

## 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 capital are measured with the CAR, first the tier 1 capital, can absorb a reasonable amount of loss without forcing the bank to cease its trading and the second type, tier 2 capital, 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 backbone of any business specially, 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 on 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 to be followed.

- (i) **Minimum Capital:** Minimum capital requirements to be maintained by a bank against credit, market, and operational risks.
- (ii) **Capital Growth:** Process for assessing the overall capital adequacy aligned with risk profile of a bank as well as capital growth plan.
- (iii) **Public Disclosure:** Framework of public disclosure on the position of a bank's risk profiles, capital adequacy, and risk management system. This forms the basis of Market Discipline.

## Two Level of Regulatory Capital Requirement:

As per guideline two tier of capital is required to be kept ie. Tier 1 Capital and Tier 2 Capital.

**Core Capital:** Tier 1 Capital, also called the 'Core Capital', is the core measure of a bank's financial strength from a regulator's point of view. Banks 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)	$\geq 5\%$
(ii) Total Capital (Core + Supplementary)	(Total Capital/ Risk-adjusted Assets)	$\geq 10\%$

Effective risk management is considered as 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 that 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 bank 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 that a company or bank 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	
	2021	2020	2021	2020
Fully paid-up capital/capital lien with BB	1,737.77	1,737.77	1,737.77	1,737.77
Statutory reserve	371.95	371.95	371.95	371.95
Non-repayable share premium account (Share money deposit)	-	-	-	-
General reserve	50.80	50.80	67.80	67.80
Retained earning	(944.94)	(56.35)	(86.02)	24.35
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	-	-	-	-
<b>Total</b>	<b>1,215.58</b>	<b>2,104.16</b>	<b>1,317.51</b>	<b>2,202.02</b>

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

Amount in Million

Particulars	Solo Basis		Consolidated Basis	
	2021	2020	2021	2020
General provision (unclassified loans up to specific limit + SMA+ Off B/S exposure)	169.79	179.54	447.89	476.27
50% of Assets Revaluation Reserve	-	-	-	-
10% of Securities Revaluation Reserve	-	-	-	-
All other preference shares	-	-	-	-
Other (if any item approved by Bangladesh Bank)	-	-	-	-
<b>Total</b>	<b>169.79</b>	<b>179.54</b>	<b>447.89</b>	<b>476.27</b>

## Risk Management

At IIDFC Limited, disciplined risk management is considered as the key to organizational success. With that objective in mind, strong management structure and risk management system, along with robust policies are developed to allow the company to manage the internal and external, and regulatory environments. A robust risk management framework is built to effectively cover the necessary requirements of managing risk. Establishment and oversight of the Group's risk management framework lies with the Company's Board of Directors. The risk management policies are established to identify and analyze the risks faced by the Group, to set appropriate risk control standards, and to monitor the risks and adhere to defined policies. Protocols and responsibilities are clearly delineated such that decision making with regards to risk management are taken positively. IIDFC contemplate on having the industry practices of identifying, measuring and controlling risks. The Risk management policies and systems are reviewed regularly to reflect changes in market conditions and operations. The Group, through its training and management standards and procedures, aims to develop a disciplined and constructive control environment in which all employees understand their roles and obligations.

By implementing rigorous risk management policy, risk adjusted returns are maximized, while ensuring that the company remains within its desired risk appetite. Emphasis is given on establishing a risk management culture which takes into account the underlying assertions: (i) Risk considered must be in line with the company's goals, and also must support the company's risk appetite. (ii) Responsibility of identifying and taking risks within the organization lies with every employee.

The company carries the overall responsibility of ensuring that the risk-taking within the organization is disciplined and focused. Accountability is ensured by taking risk agreed by the respective company authorities and also assuring that the risks taken are transparent, controlled, reported and falls within the appropriate infrastructure and resource. Future risk emergence is identified and necessary steps taken to anticipate its impacts. Effective Risk Management Policy and Controls are founded to use the risk as a competitive advantage. Continuous improvement of the risk management approaches and methodologies to enhance current risk policies. Analyze and establish any new or improved policy to strengthen the company's risk management position. Ensuring consistent statutory compliance with regards to capital adequacy and risk management.

In accordance with the Basel II guidelines, IIDFC takes precautionary methods against credit, market, operational, and liquidity risks.

**(i) Credit Risk:** Credit Risk is effectively measured and managed through a framework of policies and procedures. All credit exposures undergo proper approving authority as a mean of effective management of counter party credit risk. A defined structure is established for delegation of credit approval authority and for monitoring compliance with appetite. Proper due diligence is applied to review the credit applications. Defined processes and procedures are used to support credit underwriting activities at levels of the business. As a part of proper underwriting standards, appropriate valuations of collaterals are done for secured credits.

A counter party is also required to have an approved limit in place, prior to draw down of funds. Every credit party is subject to credit rating, and the rating is actively monitored as a part of effective credit risk management. Account level activity along with limit utilization monitoring is set as a part of risk trigger-mechanism. This helps to identify early alert situations based on which the company can take proper actions. Potential problem accounts are identified, investigated, controlled and monitored.

Past dues and impaired exposures are defined in accordance with the relevant Bangladesh Bank regulations. Specific and general provisions are computed periodically in accordance with the Bangladesh Bank regulations. The Group writes off a loan or an investment debt security balance, and any related allowances for impairment losses, when Group Credit determines that the loan or security is non-collectable. This determination is made after considering information such as the occurrence of significant changes in the borrower's / issuer's financial position such that the borrower/issuer can no longer pay the obligation, or that proceeds from collateral will not be sufficient to pay back the entire exposure.

**(ii) Market Risk:** Market Risk management is set as per the parameters defined in the policy. The objective of the Group's market risk management is to manage and control market risk exposures set within the acceptable parameters, thereby ensuring solvency while optimizing the Group's risk return strategy. Sufficient oversight and reporting are conducted for management of market risk profile. Overall authority for market risk rests with the ALCO. Setting market liquidity as the primary factor for determining the level of limits for portfolio trading, ALCO provides limits for each type of risk in aggregate and for individual portfolios.

**(iii) Operational Risk:** Operational Risk framework is designed to ensure operational risk identification, assessment, control and monitoring at business and group level. Management of operational risks is an integral part of the roles played by business and the functional teams. The Risk Management Division oversees whether the operational risk exposures fall within the policy. Defined standards of measurement are also outlined which plays one of the critical roles of ensuring that the risks are managed within the acceptable tolerance limits. The policies and standards are also reviewed periodically to keep the framework updated. The types of events that could result in material operational risk loss or business disruptions are as follows:

- a. Internal and external fraud
- b. Damage to physical assets
- c. Business process disruptions and system failures
- d. Failure in service executions and deliveries, as well as process management
- e. Liquidity Risk is managed by the ALCO team within the pre-defined liquidity limits set by and in compliance with the policies and regulatory requirements. The Treasury division oversees the implementation of policies and other controls relating to liquidity risks while managing the liquidity position of the company on a day to day basis.

RWA figure is calculated on the basis of credit, market, and operational risks. Total RWA is determined by first multiplying the amount of capital charge for market risk and operational risk with the reciprocal of the minimum CAR. The resulting figure is added to the sum of the risk weighted assets for credit risk.

#### Calculation of Risk Weighted Assets

(Amount in million)

Particulars	Solo Basis		Consolidated Basis	
	2021	2020	2021	2020
<b>Credit Risk</b>				
1. On B/S	13,532.57	14,312.03	14,562.38	15,099.95
2. Off B/S	50.89	50.89	50.60	50.89
Market Risk	851.02	416.10	704.31	708.17
Operational Risk	824.24	1017.21	1,017.59	1232.60
<b>Total RWA</b>	<b>15,258.72</b>	<b>15,796.23</b>	<b>16,334.89</b>	<b>17,091.61</b>

**Capital Adequacy Ratio (CAR) = (Core Capital +Supplementary Capital)/RWA**

## Capital Adequacy

(Amount in million)

Particulars	Solo Basis		Consolidated Basis	
	2021	2020	2021	2020
Core Capital	1,215.58	2,104.16	1,317.51	2,202.03
Supplementary Capital	169.79	179.54	447.89	476.27
Total Eligible Capital	1,385.37	2,283.70	1,765.40	2,678.30
Risk Weighted Assets	15,258.72	15,796.23	16,334.89	17,091.61
Capital Adequacy Ratio	9.08	14.46	10.81	15.67
Core Capital to RWA	7.97	13.32	8.07	12.88
Supplementary Capital to RWA	1.11	1.14	2.74	2.79
Minimum Capital Requirement (10% of RWA)	1,525.87	1,579.62	1,633.49	1,709.16
Excess capital over regulatory requirement	(140.50)	704.08	131.91	969.14

Capital Adequacy Ratio (CAR) of IIDFC is more than the Bangladesh Bank's CAR requirement of 10%. The status is in line with the IIDFC's approach for being compliant and to establish investors' confidence. Moreover IIDFC is getting prepared for the BASEL-III requirement which is currently applicable for Bank but may be applicable for Non-Banking Financial Institutions in near future.