NATIONAL BANK OF PAKISTAN

Bangladesh Operation

DISCLOSURES ON RISK BASED CAPITAL (BASEL II) FOR THE YEAR 2011

Bank followed the given guidelines Bank's Tier 2 Capital comprises of above specified elements. However, Bank is yet to resort to preference shares or any kind of subordinate debts.

These disclosures under Pillar III of Basel II are made following revised "Guidelines on Risk Based Capital Adequacy (RBCA) for banks issued by Bangladesh Bank (Central Bank of Bangladesh) in December 2010. These quantitative and qualitative disclosures are intended to complement the Minimum Capital Requirement (MCR) under Pillar I and Supervisory Review Process (SRP) under Pillar II of Basel II.

The major highlights of the Bangladesh Bank regulations are :

▶ To maintain capital adequacy ration (CAR) at a minimum of 9% Risk Weighted Assets

▶ To adopt the standardized approach for credit risk for implementing Basel II, using notional discretion for;

- adopting the credit rating agencies as external credit assessment institutions (ECA) for claims on sovereigns and banks;
- adopting simple/comprehensive approach for Credit Risk Mitigation (CRM)
- all unrated corporate exposures are risk weighted by assigning 125% of risk weight.

▶ To adopt standardized approach for market risk and indicator approach for operational risk.

▶ Capital adequacy returns must be submitted to Bangladesh Bank on a quarterly basis.

The purpose of these disclosures is to present relevant information on adequacy of capital in relation to overall risk exposures of the Bank so that the market participants can assets the position and direction of the Bank in making economic decisions.

Above guidelines were issued by Bangladesh Bank (BB) under section 13 section 45 of Bank Company Act, 1991 and also in accordance with "International Convergence of Capital Standards: A Revised Framework" of June, 2006 (popularly known as 'Basel II Capital Adequacy Framework') released by Basel Committee on Banking Supervision (BCBS).

Scope of Application

The Bank has no subsidiaries or significant investment and Basel II is applied at the Bank level only.

Capital Base

Regulatory capital has been categorized into three tiers: Tier 1. Tier 2. Tier 3 respectively

a) Tier 1 Capital:

Tier 1 capital called 'Core Capital' comprises of highest quality of capital elements that consists of

- Paid-up Capital
- Statutory Reserve
- Retained Earnings
- Dividend Equalization Fund
- Non- Repayable Share Premium Account
- General Reserve
- Minority interest in Subsidiaries
- Non-Cumulative irredeemable Preference Shares
- Dividend Equalization Account

Bank's Core comprises of the above elements except for " Non-cumulative irredeemable preference shares' and 'Divided Equalisation Account'.

b) Tier 2 Capital:

Tier 2 Capital called ' Supplementary Capital' represents

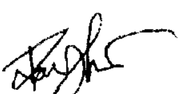
- General provisions
- Assets Revaluation Reserves
- All Other Preference Shares
- Perpetual Subordinate Debt
- Exchange Equalization Accounts
- Revaluation Reserve fro Fixed Assets
- Revaluation Reserve fro equity instrument

c) Tier 3 Capital:

Tier 3 capital called 'Additional Supplementary Capital', consists of short-term subordinated debt (original maturity less than or equal to five years but greater than or equal to two years) would be solely for the purpose of meeting a proportion of the capital requirements for market risk.

The amount of Tier 2 capital will be limited to 100% of the amount of Tier 1 capital.

Bank has no Tier 3 capital as mentioned earlier.



Conditions for maintaining regulatory capital

The calculation of Tier 1 capital, Tier 2 capital, and Tier 3 capital is subject to the following conditions

(a) The amount of Tier 2 capital will be limited to 100% of the amount of Tier 1 capital

(b) 50% of revaluation reserves for fixed assets and securities eligible for Tier 2 capital

(c) 10% of revaluation reserves for equity instruments eligible for Tier 2 capital

(d) Subordinated debt shall be limited to a maximum of 30% of the amount of Tier 1 capital

(e) Limitation of Tier 3: A minimum of about 28.5% of market risk needs to be supported by Tier 1 capital. Supporting of Market Risk from Tier 3 capital shall be limited up to maximum of 250% of a banks Tier 1 capital that is available after meeting credit risk capital requirement

Bank complied with the conditions as embodied in this respect wherever applicable.

In order to obtain the eligible regulatory capital for the purpose of calculating Capital Adequacy Ratio (CAR), banks are required to make following deductions from their Tier-1 capital

(a) Intangible asset e.g., book value of goodwill and value of any contingent assets, etc. which are shown as assets

(b) b) Shortfall in provisions required against classified assets.

(c) Shortfall in provisions required against investment in shares

(d) Remaining deficit on account of revaluation of investments in securities after netting off from any other surplus on the securities.

(e)) Reciprocal/crossholdings of banks capital/subordinated debt artificially intended to inflate the capital position of banks

(f) Holding of equity shares in any form exceeding the approved limit under section 26(2) of Bank Company Act, 1991. The additional/unauthorized amount of holdings will be deducted at 50% from Tier 1 capital and 50% from Tier 2 capital.

g) Investments in subsidiaries, which are not consolidated. The normal practice is to consolidate subsidiaries for the purpose of assessing the capital adequacy of banking groups. Where this is not done, deduction is essential to prevent the multiple uses of the same capital resources in different parts of the group. The deduction for such investments will be 50% from Tier 1 capital and 50% from Tier 2 capital. The assets representing the investments in subsidiary

companies whose capital had been deducted from that of the parent would not be included in total assets for the purposes of computing the CAR

Eligible Tier 2 capital will be derived after deducting components (if any) qualified for deduction. Total eligible regulatory capital will be calculated by summing up the eligible Tier 1, Tier 2 and Tier 3 capital.

Calculation of Capital Adequacy Ratio

In o rder to calculate C AR, banks are r equired to calculate t heir Risk Weighted-Assets (RWA) on the basis of credit, market, and operational risks. Total RWA will be determined by multiplying the amount of capital charge for market risk and operational risk by the reciprocal of the minimum CAR and adding the resulting figures to the sum of risk w eighted a ssets for credit risk. T he CAR is then calculated by taking eligible regulatory capital as numerator and total RWA as denominator.

In proper terms.

Minimum capital requirements

a) No Scheduled Bank in Bangladesh shall commence and carry on its business unless it has the minimum required capital fixed by BB from time to time as per section 13 of Bank Company Act, 1991.

b) Banks have to maintain minimum CAR on „Solo basis as well as on „Consolidated basis as per instruction(s) given by BB from time to time.

Bank has been able to maintain required CAR on both 'Solo' as well as 'Consolidated' basis. Banks presents Tier I Capital ratio is 84.66% and 84.57% to total Capital on Solo and Consolidated basis respectively.

c) Banks have to maintain at least 50% of required capital as Tier 1 capital

Credit Risk:

Credit risk is the risk of financial loss if a customer or counter party fails to meet a payment obligation under a contract. It arises principally from direct lending, trade finance and leasing business, but also from off-balance sheet products such guarantees and credit derivatives, and from the holdings of debt securities. HSBC Bangladesh has standards, policies and procedures dedicated to controlling and monitoring risk from all such activities. Among the risks the HSBC Bangladesh engages in, credit risk generates the largest regulatory capital requirement.

The aims of credit risk management, underpinning sustain ably profitable business, are principally

▶ To maintain a strong culture of responsible lending supported by a robust risk policy and control frame work.

▶ To both partner and challenge business originators effectively in defining and implementing risk appetite, and its re-evaluation under actual and scenario conditions: and'

▶ To ensure independent, expert scrutiny and approval of credit risks, their costs and their mitigation.

The standardized approach is applied for risk weighting of exposure as per directive of Bangladesh Bank. It requires banks to use risk assessments prepared by External credit Assessment Institution (ECAIS) to determine the risk weighing applied to rated counter parties. The bank has used some of customer rating based on their entry rating as assigned by the approved ECAIS of Bangladesh Bank.

A typical Credit risk management framework in a financial institution may be broadly categorized into following main components:

a) Credit Committee and senior Management's Oversight
b) Organizational structure
c) Systems and procedures for identification, acceptance, measurement, monitoring and control risks.

Measuring Credit Risk

The measurement of credit risk is of vital importance in credit risk management.
A number of qualitative and quantitative techniques to measure risk inherent in credit portfolio are evolving. To start with, banks should establish a credit risk-rating framework across all type of credit activities. Among other things, the rating framework may, incorporate:

Business Risk

- Industry Characteristics
- Competitive Position (e.g. marketing/technological edge)
- Management

Financial Risk

- Financial condition
- Profitability
- Capital Structure
- Present and future Cash flows
- **Credit Risk Monitoring & Control:**

Credit risk monitoring refers to incessant monitoring of individual credits inclusive of Off-Balance sheet exposures to obligors as well as overall credit portfolio of the bank. Banks need to enunciate a system that enables them to monitor quality of the credit

portfolio on day-to-day basis and take remedial measures as and when any deterioration occurs. Such a system would enable a bank to ascertain whether loans are being serviced as per facility terms, the adequacy of provisions, the overall risk profile is within limits established by management and compliance of regulatory limits. Establishing an efficient and effective credit monitoring system would help senior management to monitor the overall quality of the total credit portfolio and its trends. Consequently the management could fine tune or reassess its credit strategy /policy accordingly before encountering any major setback. The banks credit policy should explicitly provide procedural guideline relating to credit risk monitoring. At the minimum it should lay down procedure relating to

- The roles and responsibilities of individuals responsible for credit risk monitoring
- The assessment procedures and analysis techniques (for individual loans & overall portfolio)
- The frequency of monitoring
- The periodic examination of collaterals and loan covenants
- The frequency of site visits
- The identification of any deterioration in any loan

Methodology

Bangladesh Bank adopted Standardized Approach for calculating Risk Weighted Assets. The capital requirement for credit risk is based on the risk assessment made by external credit assessment institutions (ECAIs) recognized by BB for capital adequacy purposes. Banks are required to assign a risk weight to all their on-balance sheet and off-balance sheet exposures. Risk weights are based on external credit rating (solicited), which was mapped with the BB rating grade or a fixed weight that is specified by Bangladesh Bank.

Credit Risk Mitigation

National Bank of Pakistan uses a number of techniques to reduce its credit risk to which the Bank is exposed. For example, exposures may be collateralized by first priority claims, in whole as in part with cash or securities, a loan exposure may be guaranteed by a third party. Additionally Bank may agree to net loans owed to them against deposits from the same counter party.

National Bank of Pakistan

Bank uses Comprehensive Approach as adopted by the Central Bank. In this approach when taking collateral, Bank will need to calculate adjusted exposure to a counter party

for capital adequacy purposes in order to take account of the effects of that collateral. Using haircut, Bank is required to adjust both the amount of the exposure to the counter party and the value of any collateral received in support of that counter party to take account of possible future fluctuations in the value of either, occasioned by market movements. This will produce volatility-adjusted amounts for both exposure and collateral.

Market Risk:

It is the risk that the value of on and off-balance sheet positions of a financial institution will be adversely affected by movements in market rates or prices such as interest rates, foreign exchange rates, equity prices, credit spreads and/or commodity prices resulting in a loss to earnings and capital.

Methodology

In Standardized Approach, the capital requirement for various market risks (interest rate risk, equity price risk, commodity price risk, and foreign exchange risk) is determined separately. The total capital requirement in respect of market risk is the sum of capital requirement calculated for each of these market risk sub-categories. The methodology to calculate capital requirement under Standardized Approach for each of these market risk categories is as follows:

a) Capital Charge for Interest Rate Risk = Capital Charge for Specific Risk + Capital Charge for General Market Risk.

b) Capital Charge for Equity Position Risk = Capital Charge for Specific Risk + Capital Charge for General Market Risk.

c) Capital Charge for Foreign Exchange Risk = Capital Charge for General Market Risk

d) Capital Charge for Commodity Position Risk = Capital Charge for General Market Risk

Operational risk:

Bank followed the suggested methodology, process as contained in the guidelines.

The risk of losses resulting from inadequate or failed internal process, people and system or from external events creates operational risk. Its includes legal risk, but exclude strategic and reputation risk.

Measurement Methodology

In Bangladesh to operate bank shall compute the capital requirements for operational risk under the basic indicator. The capital charge for operational risk is a fixed percentage, denoted by (alpha), Approach (BIA) Under BIA, of a average positive annual gross income of the bank over the past three years If annual gross income figure is negative or zero for any years should be excluded from both the numerator and denominator when calculating the average.

Disclosure under Pillar

Disclosure given below as specified by RBCA guideline dated 29 December

Scope of Application

Qualitative Disclosure

a) The name of the top corporate entity in the group to which this guidelines applies.	The financial statement of National Bank of Pakistan is as follows: National Bank of Pakistan, Bangladesh Operation
b) An outline of differences in the basis of consolidation for accounting and regulatory purposes, with a brief description of the entities within the group (a) that are fully consolidated; That are given a deduction treatment; and (c) that are neither consolidated nor deducted (e.g. where the investment is risk weighted)	The Bank opened its branch in Dhaka in August; 1994.The bank opened its 2nd branch in April 2004 at Agrabad, Chittagong in Bangladesh to extend state-of-the-art computerization banking service to the people of the port city and commercial capital of Bangladesh. The bank opened its 3rd branch at Sylhet (Metropolitan Market, Sobhanighat) Sylhet on 1st April 2008 in Bangladesh to cater the banking services to the people of the south -east region of the country. The bank opened its 4th branch on 03rd April 2008 at Gulshan (80,Gulshan Avenue), Dhaka in Bangladesh to extend the banking service to the elite group of the aristocratic area as well as for all the people of the northern zone of the country. The bank also shifted its controlling office for Bangladesh operations at Gulshan 80,Gulshan Avenue (1st Floor) Dhaka.
(c) Any restrictions, or other major impediments, on transfer of funds or regulatory capital within the group	Not Applicable

Capital Structure
Qualitative Disclosure

a) Summary information on the terms and conditions of the main features of all capital instruments, especially in the case of capital instrument eligible for inclusion in tier 1 or tier 2	The main features of all capital instrument have been segregated in line with of the eligibility criteria set forth vide BRPD circular No.35 dated 29 December 2010and other relevant instruction given by Bangladesh bank from time to time. Below given the main features of the capital instruments. **Tier 1 capital instruments** **Paid-up share capital:** Issued, subscribe and fully paid up share capital of the bank. It represents paid up capital, Right shares as well as Bonus Shares issued from time to time. **Statutory Reserve:** As per section 24(1) of the bank companies act, 1991, an amount equivalent to 20% of the profit before taxes for each year of the Bank has been transferred to the statutory Reserve Fund. Bank is complied in this respect. General reserve: Any reserve created through Profit and loss Appropriation Account for fulfilling any purpose. Bank is complied in this respect Retained Earnings: After meeting up all expenditure, provision and appropriations which amount of profit retained with the banking company is called retained earning. Bank is complied in this respect. Tier 2 Capital instruments. Unclassified loans and off-balance exposure against general provision maintained: As per BB directive, amount of provision maintained against unclassified loans and off- balance sheet exposure as of the reporting date has been considered. Asset revaluation reserve: Asset revaluation reserve is considered on the basis of 50% as Tier 2 capital .The revaluation reserve was carried out by professional qualified valuation firm and duly certified by the external auditor of the bank.

	Revaluation reserve of securities: Up to 50% of revaluation reserves of governments securities has been considered as Tier 2 Capital as per Bangladesh Banks instruction. This compromises

Quantitative Disclosure as on 31-12-2011

		(Amount in core in Taka)
a) The amount of tier 1 capital with separate disclosure of (as of 30-09-2011)	**- Paid up Capital**	**460.74**
	- Non-repayable share premium account.	-
	- General reserve	-
	- Retained earnings	**1.61**
	- Minority interest in subsidiaries	-
	- Non-cumulative irredeemable shares	-
b) Total amount of tier 2 & Tier 3 Capital		**15.27**
c) Other deduction from capital		-
d) Total eligible capital		**477.62**

Capital Disclosure

- The discussion of the summary of banks approach to evaluates the adequacy of its capital to support current and future activities.
- It is the cushion required to be maintained for covering the credit risk. Market risk, and operational risk so as to protect the depositors and general creditors interest against such losses. In line with BRPD circular no.35 dated 29 December, 2010, the bank has adopted standardized approach for credit Risk, Standardized

(Rule Based) Approach for Market Risk and Basic Indicator Approach for operational Risk for computing Capital Adequacy. Quantitative Disclosure

Risk Weighted Asset (RWA) as on 31-12-2011

Risk Weighted Asset (RWA) for	Amount in core Taka
A) Credit Risk On- Balance sheet Off- Balance sheet	 1147.81 132.09
B) Market Risk	18.20
C) Operational Risk	63.55
Total: RWA (A+B+C)	1361.65

(Amount in core Taka)

b) Capital requirement for credit risk	127.99
c) Capital requirement for Market risk	1.82

d) Capital requirement for operational risk	6.35
e) Capital adequacy ratio	35.08%

Credit Risk

Qualitative Disclosure

- Credit risk is the potential for loss due to failure of a counter party to meet its obligation to pay the bank in accordance with agreed time.
- Credit risk is managed through a framework, which sets out policies and procedures covering the measurement and management of credit risk. There is a clear segregation of duties between transaction originators in the businesses and approvers in risk function. All credit exposure limits are approved within a defined credit approval authority framework.
- A comprehensive framework is in place for the management of counter party credit risk. This includes a structured process for the delegation of credit approval authority and for monitoring compliance with appetite. Policy and procedures are defined to support credit under writing activities at all levels of the group. These policies are defined at 3 levels- group, Business and country level.
- All credit decision are subject to underwriting standards which mandate defined process and procedures for performing credit checks and detailed due diligence reviews. System and controls are in place to monitor collateral value and loan covenants. Each counter party is also required to have an approved limit in place prior to draw down of funds. Limit excesses are actively managed and subject to reporting and escalation.
- Counter parties are subject to credit rating and these ratings are reviewed on a regular basis. Active monitoring of account of account level activity and limit utilization trends help to inform the early alert and risk trigger mechanism. Potential problem accounts are investigated, monitored and appropriate action taken. Standing committees dedicated to account and portfolio monitoring supported by portfolio information reports are a well established discipline. The portfolio is monitored from the point of view of industry concentrations, risk grade distribution and tenor and security profiles amongst other parameters.
- Credit risk from traded products is managed within the overall credit risk appetite for corporate and financial institution. The credit risk exposure from traded

products is derived from the positive market – to-market value of the underlying instrument, and an additional component to cater for potential market movements.

- Past dues and impaired exposure are defined in accordance with the relevant Bangladesh bank regulation. Specific and general provisions are computed periodically in accordance with the Bangladesh Bank regulations.

Details of Credit risk as on 31-12-2011

Quantitative Disclosure

Gross credit risk exposure:	**Amount in core TK Exposure**
Funded	**1539.87**
Non-funded	**105.67**
Total	**1645.54**
Distribution of risk exposure by claims	
a) Cash	**5.32**
b) Claims on Bangladesh Government and Bangladesh Bank.	**501.10**
c) Claims on bank & NBFIs:	
- Original maturity over 3 months	**-**
- Original maturity less than 3 months	**1.68**
d) Claims on corporate	**686.94**
e) Claims on retail portfolio and small enterprise	**223.96**
f) Past due claims	**103.61**
g) Investments in premises, plant and equipment and all other fixed asset	**2.10**
h) All other asset	
i) Off balance sheet items	**15.16**
	105.67

Credit Risk Mitigation	Amount TK. (Core)
➢ Claims secured by financial collateral	--
➢ Net exposure after the application of haircuts	--
➢ Claims secured by eligible guarantee	--

(Amount core tk)

Gross non performing asset (NPAs) Non performing asset to outstanding loan and advance as % basis	**13.03%**
Movement of non performing asset (NPAs) Opening balance Net movement during the quarter Closing balance	 **229.02** **(92.55)** **136.47**
Movement of specific provision for (NPAs) Opening balance of specific provision Provision recover during the period	 **36.05** **(3.2)**
Closing Balance of Specific Provision	**32.85**

MARKET RISK ON TRADING BOOK

Qualitative Disclosure:

Market risk is the risk that the fair value of future cash flows of the financial instrument will fluctuate due to change in different market variables, namely

- Interest rate risk
- Equity Position Risk
- Foreign exchange Risk
- Commodity Risk

All these risk are monitored by the treasury. The foreign exchange risk is managed by setting limits on open foreign exchange position.

Method Used to Measure Market Risk

To measure of market risk the Bank uses -- Value-at-Risk (VaR)

Market Risk & Liquidity Risk Management Policies and System

The objective of investment policy covering various face of market Risk is to assess and minimize risk associated with treasury operation by extensive use of risk management tools. Broadly it encompasses policy prescriptions for managing systematic risk, credit risk, market risk, operational risk and liquidity risk in treasury operation.

For market arising out of various products in trading book of the bank and its business activities, the bank sets regulatory internal and ensure adherence thereto. Limits for exposure to counter-parties, industries and countries are monitored and the risks are controlled through stop loss limits, Overnight limit, Daylight limit, Aggregate Gap limit, value at Risk (VAR) limit for Forum, Inter-bank dealing and investment limit etc.

The Bank uses the standardized (market risk) approach to calculate market risk for the trading book exposure for the purpose of regulatory reporting. Trading book consists of position in financial instruments held with trading intent or in order to hedge other elements of the trading book. A capital charge will be applicable for financial instrument which are from any restrictive covenants on tradability, or able to hedge completely. Generally, investments in Held for Trading portfolios are focal parts of the trading Book.

Liquidity risk of the bank is assessed through Gap analysis for maturity mismatch based on residual maturity in different time buckets as well as various liquidity ratios and management of the same is done within the prudential limit fixed thereon. Further bank is also monitoring the liquidity position through various stock ratios. The bank is proactively using duration gap and interest rate forecasting to minimize the impact of interest rate change.

Quantitative Disclosure

Particulars (The capital requirements For)	Amount (Core TK)
➤ Interest Rate Risk	--
➤ Equity position risk	--

➢ Foreign exchange risk	.80
➢ Commodity risk	- -
Total	**.80**

Operational risk:

Qualitative Disclosure:

Operational risk is the risk of direct or indirect loss due to an event or action resulting from the failure of internal process, people and system, or from external events. We seek to minimize exposure to operational risk, subject to cost trade-offs. We started capturing some pre identified risk events associated with all functional departments of the bank through standard reporting format. In every month, bank operational risk Management committee (BORC) sits with all these reports and decides action plans to resolve risk issues by specific individual and/or group within an agree timeline. The committee also escalates high level risk to (MANCOM) Management Committee). BORC is responsible for setting and maintaining standards for operational risk management and measurement, which is separate from the business functions.

Quantitative Disclosures

Particulars (The capital Charge for)	Tk (Core)
➢ Operational Risk	5.744