Meridian Finance & Investment Limited

Disclosure under Pillar III on Capital Adequacy and Market Discipline

As on December 31, 2018

Significance of Capital Adequacy

Capital is the foundation of any business. In a Financial Institution, capital is a prime factor to consider when assessing the safety and soundness. It acts as a cushion in case the value of the bank's assets decline and liability rises. Maintaining a minimum capital level is of paramount importance 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 a view on a Financial Institution's financial strength and stability. Adequate capital provides assurance to the stakeholders on the company's ability to provide consistent services.

Capital Adequacy is a basis for measurement of the amount of capital that the FI needs to hold to ensure that no excess leverage is taken that would lead to insolvency. Capital Adequacy is best expressed as the Capital Adequacy Ratio (CAR), also known as Capital to Risk Weighted Assets Ratio. CAR is a measure of a FI's core capital expressed as a percentage of its risk weighted asset. The objective of CAR is built around the Market Discipline, whereby depositors' get a standardized measurement on the extent to which their wealth is exposed to risk, and thereby establish confidence on the Financial Institution's operations. The CAR measurement is also directed towards making a FI's capital more risk sensitive and shock absorbent.

Basel II guidelines are formed on three features as follows:

(1) Minimum capital requirements to be maintained by a bank against credit, market, and operational risks.
(2) Process for assessing the overall capital adequacy aligned with risk profile of a bank as well as capital growth plan.
(3) 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.

The three tiers of regulatory capital are as follows: Tier 1 Capital, Supplementary Capital, and Tier 3.

- 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.
- 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 bank.
- Tier 3 Capital is called the '**Additional Supplementary Capital**' and consists of short-term subordinated debt. This capital base is solely for the purpose of meeting a proportion of capital requirements for market risk.

The computation of the three capital grades are subject to the following conditions:

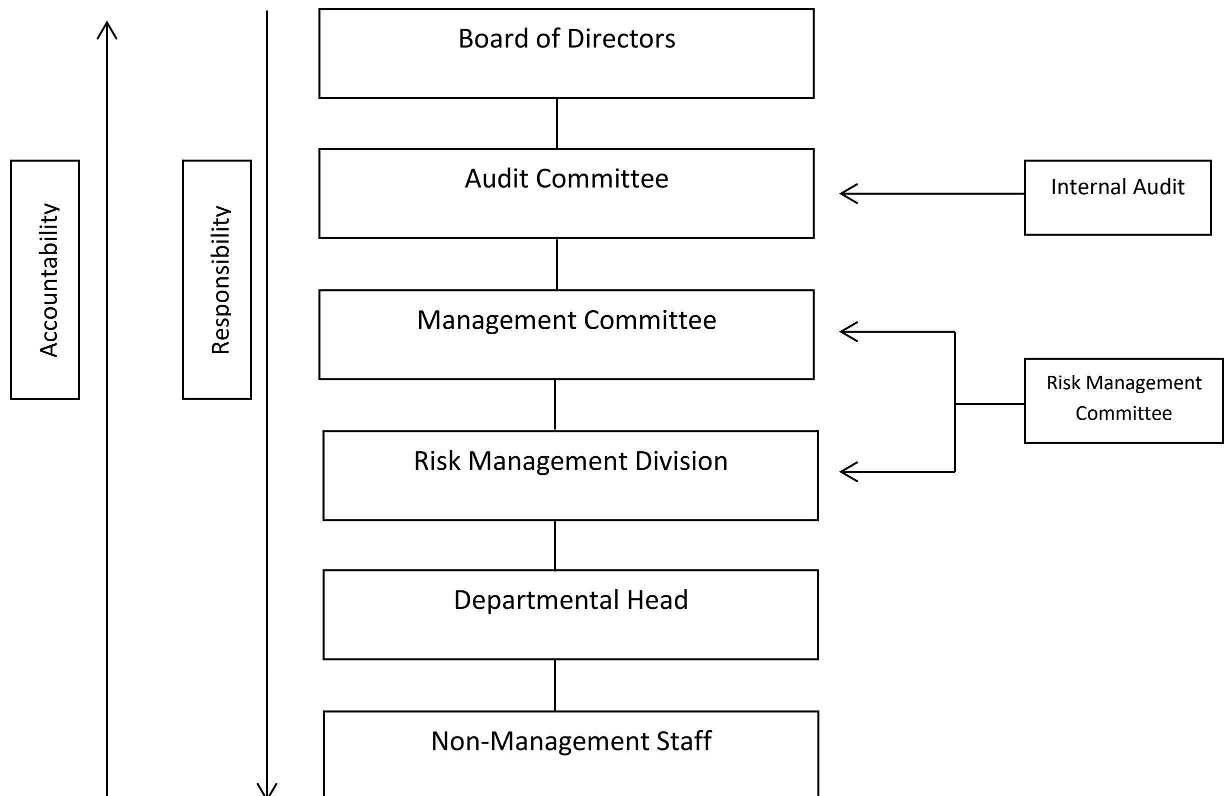
(1) Tier 2 Capital amount will be limited to 100% of the amount of Tier 1 Capital.
(2) 50% of revaluation reserves for fixed assets and securities, and 10% of revaluation reserves for equity instruments are eligible for Tier 2 Capital.
(3) Subordinated debt shall be limited to a maximum of 30% of the amount of Tier 1 capital.
(4) A minimum of around 28.5% of market risk needs to be supported by the Tier 1 capital. Market risk must be supported by Tier 3 capital up to a maximum of 250% of Tier 1 capital, available after meeting the necessary credit risk capital requirement.

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

Capital Ratios			Statutory Limits
Core Capital ratio	=	Core Capital / Risk-adjusted assets	>= 5%
Total capital (Core and Supplementary Capital) ratio	=	Total Capital (Core + Supplementary) / Risk-adjusted assets	>= 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. The diagram below illustrates this concept.



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

- 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 counterparty 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:
  - 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.
  - Off Balance Sheet credit exposures refer to the credit risks on the credit equivalent amounts of the various off balance sheet items.

- 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 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.

- Liquidity Risk is the potential risk of failure to meet all the financial obligations of the FI as they fall due, resulting from insufficient liquid financial resources.

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.

Capital Adequacy Details of Meridian Finance & Investment Limited (Meridian Finance).

Capital Adequacy

At Meridian Finance, Capital Management Policy sets out the principles and guidelines for effective and prudent capital planning, usage, and management. The policy delineates the minimum criteria for ensuring that adequate capital is met 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 Meridian Finance 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 Meridian Finance, 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 a level (0.5% to 1%) higher than the regulatory requirement, while capital target will be 1% to 2% 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:

- Oblige to regulatory requirements of capital base maintenance.
- Supply and demand forecast of capital to support business strategy and continuity.
- Incorporate rolling capital plan covering a time horizon of two to three years.
- 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' basis.

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

The guidelines apply only 'Solo' basis.

Breakdown of each category of eligible capital is given below.

- **Core Capital** of Meridian Finance is as follows:

Figures in BDT Million

Particulars	Solo	
	2018	**2017**
Fully paid-up capital/capital lien with BB	1,200.00	1,200.00
Statutory reserve	54.99	30.25
Non-repayable share premium account	-	-
General reserve	-	-
Retained Earnings	99.97	120.99
Minority interest in subsidiaries	-	-
Non-cumulative irredeemable preference shares	-	-

Dividend equalization account	-	-
Other (if any item approved by Bangladesh Bank	-	-
Less Shortfall in provisions required against investment in shares	-	-
Total	**1,354.97**	**1,351.24**

- **Supplementary Capital** of Meridian Finance is as follows:

Figures in BDT Million

Particulars	Solo	
	2018	**2017**
General Provision (Unclassified loans up to specified limit + SMA + off Balance Sheet exposure	44.51	38.44
50% of Asset Revaluation Reserve	-	-
45% of Securities Revaluation Reserve	-	-
All other Preference Shares	-	-
Other (if any item approved by Bangladesh Bank	-	-
Total	**44.51**	**38.44**

- Meridian Finance does not have any **Additional Supplementary Capital**.

Risk Management

At Meridian Finance, 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 Company'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 Company, 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. Meridian Finance 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

Company, 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:

- Risk considered must be in line with the company's goals, and also must support the company's risk appetite.
- 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, Meridian Finance takes precautionary methods against credit, market, operational, and liquidity risks.

➢ 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 counterparty 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 counterparty is also required to have an approved limit in place, prior to drawdown 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 mechanisms. 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 Company writes off a loan or an investment debt security balance, and any related allowances for impairment losses, when the Company Credit determines that the loan or security is uncollectible. 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.

The table below gives details of Credit Risk for 2018 and 2017:

Figures in BDT Million

Distribution of risk exposure by claims	Solo	
	2018	2017
Cash and Cash Equivalents	0.13	0.12
Claims on Bangladesh Govt. and Bangladesh Bank	30.25	28.83
Claims on NBFIs and Banks	929.46	179.20
Claims on Corporate	2,478.61	2,412.25
Claims categorized as retail portfolio & Small Enterprise	1,030.57	1,413.40
Consumer finance	166.09	196.06
Claims fully secured by residential property	493.18	380.08
Claims fully secured by commercial real estate	60.61	74.86
Past Due Claims	8.55	-
All other assets	306.53	137.70
Total	**5,503.98**	**4,822.50**

Figures in BDT Million

Particulars	Solo	
	2018	2017
Gross Non Performing Loans (NPLs)	13.42	-
Non Performing Loans (NPLs) to outstanding loan and advance	0.32%	-
Movement of Non Performing Loans (NPLs)		
Opening balance	-	-
Add/Less Net movement during the year	13.42	-
Closing Balance of Non Performing Loans (NPLs)	**13.42**	**-**
Movement of specific provision for (NPLs)		
Opening balance of Specific Provision	-	-
Less Written off during the year	-	-
Recovers during the period	-	-
Add Provision made during the period	4.87	-
Closing Balance of specific provision for (NPAs)	**4.87**	**-**

- Market Risk management is set as per the parameters defined in the policy. The objective of the Company's market risk management is to manage and control market risk exposures set within the acceptable parameters, thereby ensuring solvency while optimizing the Company'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.

  The table below gives details of Market Risk for 2018 and 2017:

Figures in BDT Million

Capital Requirements	Solo	
	2018	**2017**
Interest rate risk	-	-
Equity position risk	14.80	59.94
Foreign exchange risk	-	-
Commodity risk	-	-
Total	**14.80**	**59.94**

- 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:

  - Internal and external fraud
  - Damage to physical assets
  - Business process disruptions and system failures
  - Failure in service executions and deliveries, as well as process management
- Liquid 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.

Figures in BDT Million

Particulars	Solo	
	2018	**2017**
Credit Risk		
1. On Balance Sheet	3,801.09	3,618.87
2. Off Balance Sheet	59.71	-
Market Risk	148.00	599.40
Operational Risk	384.03	238.73
Total RWA	**4,392.84**	**4,457.00**

Based on the data derived, the Capital Adequacy Ratio (CAR) is calculated. Meridian Finance follows the standard CAR measurement method.

$$\text{Capital Adequacy Ratio (CAR)} = \frac{\text{Core Capital + Supplementary Capital}}{\text{Risk Weighted Assets}}$$

Figures (except percentage) in BDT Million

Particulars	Solo	
	2018	**2017**
Core Capital	1,354.97	1,351.24
Supplementary Capital	44.51	38.44
Total Eligible Capital	1,399.48	1,389.68
Risk Weighted Asset (RWA)	4,392.84	4,457.00
Capital Adequacy Ratio (CAR)	31.86%	31.18%
Core Capital to RWA	30.84%	30.32%
Supplementary Capital to RWA	1.01%	0.86%
Minimum Capital Requirement (Higher of 10% of RWA or 100 crore)	1,000	1,000
Excess Capital over Regulatory Requirement	399.48	389.68

The CAR figure of Meridian Finance & Investment Limited can be seen to be comfortably above the Bangladesh Bank’s CAR requirement of 10%. This is in line with the institution’s approach to being compliant, establish investors’ confidence, and demonstrate company stability.