease its trading and the second type, tier 2 capital which can sustain loss in the event of liquidation. Tier 2 capital provides comparatively less protection to its depositors and creditors.

The CAR provides shareholders with a better understanding of the risks a financial institution is taking with the equity they provide. A bank that continually takes more risks than it can reasonably sustain leaves potential shareholders with a sense that their equity investments are more at risk. A financial institution must maintain a professional level of risk management and sound lending practice to attract the capital that acts as its first line of defense against loss, both expected and unforeseen.

Significance of Capital Adequacy:

Capital is the backbone of any business, especially a financial institution where capital sufficiency is a prime factor to consider when assessing the safety and soundness of business. Minimum capital level is significantly important for a Financial Institution so that adequate protection against risk can be ensured. A strong Capital Management Policy protects an organization by identifying and mitigating risks, as well as establishes a base of confidence by depositors, creditors, and other stakeholders.

Capital Adequacy gives an over-view on a Financial Institution's strength and stability and adequate capital provides assurance to the stakeholders regarding the company's ability to provide consistent services and financial supports. Capital Adequacy is a basis for measurement of capital that FI needs to hold for ensuring that no excess leverage is taken that could lead to insolvency. Capital Adequacy measurement is expressed as the Capital Adequacy Ratio (CAR), also known as Capital to Risk Weighted Assets Ratio.

CAR is a measure of a financial institution's eligible capital expressed as a percentage of its risk weighted asset. The objective of CAR is built around the Market Discipline, whereby depositors' and creditors get a standardized measurement on the extent to which their wealth is exposed to risk, and thereby establish confidence on the Financial Institution's continuity and strength. The CAR measurement is also directed towards making a financial institution's capital more risk sensitive and shock absorbent.

Basel II guidelines:

According to the capital adequacy guideline, the following three points are important and to be followed:

(i) **Minimum Capital:** Minimum capital requirements to be maintained by a FI against credit, market, and operational risks.

(ii) **Capital Growth:** Process for assessing the overall capital adequacy aligned with risk profile of a FI as well as capital growth plan.

(iii) **Public Disclosure:** Framework of public disclosure on the position of a FI risk profiles, capital adequacy, and risk management system. This forms the basis of Market Discipline.

Two Levels of Regulatory Capital Requirement:

As per guideline, two tiers of capital is required to be kept i.e. Tier 1 Capital and Tier 2 Capital.

Core Capital: Tier 1 Capital, also called the 'Core Capital', is the core measure of a FI financial strength from a regulator's point of view. FI have to maintain at least 50% of required capital as Tier 1 capital.

Supplementary Capital: Tier 2 Capital is called the 'Supplementary Capital' and represents other elements which fall short of some of the characteristics of the core capital but contribute to the overall strength of a financial institutions. According to Bangladesh Bank's Guideline for NBFIs, the computation of the two capital grades are subject to the following conditions:

(i) Tier 2 Capital amount will be limited to 100% of the amount of Tier 1 Capital.

(ii) 50% of revaluation reserves for fixed assets and 45% for securities, and 10% of revaluation reserves for equity instruments are eligible for Tier 2 Capital.

(iii) General provision in the Tier 2 Capital can be up to a limit of 1.25% of Risk Weighted Asset for Credit Risk.

Common capital ratios as per the regulatory requirements are as follows:

Capital Ratio		Statutory Limit
(i) Core Capital Ratio	(Core Capital/ Risk-adjusted Assets)	>= 5%
(ii) Total Capital (Core + Supplementary)	(Total Capital/ Risk-adjusted Assets)	>= 10%

Effective risk management is considered a central part of the financial and operational management of any company, whereby company sustainability and consistent profit generation are ensured. Only by adopting and strengthening risk management measures can the company deal with the complex and dynamic business environment. Group Risks are managed on an integrated basis. Risk management is incorporated in the Group decision making with regards to strategic planning.

Effective Risk Management

The risks which form the basis for effective risk management are: credit, market, operational, and liquidity risks.

Credit Risk: Credit risk is a risk where the FI will not be able to recover the money it has owed. It occurs due to failure of the counter party to meet its obligations to pay the company in accordance with the agreed terms. The risk depends on the financial strength of the party owing to the FI as well as market factors that affect the value of assets used as lien against the loan. Credit risk calculation recognizes and adjusts for two factors:

(i) On Balance Sheet credit exposures refer to the credit risks that the various assets in the balance sheet are exposed to. These assets are weighted according to the degree of the risks exposed.

(ii) Off Balance Sheet credit exposures refer to the credit risks on the credit equivalent amounts of the various off balance sheet items.

Market Risk: Market risk is the potential for loss in earnings or in economic value of the FI's asset portfolio due to adverse changes in financial market rates or prices. The preferred approach to calculating this risk is VaR (Value at Risk).

Operational Risk: Operational Risk is the risk of a change in value caused by the fact that actual losses, incurred for inadequate or failed internal processes, people and systems, or from external events (including legal risk), differ from the expected losses. The risk can be deliberate, accidental or natural. The FI's objective is to minimize the operational risk exposure within a framework of policies and procedures. Risk Weighted Assets (RWA) is a Financial Institution's assets or off balance-sheet exposures, weighted according to risk. By adjusting the amount of each asset for an estimate of how risky it is, a rough measurement of the company's financial stability can be determined.

Liquidity Risk: Liquidity risk is the risk where a company or FI may be unable to meet short term financial demands. This usually occurs due to the inability to convert a security or hard asset to cash without a loss of capital and/or income in the process.

Capital Adequacy for IIDFC Limited

At IIDFC, Capital Management Policy sets out the principles and guidelines for effective and prudent capital planning, usage, and management of it. The policy defines the minimum criteria for ensuring that adequate capital is kept and effective management is performed. Capital Adequacy is explicitly followed in adherence to the statutory compliance and regulatory requirements of Basel II guidelines, affected by Bangladesh Bank from 1st January 2010. The guidelines are prudently followed to safeguard the IIDFC's ability to continue as a going concern, by establishing a strong capital base, and to maintain high credit rating as well as the confidence of the investors and creditors. At IIDFC, capital planning is done in alignment with the company's risk appetite and profile. Capital goals are set to incorporate both normal and stressful business conditions. As such, the goals take into considerations current and future regulatory requirements and economic conditions, and the expectations of stakeholders. Capital targets accommodate forward looking viewpoints on economic outlook, company's current financial condition, and future uncertainties inherent in capital planning. In line with this objective, capital base is set at 1% higher than the minimum CAR. This ensures full compliance as well as a buffer against capital loss during stressful situations.

The company emphasizes on strong capital management through the followings:

(i) Maintaining regulatory requirements of capital.
(ii) Supply and demand forecast of capital to support business strategy and continuity.
(iii) Incorporate rolling capital plan covering a time horizon of two to three years.
(iv) Internal Controls and Governance to manage company's risk, performance and capital.

Capital strategies are periodically reviewed to ensure that strong governance and process framework are in place for effective risk management. Material capital risk is assessed periodically which supports the company's internal capital adequacy requirements. The scope of application of such guidelines applies to 'Solo' as well as to the 'Consolidated' basis.

(i) 'Solo Basis' refers to all position of the FI and its local and overseas branches/offices.

(ii) 'Consolidated Basis' refers to all position of the FI (including its local and overseas branches/offices) and its subsidiary companies engaged in financial (excluding insurance) activities like merchant banks, brokerage firms, discount houses, etc. Since IIDFC has subsidiary companies, the guidelines apply to both 'Solo' and 'Consolidated' basis.

Breakdown of each category of eligible capital is given below.

(A) Core Capital of IIDFC Limited is as follows:

Amount in Million

Particulars	Solo Basis		Consolidated Basis	
	2018	2017	2018	2017
Fully paid -up capital/capital lien with BB	1,200.00	1,000.00	1,200.00	1,000.00
Statutory reserve	366.71	336.31	366.71	336.31
Non -repayable share premium account (Share money deposit)	123.11	-	123.11	-
General reserve	49.80	48.80	66.80	65.80
Retained earning	238.02	317.44	306.68	361.69
Minority interest in subsidiary	-	-	0.15	0.15
Non -cumulative irredeemable preference share	-	-	-	-
Dividend equalization account	-	-	-	-
Other (if any item approved by BB) share money deposit	-	-	-	-
Less: Shortfall in provisions required against investment in shares	-	-	-	-
Less: Book value of Goodwill	-	-	-	-
Total	**1,977.64**	**1,702.55**	**2,063.45**	**1,763.95**

(B) Supplementary Capital of IIDFC Limited is as follows:

Amount in Million

Particulars	Solo Basis		Consolidated Basis	
	2018	2017	2018	2017
General provision (unclassified loans up to specific limit + SMA+ Off B/S exposure)	201.32	113.51	517.70	450.87
50% of Assets Revaluation Reserve	-	-	-	-
10% of Securities Revaluation Reserve	-	-	-	-
All other preference shares	-	-	-	-
Other (if any item approved by Bangladesh Bank)	-	-	-	-
Total	**201.32**	**113.51**	**517.70**	**450.87**