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Performance Evaluation of Prime Bank Limited in Terms of Capital Adequacy

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I. Introduction

Bank is a financial institution (Khan). It require fund to carry out business. Fund may come from deposit and non deposit. One of the non-deposit source of found is capital. Capital can be defined as long term fund coming from debt and equity that support a banks long term assets and absorb earning losses (Rose). Lack of capital increases uncertainty to the depositors. Capital performs several indispensable jobs in the operation of a bank, such as supplying resources to get a new bank started, providing a base for growth and expansion, defending a bank against risk and maintaining public confidence in the bank's management and stockholders (Mishkin and Eskin). Regulators concerned with systematic risk of a bank runs do not like to rely on exclusively reserve requirement, deposit insurance because of the potential moral hazard (Berger,et al.1995). As a result regulators aiming at minimizing the moral hazard requiring equity capital as a fraction of bank risk weighted asset. An international standard which recommends minimum capital adequacy ratios has been developed to ensure banks can absorb a reasonable level of losses before becoming insolvent. Applying minimum capital adequacy ratios serves to protect depositors and promote the stability and efficiency of the financial system (Reserve Bank of New Zealand, 2007). In past years, the world has witnessed 'the crack' and in some cases, total collapse of major financial institutions, which before then, had made and declared significant and sometimes enviable returns. Following these collapse, there was a need to review the contradiction that played out in some of these cases, between declaration of significant returns and sudden death. This informs the evaluation of banks' performance from a risk adjusted basis. Banks are among the most leveraged businesses with substantial proportion of their assets in loan and advances exposing them to considerable risk. There is also an established fact of risk – return relationship whereby the higher the risk taken the higher the return expected. In essence, banks by the nature of their operations may make substantial profit from loans and advances but without commensurate level of capital to cushion unanticipated losses may fail (Onaolopo and olufemi 2012). Prime Bank ltd operating its business in Bangladesh over a decade. It is perfect time to measure performance how well the bank meeting regulatory requirement. The study organized as Capital Standard in Bangladesh, Literature Review, Objective of the Research Work, Research Methodology, Financial indicators for capital adequacy, Conclusion.

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II. Capital Standard in Bangladesh

In order to calculate CAR, banks are required to calculate their 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 weighted assets for credit risk. The CAR is then calculated by taking eligible regulatory capital as numerator and total RWA as denominator. Minimum capital requirement in Bangladesh is 10% of total risk weighted asset or 4 billion as capital whichever is higher of which 5% should be core capital(BRPD Circular No. 10).

III. Literature Review

Generally financial performance of banks and other financial institution measured by using combination of financial ratio analysis, benchmarking, measuring performance against budget or mix of these methodologies(Avkiran,1995). The comparative financial performance of banking sector conducted by using CAMELS rating system (Nimalathasan, 2008). The performance of Malaysian Islamic bank carried out by using financial ratios(Samad and Hassan).The south African commercial banks performance measured by financial ratios analysis(kumbiari and Webb,2010). Performance of selected Indian commercial banks has done by view growth in asset, profit, revenue, investment and deposit (Jaladhar, Anchula and Achari, 2011). EVA (Economic Value Added) is modern financial

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measurement tool that determines if a business is earning more than its true cost of capital (Gabriela et al, 2009). While analyzing performance of AXIS bank in terms of capital adequacy ratios and correlation analysis is used (Shrivastava et al, 2011). The analysis includes CAMELS rating and multivariate regression analysis for comparing financial performance commercial banks (Jha and Hui, 2012). The financial performance of commercial bank measured in terms of capital adequacy and methodology used as ordinary least square method (Onaolopo and olufemi 2012). Using data for Taiwan Province of China, Lin, Penm, Garg, and Chang (2005) study the direct effects of capital regulations and capital requirements. More specifically, they study three areas: (i) the relation between capital adequacy and the bank insolvency risk index, (ii) the relation between capital adequacy and financial performance, and (iii) the interaction and relationship between the insolvency risk of banks and financial performance.

IV. Objective of the Research Work

Banks is a special form of financial institution. Most of it fund coming from depositors. Owner's contribution is infinitesimal. Banking business depends on trust of the depositors on a bank. The measure of this trust is the strength and soundness of a bank. Specific objectives of the study are as follows.

- To analyze the adequacy of capital by using capital adequacy ratios;
- To identify the financial strength and soundness of the bank and provide suggestions:

V. Research Methodology

In order to evaluate performance prime bank different capital adequacy ratios are used. They are capital adequacy ratio (CAR), advance to asset ratio and debt equity ratio. At last t test is applied to test hypothesis. Secondary data have been collected from annual report books, journals, magazines and newspapers for the period of 2008 to 2012.

VI. Financial Indicators for Capital Adequacy

a) Capital Adequacy Ratio

Capital adequacy gives insights of overall financial position of the bank (Shrivastava.et al). Bank capital is a focal issue of financial soundness and safety of a bank. In fact the ultimate strength of a bank lies in its capital funds given its significance as a tool for meeting liabilities in a financial crisis and as a cushion for absorbing losses(Rose). From the table we see that capital adequacy ratio above 10% i.e. Prime Bank ltd maintained adequate capital in study period. In addition to capital adequacy ratio there is a high positive correlation of risk weighted asset and capital fund r_{xy}=0.99.

Year	Capital Fund(X)	Risk Weighted asset(Y)	Capital Adequacy Ratio	Tier -i
2007-08	7859	72253	10.88	8.67
2008-09	12168	82710	14.71	10.95
2009-10	21483	183747	11.69	8.60
2010-11	24229	194380	12.46	9.64
2011-12	25916	205103	12.64	10.08

Source: Annual Report of Prime Bank Ltd (2008-2012)

Here r_{xy}=0.99(using MS Excel). Now test of hypothesis, two hypotheses are

H_0: There is no significance difference between risk weighted asset and capital fund

H_1: risk weighted assets have increased with an increase in capital fund.

$$t = \frac{r * \sqrt{n-2}}{\sqrt{1-r2}}$$

$$= \frac{0.99 * \sqrt{5-2}}{\sqrt{1-(0.99)(0.99)}}$$

$$= 12.15$$

Tabulated value for 3 degrees of freedom at 5% level of significance is 3.18. Since the calculated value is greater than tabulated value it is highly significant. Hence the null hypothesis is rejected and we conclude that risk weighted asset increased with an increase in capital fund.

b) Advance To Total Asset

The ratio is the total advance to total asset. Advance to asset ratio shows a bank position and risk taking ability in lending funds. The higher the ratio indicates that bank is aggressive in lending (Shrivastava.et al). There is a link that the higher the ratio more capital requires to absorb losses as risk weighted asset increases. For prime bank was the highest in year 2009-10 and lowest at 2008-09 and 2011-12 which is below to industry average.

Year	Total Asset	Total Advance	Ratio
2007-08	110437	75156	0.68
2008-09	124806	89252	0.72
2009-10	154342	116057	0.75
2010-11	199950	138848	0.69
2011-12	236833	160890	0.68

Source: Annual Report of Prime Bank Ltd (2008-2012)

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c) Debt Equity Ratio

The ratio indicates the degree of leverage of a bank. It shows how much of a bank business is financed through debt and how much through equity (Maheswari). The ratio is arrived at by dividing total borrowing and deposit by shareholders net worth which includes equity capital, reserve and surplus. Bank capital can absorb financial shock. In case asset value decrease or loans are not repaid bank capital provides protection against those loan loss. A lower debt equity ratio is good sign for a bank. (Samad and Hasan). The below table indicates high debt equity ratio of prime bank ltd. The table shows that the ratio was highest in 2007-08 and lowest in 2009-10.

Year	Debt Equity Ratio
2007-08	93.55
2008-09	89.41
2009-10	87.70
2010-11	89.44
2011-12	90.38

Source: Annual Report of Prime Bank Ltd (2008-2012)

VII. Conclusion

From above table we see that prime bank manages regulatory requirement in terms of capital adequacy. The capital adequacy ratio is above 10% in each year. Loan to asset ratio is satisfactory. But a debt equity ratio is very high. Since bank financial institution is highly levered and different from other firms and lion portion of bank fund coming from deposit. The suggestion for the bank to increase equity contribution for sustainability. Finally we can conclude that prime is performing well.

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