



# Basel 2 – Pillar 3 Disclosures

For the year ended 31 December 2008

## EXECUTIVE SUMMARY

The Central Bank of Bahrain's (CBB) Basel 2 guidelines outlining the capital adequacy framework for banks incorporated in the Kingdom of Bahrain became effective from 1st January 2008.

NBB has adopted the Standardised Approach for Credit Risk, Internal Model Approach for Market Risk and the Basic Indicator Approach for Operational Risk to determine the capital requirement. This report consists of the Basel Committee's Pillar 3 disclosure requirements as stipulated by the CBB. The report contains a description of the Bank's risk management and capital adequacy policies and practices including detailed quantitative information on capital adequacy.

As at 31<sup>st</sup> December 2008, the Bank's total risk weighted assets amounted to BD 1,162.9 million; Tier 1 Capital and total regulatory capital amounted to BD 202.4 million and BD 224.5 million respectively. Accordingly, Tier 1 Capital Adequacy Ratio and total Capital Adequacy Ratio were 17.4% and 19.3 % respectively. These ratios exceed the minimum capital requirements under the CBB's Basel II framework. The Bank's intention is to maintain a Tier 1 capital ratio above 8 per cent and a total capital ratio in excess of 12 per cent.

The Bank views the Basel 2 Pillar 3 disclosures as an important means of increased transparency and accordingly has provided extensive disclosures in this report that is appropriate and relevant to the Bank's stakeholders and market participants.

This report should be read in conjunction with the Bank's Financial Statements as at 31 December 2008 including Notes to the Financial Statements. There is a growing convergence of disclosures under International Financial Reporting Standards (IFRS) and the Basel 2 Pillar 3 disclosure requirements, which are in addition to or in some cases, serve to clarify the disclosure requirements of IFRS.

## SCOPE OF APPLICATION

The Bank operates as an independent banking institution with headquarters in Bahrain and branches in Bahrain, the United Arab Emirates and Saudi Arabia. The Bank's capital adequacy requirements are computed on a consolidated basis.

## RISK AND CAPITAL MANAGEMENT

The Bank is exposed to the following types of risks:

- Credit risk
- Liquidity risk
- Market risk
- Interest rate risk
- Operational risk

### Risk management framework

The overall authority for risk management in the Bank is vested in the Board of Directors. The Board authorises appropriate credit, liquidity and market risk policies as well as operational guidelines based on the recommendation of Management. The Bank has established various committees that review and assess all risk issues. Approval authorities are delegated to different functionaries in the hierarchy depending on the amount, type of risk and nature of operations or risk. The Credit Policy and Risk Management (CPRM) division of the Bank provides the necessary support to Senior Management and the business units in all areas of risk management. This division functions independent of the business units and reports directly to the Chief Executive Officer. The division comprises of a Credit Review Department (responsible for pre-approval analysis of credit/ investment proposals as well as risk policy and procedures management), Credit Administration Department (responsible for post approval implementation and follow up), Legal Department



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(responsible for management of legal risk) and Risk Management and Compliance Department (responsible for market risk, operational risk and compliance management)

The Audit Committee of the Board is responsible for monitoring compliance with the Bank's policies and procedures, and for reviewing the adequacy of the risk management framework in relation to the risks faced by the Bank. The Audit Committee is assisted in these functions by the Management Internal Control division, which undertakes both regular and adhoc reviews of risk management controls and procedures, the results of which are reported to the Audit Committee and to Management.

### **Credit Risk**

Credit Risk represents the potential financial loss as a consequence of a customer's inability to honour the terms and conditions of a credit facility. Such risk is measured with respect to counterparties for both on-balance sheet assets and off-balance sheet items.

The Bank acknowledges that credit risk is an inherent and substantial cost that needs to be set against income. Risk is just one aspect of the triangle for any economic capital system and must be seen in conjunction with capital requirements and returns. The Bank evaluates risk in terms of the impact on income and asset values and the evaluation reflects the Bank's assessment of the potential impact on its business on account of changes in political, economic and market conditions and in the credit worthiness of its clients. Risk management at the Bank has always been conservative and proactive with the objective of achieving a balanced relation between risk appetite and expected returns.

The Bank monitors and manages concentration risk by setting limits on exposures to countries, sectors, products and counterparty groups. Stringent criteria are used by CPRM in setting such limits and these have ensured that the impact on the Bank's income stream and capital strength of any adverse developments is limited. Prior to launch of any new asset product, based on a comprehensive risk analysis, product specific transaction approval criteria are set. Similarly, prudent norms have been implemented to govern the Bank's investment activities, which specify to the Bank's Treasury department the acceptable levels of exposure to various products, based on its nature, tenor, rating, type, features, etc.

The Bank has well laid out procedures, not only to appraise but also regularly monitor credit risk. Credit appraisal is based on the financials of the borrower, performance projections, market position, industry outlook, external ratings (where available), track record, product type, facility tenor, account conduct, repayment sources and ability, tangible and intangible security, etc. Regular reviews are carried out for each account and risks identified are mitigated in a number of ways, which include obtaining collateral, counter-guarantees from shareholders and/or third parties. Adequate margins are maintained on the collateral to provide a cushion against adverse movement in the market price of collateral. Not only are regular appraisals conducted to judge the credit worthiness of the counterparty but day-to-day monitoring of financial developments across the globe by the Business Units and CPRM ensures timely identification of any events affecting the risk profile.

The Business Units of the Bank are responsible for business generation and initial vetting of proposals to make sure that the Bank's risk acceptance criteria are met. Credit facilities in excess of BD 250,000 or falling outside pre-approved product criteria are referred to CPRM for review. The Credit Review Department within CPRM analyses the proposal and puts forth its recommendations prior to approval by the appropriate authorities. In addition to rigorous credit analysis, the terms and conditions of all credit facilities are strictly implemented by the Credit Administration Department. An internal grading system and review process ensures prompt identification of any deterioration in credit risk and consequent implementation of corrective action.

The Bank's internal ratings are based on a 10-point scale, which takes into account the financial strength of a borrower as well as qualitative aspects to arrive at a comprehensive snapshot of the risk of default associated with the borrower. Ratings are further sub-divided into categories, which reflect estimates of the potential maximum loss in an event of default. Risk Ratings assigned to each borrower are reviewed at least on an annual basis. Regular monitoring of the portfolio enables the Bank to identify accounts, which witness deterioration in risk profile. Consumer credit facilities which are granted based on pre-defined criteria such as salary assignment, maximum repayment obligation as a percentage of salary, etc are excluded from this rating system



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The Bank also uses the ratings by established rating agencies, viz., Moody's, Standard & Poor and Fitch as part of the appraisal process while considering exposures to rated entities.

For purposes of comparison, the Bank's internal ratings are mapped to Moody's and Standard and Poor (S&P) ratings as under:

<b>Bank's Internal Ratings Scale</b>	<b>Equivalent to Moodys and S&amp;P ratings</b>
1	AAA/Aaa
2	AA/Aa2
3	A/A2
4	BBB+/Baa1
5	BBB-/Baa3
6	BB/Ba2
7	B+/B1
8 - 10	CCC/Caa to C

However, the above mapping is not intended to reflect a direct relationship between the Bank's internal ratings and the corresponding rating of the external agencies since the basis and methodology differ.

## **Liquidity Risk**

Liquidity Risk is the potential inability of a bank to meet its financial obligations on account of a maturity mismatch between assets and liabilities. Liquidity risk management ensures that funds are available at all times to meet the funding requirements of the Bank.

The asset/liability management policies of the Bank define the proportion of liquid assets to total assets with the aim of minimising liquidity risk. The Bank maintains adequate liquid assets such as inter-bank placements, treasury bills and other readily marketable securities, to support its business and operations. The Treasury Department monitors the maturity profile of assets and liabilities so that adequate liquidity is maintained at all times.

The Bank's ability to maintain a stable liquidity profile is primarily on account of its success in retaining and growing its customer deposit base. The marketing strategy of the Bank has ensured a balanced mix of demand and time deposits. Stability of the deposit base thus minimises the Bank's dependence on volatile short-term borrowings. Further, investment securities with contractual maturities of more than three months can also be readily liquidated. Considering the effective maturities of deposits based on retention history and in view of the ready availability of liquid investments, the Bank is able to ensure that sufficient liquidity is always available. The Asset Liability Committee (ALCO) chaired by the Chief Executive Officer reviews the Liquidity Gap Profile and the Liquidity scenario and addresses strategic issues concerning liquidity.

## **Market Risk**

Market Risk is the risk of potential losses arising from movements in market prices of interest rate related instruments and equities in the trading portfolio and foreign exchange and commodities holdings throughout the Bank. The Bank's trading activities are governed by conservative policies that are clearly documented, by adherence to comprehensive limit structures set annually and by regular reviews. Quality and rating are the main criteria in selecting a trading asset. The Bank uses the Value-at-Risk (VaR) measure to estimate the exposure of the trading portfolio and total currency book to market risk. The VaR quantifies the maximum potential change in the future value of the portfolio due to the sensitivity of the positions to the volatility of and correlation between the risk factors such as interest rates, foreign exchange rates and equity prices. Daily reports in this regard are submitted to senior management for review and decision making purposes.

The Bank also uses back testing to validate the VaR model and the results confirm that the model adequately captures risk within the Bank's trading portfolio. On a monthly basis, the Bank stress tests its trading portfolio to assess the adequacy of the market risk capital held. Stress tests cover scenarios mandated by the Central Bank of Bahrain under its Market Risk regulations as well as specific scenarios created (and amended by the Bank from time to time) based on market developments and the structure of the Bank's portfolio. The results of stress testing carried out so far have shown a satisfactory position.



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## Interest rate Risk

Interest Rate Risk is measured by the extent to which changes in the market interest rates impact margins, net interest income and the economic value of the Bank's equity. Net interest income will be affected as a result of volatility in interest rates to the extent that the re-pricing structure of interest bearing assets differs from that of liabilities. The Bank's goal is to achieve stable earnings growth through active management of the assets and liabilities mix while, selectively positioning itself to benefit from near-term changes in interest rate levels. The Treasurer is primarily responsible for managing the interest rate risk. Reports on overall position and risks are submitted to senior management for review and positions are adjusted if deemed necessary. In addition, ALCO regularly reviews the interest rate sensitivity profile and its impact on earnings.

The Bank's asset and liability management process is utilised to manage interest rate risk through the structuring of on-balance sheet and off-balance sheet portfolios. The Bank uses various techniques for measuring and managing its exposure to interest rate risk. Duration analysis is used to measure the interest rate sensitivity of the fixed income portfolio. Duration of the portfolio is governed by economic forecasts, expected direction of interest rates and spreads. Modified Duration gives the percentage change in value of the portfolio following a 1% change in yield. Interest rate swaps and forward rate agreements are used to manage the interest rate risk. The Bank uses interest rate gap analysis to measure the interest rate sensitivity of its annual earnings due to re-pricing mismatches between rate sensitive assets, liabilities and derivatives positions.

## Operational Risk

Operational Risk is the risk of monetary loss on account of human error, fraud, systems failures or the failure to record transactions. In order to manage and mitigate such risks, the Bank ensures that proper systems and resources (financial and personnel) are available to support the Bank's operations. Proper segregation of duties and other controls (including reconciliation, monitoring and reporting) are implemented to support the various operations, especially credit, treasury and electronic banking activities.

Detailed operational guidelines are spelt out in the Operations Manual to specify the steps to be followed in handling any transaction. These steps are designed to mitigate the risks arising from errors, omissions and oversights in dealing with customer instructions and transaction processing. The overriding principles in drawing up operational processes are that transactions must be scrutinized by a "checker" independent from the "originator" prior to booking and that there should be a clear audit trail for post facto scrutiny. The Bank's Fraud Manual and the Code of Conduct provide necessary guidance to mitigate risks and ensure that adequate controls are in place for detecting suspicious transactions. Any changes to operational procedures need to be processed through the Management Internal Control Department, who ensure that satisfactory control mechanisms are in place in all procedures.

Specific limits are set up to mitigate and monitor the Bank's exposure including limits on maximum branch cash limit, maximum teller limit, maximum payment authorization limit, signature authorities, etc. Documented policies and procedures, approval and authorization process for transactions, documented authority letters, process of verification of transaction details and activities, reconciliation of key activities, dual custody of financial assets like demand drafts, cheques etc. and insurance coverage of various operational risks are the key pillars of the operational risk management process.

The scope of the Bank's internal audit department encompasses audits and reviews of all business units, support services and branches. The internal audit process focuses primarily on assessing risks and controls and ensuring compliance with established policies, procedures and delegated authorities. New products and services are reviewed by the internal audit department and assessed for operational risks prior to their implementation. The internal audit department is operationally independent and reports significant internal control deficiencies to the Audit Committee.

The Bank has a Business Continuity Plan (BCP) to ensure that the critical activities are supported in case of an emergency. The BCP is approved by the Board of Directors.



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## Risk Monitoring and Reporting

Systems and processes are in place to regularly monitor and report risk exposures to the Board of Directors and senior management to effectively monitor and manage the risk profile of the Bank.

The Board of Directors is provided with quarterly risk reports covering credit, market, liquidity, operational, concentration and other risks.

Senior management is provided with a daily report on market risk and monthly reports on other risks. Reports on capital adequacy and internal capital adequacy assessment are provided to senior management on a quarterly basis. In addition, stress testing on capital adequacy is undertaken once a year or in times of need and communicated to senior management for appropriate decisions.

## Capital Management

The Bank's policy is to maintain sufficient capital to sustain investor, creditor and market confidence and to support future development of the business. The impact of the level of capital on return on shareholder's equity is also considered and the Bank recognises the need to maintain a balance between the higher returns that might be possible with greater gearing and the advantages and security afforded by a sound capital position.

The Bank's capital management framework is intended to ensure that there is capital sufficient to support the underlying risks of the Bank's business activities and to maintain a well-capitalised status under regulatory requirements. The Bank has a comprehensive Internal Capital Adequacy Assessment Process (ICAAP) that includes Board and senior management oversight, monitoring, reporting and internal control reviews, to identify and measure the various risks that are not covered under Pillar 1 risks and to regularly assess the overall capital adequacy considering the risks and the Bank's planned business strategies. The non Pillar 1 risks covered under the ICAAP process include concentration risk, liquidity risk, interest rate risk in the banking book and other miscellaneous risks. The ICAAP also keeps in perspective the Bank's strategic plans, credit growth expectations, future sources and uses of funds, dividend policy and the impact of all these on maintaining adequate capital levels. In addition, the ICAAP process also includes stress testing on the Bank's capital adequacy to determine capital requirement and planning to ensure that the Bank is adequately capitalized in line with the overall risk profile.

The Bank ensures that the capital adequacy requirements are met on a consolidated basis and also with local regulator's requirements, if any, in countries in which the Bank has branches. The Bank has complied with regulatory capital requirements throughout the period.

## CAPITAL STRUCTURE AND CAPITAL ADEQUACY

The Bank's paid up capital consists only of ordinary shares which have proportionate voting rights. The Bank does not have any other type of capital instruments.

The Bank's Tier 1 capital comprise of share capital, share premium, retained earnings and eligible reserves. Retained profits are included in Tier 1 pursuant to an external audit. The eligible reserves in Tier 1 are excluding revaluation gains and losses arising on the re-measurement to fair value of available-for-sale securities. Further, the following items are adjusted from Tier 1 capital as per CBB guidelines:

- Unrealized losses, on equity securities classified as available-for-sale, are deducted wholly from Tier 1.
- Fair value of investments in associates deducted 50% from Tier 1 and 50% from Tier 2.

The Bank's Tier 2 Capital comprises interim profits, collective impairment provisions and 45 per cent of unrealised gains arising on the re-measurement to fair value of equity securities classified as available-for-sale.

The fair value of the investments in The Benefit Company (associate company based on the Bank's 34.84 percent holding) is deducted equally from the Tier 1 and Tier 2 capital of the Bank as required by the Central Bank of Bahrain guidelines.

The Bank has no subsidiaries and/or investments in insurance companies exceeding 20% of the Bank's capital or the investee company's capital that is required to be deducted from capital.



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## Capital structure, minimum capital requirement and Capital Adequacy:

**As at 31 December 2008**

**BD '000s**

### Tier 1 capital

Share Capital	77,760
Statutory Reserve	38,880
General Reserve	32,400
Other Reserves	6,953
Retained Earnings	48,245
Deductions from Tier 1 Capital	(1,875)

**Total Tier 1 (A) 202,363**

### Tier 2 capital

45% of revaluation reserves on available for sale equity investments	17,387
Collective impairment provision subject to a 1.25% risk adjusted exposure limitation	5,375
Deductions from Tier 2 Capital	(673)

**Total Tier 2 22,089**

**Total capital base (Tier 1 + Tier 2) (B) 224,452**

<b>As at 31 December 2008</b>	<b>Risk weighted exposure</b>	<b>Capital requirement @ 12%</b>
<b>BD '000s</b>		
Cash and collection items	525	63
Sovereigns	–	–
Banks	195,685	23,482
Corporates	338,226	40,587
Regulatory retail	203,522	24,423
Residential mortgages	14,033	1,684
Investments in equities/funds	109,913	13,190
Securitisation exposures	219	26
Others	112,208	13,465
<b>Total Credit risk exposures</b>	<b>974,331</b>	<b>116,920</b>
<b>Market risk</b>	<b>76,283</b>	<b>9,154</b>
<b>Operational risk</b>	<b>112,284</b>	<b>13,474</b>
<b>Total Risk weighted Exposures (C)</b>	<b>1,162,898</b>	<b>139,548</b>
<b>Capital adequacy ratio (B)/(C)</b>	<b>19.30%</b>	
<b>Tier 1 Capital adequacy ratio (A)/(C)</b>	<b>17.40%</b>	



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## **CREDIT RISK**

The Bank has a diversified on and off balance sheet credit portfolio, which are divided into counter party exposure classes in line with the CBB's Basel II capital adequacy framework for the standardised approach for credit risk. A high-level description of the counter party exposure classes and the risk weights used to derive the Risk Weighted Assets are as follows:

### ***Sovereigns Portfolio***

The sovereign portfolio comprises exposures to governments and their respective central banks. The risk weights are 0 per cent for exposures in the relevant domestic currency of the sovereign, or for any exposures to GCC governments. Foreign currency claims on other sovereigns are risk weighted based on their external credit ratings.

Certain multilateral development banks as determined by the CBB may be included in the sovereign portfolio and treated as exposures with a 0 per cent risk weighting.

### ***PSE Portfolio***

Public sector entities (PSEs) are risk weighted according to their external ratings excepting that Bahrain PSEs, and domestic currency claims on other PSEs that are assigned a 0 per cent risk weight by their respective country regulator, are consequentially allowed a 0 per cent risk weight by CBB for computation purposes.

### ***Banks Portfolio***

Claims on banks are risk weighted based on their external credit ratings. A preferential risk weight treatment is available for qualifying short-term exposures to banks in their country of incorporation. Short-term exposures are defined as exposures with an original tenor of three months or less and denominated and funded in the respective domestic currency. The preferential risk weight for short-term claims is allowed on exposures in Bahraini Dinar/US Dollar in the case of Bahraini incorporated banks.

### ***Corporates Portfolio***

Claims on corporates are risk weighted based on their external credit ratings. A 100 per cent risk weight is assigned to exposures to unrated corporates. A preferential risk weight treatment is available for certain corporates owned by the Government of Bahrain, as determined by the CBB, which are assigned a 0 per cent risk weight.

### ***Equities Portfolio***

The equities portfolio comprises equity investments in the banking book, i.e. the available-for-sale securities portfolio. The credit (specific) risk for equities in the trading book is included in market risk RWAs for regulatory capital adequacy calculation purposes.

A 100 per cent risk weight is assigned to listed equities and funds. Unlisted equities and funds are risk weighted at 150 per cent. Investments in rated funds are risk weighted according to the external credit rating.

In addition to the standard portfolios, other exposures are risk weighted as under:

### ***Past due exposures***

All past due loan exposures, irrespective of the categorisation of the exposure are classified separately under the past due exposures asset class. A risk weighting of either 100 per cent or 150 per cent is applied depending on the level of specific provision maintained against the exposure.

### ***Other assets and holdings of securitisation tranches***

Other assets are risk weighted at 100 per cent. Securitisation tranches are risk weighted (ranging from 20 per cent to 350 per cent) based on their external credit ratings. Exposures to securitisation tranches that are rated below BB- or are unrated are deducted from regulatory capital rather than subject to a risk weight.



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## External Credit Assessment Institutions (ECAI)

1. The Bank uses ratings issued by Standard & Poor's, Moody's and Fitch to derive the risk weightings under the CBB's Basel 2 capital adequacy framework. Where ratings vary between rating agencies, the highest rating from the lowest two ratings is used to represent the rating for regulatory capital adequacy purposes.

The following are gross credit risk exposures considered for Capital Adequacy Ratio calculations comprising of banking book exposures.

### As at 31 December 2008

#### BD '000s

Cash and balances at central banks	82,398
Treasury bills	16,577
Placements with banks and other financial institutions	410,483
Loans and advances	1,101,086
Investment securities	399,176
Other assets	28,023
<b>Total assets</b>	<b>2,037,743</b>
Non-derivative banking commitments and contingent liabilities (notional)	<b>148,124</b>
Derivatives (notional)	<b>182,435</b>

The balances as at 31<sup>st</sup> December 2008 are representative of the position during the period; hence the average balances for the period is not separately disclosed.

## INDUSTRY OR COUNTERPARTY EXPOSURE

### As at 31 December 2008

	Govt	Mfg/ Trdg	Banks/ Fls	Const	Personal	Others	Total
<b>BD '000s</b>							
Cash and balances at central banks			82,398				82,398
Treasury Bills	16,577						16,577
Placements with banks/financial institutions			410,483				410,483
Loans and advances	156,755	216,505	179,355	144,164	289,566	114,741	1,101,086
Investment securities	137,787	20,429	189,113			51,847	399,176
Other assets	902	2,056	2,432	770	928	20,935	28,023
<b>Total assets</b>	<b>312,021</b>	<b>238,990</b>	<b>863,781</b>	<b>144,934</b>	<b>290,494</b>	<b>187,523</b>	<b>2,037,743</b>
Non-derivative banking commitments and contingent liabilities (notional)	<b>27,808</b>	<b>20,209</b>	<b>71,581</b>	<b>23,875</b>	<b>2,387</b>	<b>2,264</b>	<b>148,124</b>
Derivatives (notional)			<b>182,435</b>				<b>182,435</b>

The above includes certain exposures to customers / counter parties which are in excess of 15 % of the Bank's capital base. These have the approval of the Central Bank of Bahrain or are exempt exposures under the large exposures policy of the Central Bank of Bahrain.



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## GEOGRAPHIC DISTRIBUTION OF EXPOSURE

<i>As at 31 December 2008</i>	Middle East	USA	Europe	Rest of the world	Total
<b>BD '000s</b>					
Cash and balances at central banks	82,398				82,398
Treasury Bills	16,577				16,577
Placements with banks/ financial institutions	343,677	2,418	64,050	338	410,483
Loans and advances	1,090,474	7,464		3,148	1,101,086
Investment securities	196,976	140,253	48,880	13,067	399,176
Other assets	27,199	563	208	53	28,023
<b>Total assets</b>	<b>1,757,301</b>	<b>150,698</b>	<b>113,138</b>	<b>16,606</b>	<b>2,037,743</b>
Non-derivative banking commitments and contingent liabilities (notional)	<b>111,869</b>	<b>242</b>	<b>28,240</b>	<b>7,773</b>	<b>148,124</b>
Derivatives (notional)	<b>108,847</b>	<b>1,591</b>	<b>71,701</b>	<b>296</b>	<b>182,435</b>

## RESIDUAL CONTRACTUAL MATURITY

<i>As at 31 December 2008</i>	Upto 3 Months	3 to 6 months	6 to 12 months	1 to 3 years	3 to 5 years	5 to 10 years	10 to 20 years	Over 20 years	Total
<b>BD '000s</b>									
Cash and balances at central banks	82,398								82,398
Treasury Bills	6,608	9,969							16,577
Placements with banks/financial institutions	397,085		13,398						410,483
Loans and advances	188,292	31,636	119,878	309,928	255,027	154,215	39,249	2,861	1,101,086
Investment securities	30,596	19,317	34,517	158,285	79,623	4,035		72,803	399,176
Other assets	9,835	924	404					16,860	28,023
<b>Total assets</b>	<b>714,814</b>	<b>61,846</b>	<b>168,197</b>	<b>468,213</b>	<b>334,650</b>	<b>158,250</b>	<b>39,249</b>	<b>92,524</b>	<b>2,037,743</b>
Non-derivative banking commitments and contingent liabilities (notional)	<b>72,211</b>	<b>14,977</b>	<b>39,029</b>	<b>19,838</b>	<b>1,980</b>	<b>89</b>	<b>–</b>	<b>–</b>	<b>148,124</b>
Derivatives (notional)	<b>150,379</b>	<b>32,056</b>							<b>182,435</b>

### Past due exposures

In accordance with the Bank's policy and Central Bank of Bahrain guidelines, loans on which payment of interest or repayment of principal are 90 days past due, are defined as non-performing.

The Bank has systems and procedures in place to generate alerts in case of past dues in any account. A stringent classification process is followed for all accounts with past dues of over 90 days. The Bank applies rigorous standards for provisioning and monitoring of non-performing loans. Level of provisions required is determined based on the security position, repayment source, discounted values of cash flows, etc and adequate provisions are carried to guard against inherent risks in the portfolio.

Provision for possible loan losses, pertaining to individually significant impaired loans and advances, is determined based on the difference between the net carrying amount and the estimated recoverable amount of the loans and advances, measured at present value of estimated future cash flows from such loans and advances and discounting them based on their original effective interest rate. If a loan has a floating interest rate, the discount rate is the current effective rate determined under the contract.



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Impairment and uncollectability is also measured and recognised on a portfolio basis for a group of similar loans and advances, that are not individually identified as impaired, on the basis of estimates of incurred losses that are inherent but not yet specifically identified within the loans and advances portfolio at the balance sheet date. The estimates are based on internal risk ratings, historical default rates, rating migrations, loss severity, macroeconomic and other relevant factors with historic loss experience being adjusted to reflect the effect of prevailing economic and credit conditions.

Ageing analysis of impaired and past due loans and advances:

## As at 31 December 2008

### In BD '000s

Over 3 months to 1 year	2,291
1 to 3 years	1,545
Over 3 years	4,815
<b>Total</b>	<b>8,651</b>

Geographical location of impaired and past due loans and advances:

## As at 31 December 2008

<b>BD '000s</b>	<b>Loan Amount</b>	<b>Specific provision</b>	<b>Collective impairment</b>
Bahrain	6,959	5,829	3,936
Other GCC countries	368	368	1,328
Others	1,324	1,324	111
<b>Total</b>	<b>8,651</b>	<b>7,521</b>	<b>5,375</b>

Industry/sector wise breakdown of impaired and past due loans and advances:

<b>Year 2008</b>	<b>Loan Amount</b>	<b>Specific impairment provision</b>	<b>Collective impairment provision</b>	<b>Specific impairment charge</b>	<b>Write offs</b>
<b>BD '000s</b>					
Government	1,324	1,324	803	73	–
Manufacturing/trading	796	725	1,124	–	186
Construction	767	602	589	–	–
Personal	5,439	4,766	1,532	55	139
Others	325	104	1,318	–	24
<b>Total</b>	<b>8,651</b>	<b>7,521</b>	<b>5,375</b>	<b>128</b>	<b>349</b>

Movement in provision for impairment of loans and advances:

<b>Year 2008</b>	<b>Specific impairment provision</b>	<b>Collective impairment</b>	<b>Total provision</b>	<b>Interest in suspense</b>
<b>BD '000s</b>				
At 1 January 2008	8,054	6,491	14,545	4,371
Charge for the year	128	–	128	744
Amounts written off against provision	(344)	(5)	(349)	(7)
Recoveries & write backs	(317)	(1,111)	(1,428)	(377)
<b>At 31 December 2008</b>	<b>7,521</b>	<b>5,375</b>	<b>12,896</b>	<b>4,731</b>



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## CREDIT RISK MITIGATION

The reduction of the capital requirement attributable to credit risk mitigation is calculated in different ways, depending on the type of credit risk mitigation, as under:

**Adjusted exposure amount:** The Bank uses the comprehensive method for eligible financial collateral such as cash and equities listed on a recognized stock exchange. The exposure amount and financial collateral, where applicable, are adjusted for market volatility through the use of supervisory haircuts (for currency mis-matches, price volatility and maturity-mismatches) that are specified by the CBB.

**Substitution of counterparty:** The substitution method is used for eligible guarantees (only sovereigns, banks or corporate entities with ECAI ratings higher than that of the counterparty; guarantees issued by corporate entities may only be taken into account if their rating corresponds to A- or better) whereby the rating of the counterparty is substituted with the rating of the guarantor.

## COLLATERAL AND VALUATION PRINCIPLES

The main collaterals taken for risk mitigation on credit exposures are deposits held by customers, pledge of quoted shares, residential/commercial property mortgage, investment securities, counter-guarantees from other banks, etc. Other risk mitigants considered include salary and end of service benefits assignment for personal loans, personal guarantees of promoters etc. However, for purposes of capital adequacy computation, only eligible collaterals recognized under Basel 2 are taken into consideration and there are no significant concentrations in such eligible collaterals taken for credit risk mitigation.

The Bank's Credit Policy defines the types of acceptable collateral and the applicable haircuts or loan-to-value ratio. The Bank has a system of independent valuation of collateral. In the case of real estate, valuation is done by independent valuer at regular intervals as stipulated in the Bank's credit policy. In respect of quoted shares and other securities, the valuation is done based on the closing price on the stock exchange. The market value of the collateral is actively monitored on a regular basis and requests are made for additional collateral in accordance with the terms of the underlying agreements. In general, lending is based on the customer's repayment capacity and not the collateral value. However, collateral is considered as a secondary alternative to fall back on in the event of default.

Eligible financial collateral, guarantees and credit derivatives, presented by standard portfolio are as under:

<b>As at 31 December 2008</b>	<b>Of which secured by eligible</b>			<b>Credit exposure after risk mitigants</b>
	<b>Gross credit exposure</b>	<b>Financial collateral</b>	<b>Guarantees and credit derivatives</b>	
<b>BD '000s</b>				
Sovereigns	458,602	–	16,843	441,759
Banks	585,687	99,019	–	486,668
Corporates	569,485	21,245		548,240
Residential mortgage	18,723	12		18,711
Others	121,094	25,169		95,925

## On and off-Balance Sheet netting:

The legal documents that the Bank obtains from customers include clauses that permit the Bank to offset the customer's dues to the Bank against the Bank's dues to the customer. Thus, if the same legal entity has obtained credit facilities from the Bank and also maintains credit balance with the Bank, the Bank has the legal right to set-off the credit balances against the dues. In case of certain counter party banks, the Bank has entered into specific netting agreements that provide for netting on and off-balance sheet exposures.

The amount of financial assets and financial liabilities set off under netting agreements amounted to BHD 39.0 million.



# Basel 2 – Pillar 3 Disclosures

For the year ended 31 December 2008

## MARKET RISK

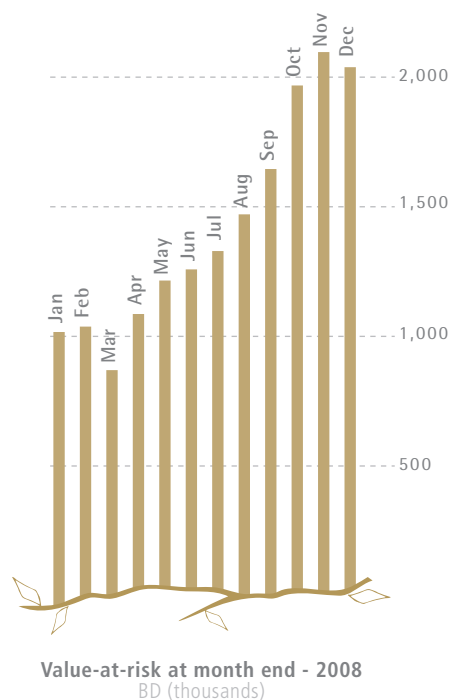
The Bank uses the Internal Model Approach for assessing the capital requirement for market risk, which includes capital charge for both general and specific risk. The principal tool used to measure and control market risk exposure is Value-at-Risk (VaR). The VaR is the estimated loss that will arise on the trading portfolio over a pre-defined time horizon from an adverse market movement for a specified confidence level. Based on the approval of the Central Bank of Bahrain, the Bank has been computing market risk using an internal model based on RiskMetrics software since 1999. The VaR model used by the Bank is based upon a 99 percent confidence level and assumes a 10-day time horizon. The multiplication factor to be applied to the Value-at-Risk calculated by the internal model has been set at the regulatory minimum of 3.0 by the CBB.

The Bank has clearly documented policies and procedures for the management and valuation of the trading portfolio. The Treasury Operations department, which is independent of the front office, is responsible for valuation which is done on a daily basis, based on quoted market prices from stock exchanges, independent third parties or amounts derived from cash flow models as appropriate.

The summary of the VaR position of the Bank at 31 December and during the period is as follows:

VaR position Year 2008	At 31 Dec	Average	Maximum	Minimum
Foreign currency risk	1,705	1,326	1,791	1,025
Interest rate risk	87	68	160	27
Other price risk	218	102	218	–
<b>Total</b>	<b>2,010</b>	<b>1,496</b>		

The chart below shows a monthly trend of VaR from January to December 2008. During this period, the maximum VaR was BD 2.11 million on 18/12/2008 while the minimum VaR was BD 1.07 million on 31/3/2008.

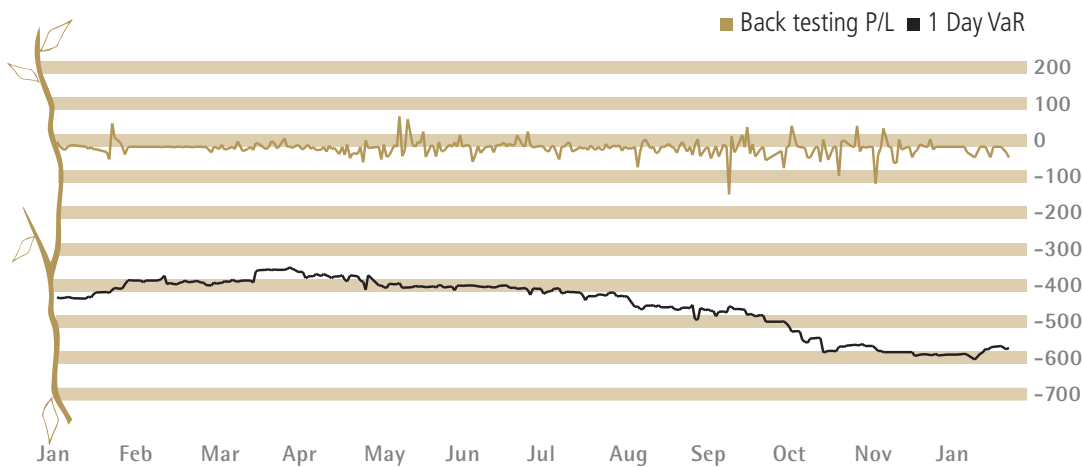




# Basel 2 – Pillar 3 Disclosures

For the year ended 31 December 2008

The Bank uses back-testing to validate the VaR model. VaR is compared with actual daily profits and losses incurred on the trading portfolio. This assists in identifying any exceptions or losses that are not covered by the VaR measure. Back-testing results, as detailed below, confirm that the internal model adequately captures risks within the Bank's trading portfolio.



Value-at-risk backtesting January-December 2008  
BD (thousands)

## OPERATIONAL RISK

Whilst the Bank recognizes that operational risks cannot be eliminated in its entirety, it constantly strives to minimise operational risks (inherent in the Bank's activities, processes and systems) by ensuring that a strong control infrastructure is in place throughout the organisation and enhanced where necessary. The various procedures and processes used to manage operational risks are regularly reviewed and updated and implemented through effective staff training, close monitoring of risk limits, segregation of duties, appropriate controls to safeguard assets and records, regular reconciliation of accounts and transactions, and financial management and reporting. In addition, regular internal audit and reviews, business continuity planning and arrangements for insurance cover are in place to complement the processes and procedures.

The Bank presently follows the Basic Indicator Approach for assessing the capital requirement for Operational Risk. The capital requirement of BD 13.5 million is based on 15% of the average of the gross operating income (excluding profit/loss on Investments held under Available for Sale, Held to Maturity categories and any exceptional items of income) for the last 3 years multiplied by 12.5 ( the reciprocal of the 8 percent minimum capital ratio) to arrive at the operational risk-weighted exposure.



# Basel 2 – Pillar 3 Disclosures

For the year ended 31 December 2008

## EQUITY POSITION IN BANKING BOOK

The Bank holds certain investments in equity securities as part of its strategic holdings and others are held with the objective of capital appreciation and realizing gains on sale thereof. All equity positions in the Banking book are classified as "Available for Sale". The accounting policies for "Available for Sale" instruments are described in detail in the Financial Statements under "Significant Accounting Policies".

**As at 31 December 2008**

**BD '000s**

Details of Equity Investments:	Balance Sheet Value	Capital Requirement
Quoted Equities:	57,325	6,879
Unquoted Equities:	15,478	2,786
<b>Total</b>	<b>72,803</b>	<b>9,665</b>
Realised gains/(losses) recorded in Income Statement	2,665	
Unrealised gains/(losses) recognized in Equity	37,436	
Unrealised losses deducted from Tier 1 Capital	1,202	
45 % of unrealized gains recognized under Tier 2 Capital	17,387	

## INTEREST RATE RISK IN BANKING BOOK

Interest Rate Risk is measured by the extent to which changes in the market interest rates impact margins, net interest income and the economic value of the Bank's equity. The Bank's asset and liability management process is utilised to manage interest rate risk through the structuring of on-balance sheet and off-balance sheet portfolios. Net interest income will be affected as a result of volatility in interest rates to the extent that the re-pricing structure of interest bearing assets differs from that of liabilities. The Bank's goal is to achieve stable earnings growth through active management of the assets and liabilities mix while, selectively positioning it to benefit from near-term changes in interest rate levels.

Overall non-trading interest rate risk positions are managed by the Treasury division, which uses investment securities, placements with banks, deposits from banks and derivative instruments to manage the overall position arising from the Bank's non-trading activities. Reports on overall position and risks are submitted to senior management for review and positions are adjusted if deemed necessary. In addition, ALCO regularly (at least on a monthly basis) reviews the interest rate sensitivity profile and its impact on earnings. Strategic decisions are made with the objective of producing a strong and stable interest income stream over time.

Duration analysis is used to measure the interest rate sensitivity of the fixed income portfolio. Duration of the portfolio is governed by economic forecasts, expected direction of interest rates and spreads. Modified Duration gives the percentage change in value of the portfolio following a 1% change in yield. Modified Duration of the Bank's fixed income portfolio was 0.92% on 31.12.2008, which implies that a 1% parallel upward shift in the yield curve could result in a drop in the value of the portfolio by BD 2.29 million.

Deposits without a fixed maturity are considered as repayable on demand and are accordingly included in the overnight maturity bucket. The Bank usually levies a pre-payment charge for any loan or deposit, which is repaid/withdrawn before the maturity date, unless it is specifically waived. This prepayment charge is to take care of any interest rate risk that the Bank faces on account of such prepayments and accordingly, no assumptions regarding such pre-payments are factored for computation of interest rate risk in the banking book.



## Basel 2 – Pillar 3 Disclosures

For the year ended 31 December 2008

The Bank uses interest rate gap analysis to measure the interest rate sensitivity of its annual earnings due to re-pricing mismatches between rate sensitive assets, liabilities and derivatives' positions. The asset and liability re-pricing profile of various asset and liability categories is set out below:

**As at 31 December 2008**

**BD '000s**

<b>Assets</b>	<b>Upto 3 months</b>	<b>3 to 6 months</b>	<b>6 to 12 months</b>	<b>1 to 5 years</b>	<b>Over 5 years</b>	<b>Rate insensitive</b>	<b>Total</b>
Cash and balances at central banks	–	–	–	–	–	82,398	82,398
Treasury Bills	6,608	9,969	–	–	–	–	16,577
Placements with banks/ financial institutions	386,550	–	13,398	–	–	10,535	410,483
Trading securities	–	–	–	–	–	385	385
Loans and advances	567,752	170,236	38,698	231,433	87,592	–	1,095,711
Investment securities	196,473	63,731	39,487	–	–	99,485	399,176
Other assets	–	–	–	–	–	29,369	29,369
<b>Total assets</b>	<b>1,157,383</b>	<b>243,936</b>	<b>91,583</b>	<b>231,433</b>	<b>87,592</b>	<b>222,172</b>	<b>2,034,099</b>
Liabilities and equity							
Due to banks and financial institutions	232,060	–	216	–	–	21,681	253,957
Borrowings under repurchase agreements	31,824	–	–	–	–	–	31,824
Customers' deposits	828,381	118,388	94,590	–	–	477,897	1,519,256
Other liabilities	–	–	–	–	–	11,677	11,677
Equity	–	–	–	–	–	217,385	217,385
<b>Total liabilities and equity</b>	<b>1,092,265</b>	<b>118,388</b>	<b>94,806</b>	<b>–</b>	<b>–</b>	<b>728,640</b>	<b>2,034,099</b>
<b>Interest rate sensitivity gap</b>	<b>65,118</b>	<b>125,548</b>	<b>(3,223)</b>	<b>231,433</b>	<b>87,592</b>	<b>(506,468)</b>	
<b>Cumulative interest rate sensitivity gap</b>	<b>65,118</b>	<b>190,666</b>	<b>187,443</b>	<b>418,876</b>	<b>506,468</b>	<b>–</b>	



# Notes to the Financial Statements

For the year ended 31 December 2008

The interest rate risk management process is supplemented by monitoring the sensitivity of the Bank's financial assets and liabilities to an interest rate shock of 200bps increase/ decrease. An analysis of the Bank's sensitivity to an increase or decrease in market interest rates (assuming no asymmetrical movement in yield curves and a constant balance sheet position) is as follows:

**In BD '000s**

<b>Year 2008</b>	<b>200 bp parallel increase</b>	<b>200 bp parallel decrease</b>
As at 31 December	(3,249)	3,249
Average for the year	(2,983)	2,983
Minimum for the year	(4,422)	4,422
Maximum for the year	(13)	13

The contents of these Basel 2 Pillar 3 disclosures and other disclosure requirements (as appropriately disclosed in the annual report) of Chapter 1.3 of the Public Disclosure Module (PD Module) of the Central Bank of Bahrain's Rule Book have been reviewed by the Bank's external auditors KPMG based upon agreed upon procedures as required under Para PD-A.2.4 of the PD Module.