

RISK AND CAPITAL MANAGEMENT DISCLOSURES

For the year ended 31 December 2009

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 31st December 2009, the Bank's total risk weighted assets amounted to BD 1,063.5 million; Tier 1 Capital and total regulatory capital amounted to BD 216.5 million and BD 237.2 million respectively. Accordingly, Tier 1 Capital Adequacy Ratio and Total Capital Adequacy Ratio were 20.4% and 22.3 % 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 2009 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 (responsible for management of legal risk) and Risk Management and Compliance Department (responsible for market risk, operational risk and compliance management)

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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:

Bank's Internal Ratings Scale	Equivalent to Moody's and S&P ratings
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 repricing 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 Bank has an Operational Risk Management Department within the Credit Policy and Risk Management Division to independently monitor and manage all aspects of operational risk on a bank wide basis. The Bank also has a dedicated Operational Risk Management Committee to supervise, monitor and review operational risks issues and ensure that adequate mitigants are developed and implemented for all operational risk issues.

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.

Prior approval of the Central Bank of Bahrain is obtained by the Bank before submitting any proposal for distribution of profits for shareholders approval.

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 and unrated securitisation exposures are deducted equally from Tier 1 and Tier 2 i.e. 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 and deduction of 50% of fair value of investments in associates and unrated securitisation exposures.

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 2009	
BD '000s	
Tier 1 capital	
Share Capital	77,760
Statutory Reserve	38,880
General Reserve	32,400
Other Reserves	7,261
Retained Earnings	65,630
Deductions from Tier 1 Capital	(5,400)
Total Tier 1 (A)	216,531
Tier 2 capital	
45% of revaluation reserves on available for sale equity investments	14,524
Collective impairment provision subject to a 1.25% risk adjusted exposure limitation	8,231
Deductions from Tier 2 Capital	(2,114)
Total Tier 2	20,641
Total Capital Base (Tier 1 + Tier 2) (B)	237,172

As at 31 December 2009	Risk weighted exposure	Capital requirement @ 12%
BD '000s		
Cash and collection items	469	56
Sovereigns	-	-
Banks	167,953	20,154
Corporates	323,871	38,865
Regulatory retail	207,601	24,912
Residential mortgages	15,238	1,829
Investments in equities/funds	57,374	6,885
Securitisation exposures	111	13
Others	98,159	11,779
Total Credit Risk Exposure	870,776	104,493
Market Risk	72,547	8,705
Operational Risk	120,223	14,427
Total Risk Weighted Exposure (C)	1,063,546	127,625
Capital Adequacy Ratio (B)/(C)	22.30%	
Tier 1 Capital Adequacy Ratio (A)/(C)	20.36%	

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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. Investments in companies engaged primarily in real estate are included in other assets and risk weighted at 200%.

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. Investments in real estate and also in bonds, funds and equities of companies engaged primarily in real estate are included in other assets and risk weighted at 200%

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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 2009	
BD '000s	
Cash and balances at central banks	81,213
Treasury bills	124,927
Placements with banks and other financial institutions	246,091
Loans and advances	1,159,654
Investment securities	483,121
Accrued interest receivable, other assets and property & equipment	29,336
Total assets	2,124,342
Non-derivative banking commitments and contingent liabilities (notional)	111,405
Derivatives (notional)	328,508

The balances as at 31st December 2009 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 2009							
BD '000s	Govt	Mfg/ Trdg	Banks/ FIs	Const	Personal	Others	Total
Cash and balances at central banks	-	-	81,213	-	-	-	81,213
Treasury Bills	124,927	-	-	-	-	-	124,927
Placements with banks/financial institutions	-	-	246,091	-	-	-	246,091
Loans and advances	300,754	158,684	138,217	164,156	305,511	92,332	1,159,654
Investment securities	244,689	4,051	181,867	4,611	-	47,903	483,121
Accrued interest receivable, other assets and property & equipment	1,452	520	2,590	509	803	23,462	29,336
Total assets	671,822	163,255	649,978	169,276	306,314	163,697	2,124,342
Non-derivative banking commitments and contingent liabilities (notional)	27,000	17,685	34,469	13,992	1,860	16,399	111,405
Derivatives (notional)	-	-	328,505	-	-	-	328,505

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

As at 31 December 2009 BD '000s	Middle East	USA	Europe	Rest of the world	Total
Cash and balances at central banks	81,213	-	-	-	81,213
Treasury Bills	124,927	-	-	-	124,927
Placements with banks/ financial institutions	170,003	18,433	57,311	344	246,091
Loans and advances	1,150,283	6,519	-	2,852	1,159,654
Investment securities	214,737	169,756	56,900	41,728	483,121
Accrued interest receivable, other assets and property & equipment	27,911	492	848	85	29,336
Total assets	1,769,074	195,200	115,059	45,009	2,124,342
Non-derivative banking commitments and contingent liabilities (notional)	88,205	622	21,185	1,393	111,405
Derivatives (notional)	153,816	-	132,363	42,329	328,508

RESIDUAL CONTRACTUAL MATURITY

As at 31 December 2009 BD '000s	Up to 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
Cash and balances at central banks	81,213	-	-	-	-	-	-	-	81,213
Treasury Bills	114,915	10,012	-	-	-	-	-	-	124,927
Placements with banks/ financial institutions	214,921	31,170	-	-	-	-	-	-	246,091
Loans and advances	236,328	66,882	189,574	380,629	162,917	78,041	44,247	1,036	1,159,654
Investment securities	10,948	13,684	47,297	267,860	69,243	9,659	-	64,430	483,121
Accrued interest receivable, other assets and property & equipment	7,225	432	70	882	800	15	-	19,912	29,336
Total assets	665,550	122,180	236,941	649,371	232,960	87,715	44,247	85,378	2,124,342
Non-derivative banking commitments and contingent liabilities (notional)	54,728	9,578	16,152	21,685	9,262	-	-	-	111,405
Derivatives (notional)	283,035	45,473	-	-	-	-	-	-	328,508

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 2009	
BD '000s	
Over 3 months to 1 year	2,431
1 to 3 years	1,482
Over 3 years	3,507
Total	7,420

- Geographical location of impaired and past due loans and advances:

As at 31 December 2009			
BD '000s	Loan Amount	Specific provision	Collective impairment
Bahrain	6,958	6,191	6,585
Other GCC countries	462	410	1,564
Others	–	–	82
Total	7,420	6,601	8,231

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

Year 2009	At 31 December 2009			During the year ended 31 December 2009	
	Loan Amount	Specific impairment provision	Collective impairment provision	Specific impairment Charge	Write offs
BD '000s					
Government	–	–	2,138	97	1,386
Manufacturing/trading	687	688	897	–	7
Construction	679	605	1,169	–	–
Personal	5,738	5,181	2,070	824	175
Others	316	127	1,957	17	1
Total	7,420	6,601	8,231	938	1,569

- Movement in provision for impairment of loans and advances:

Year 2009	Specific impairment provision	Collective impairment provision	Total provision	Interest in suspense
BD '000s				
At 1 January 2009	7,521	5,375	12,896	4,731
Charge for the year	938	3,500	4,438	722
Amounts written off against provision	(1,569)	(8)	(1,577)	(1,624)
Recoveries & write backs	(289)	(636)	(925)	(240)
At 31 December 2009	6,601	8,231	14,832	3,589

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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:

As at 31 December 2009 BD '000s	Gross credit exposure	Of which secured by eligible		Credit exposure after risk mitigants
		Financial collateral	Guarantees and credit derivatives	
Sovereigns	599,329	–	33,333	565,996
Banks	547,337	167,885	–	379,453
Corporates	663,063	22,146	–	640,917
Regulatory retail	279,151	2,351	–	276,800
Residential mortgage	20,454	136	–	20,318
Others	84,952	16,704	–	68,258

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 35.1 million.

RISK AND CAPITAL MANAGEMENT DISCLOSURES

For the year ended 31 December 2009

MARKET RISK

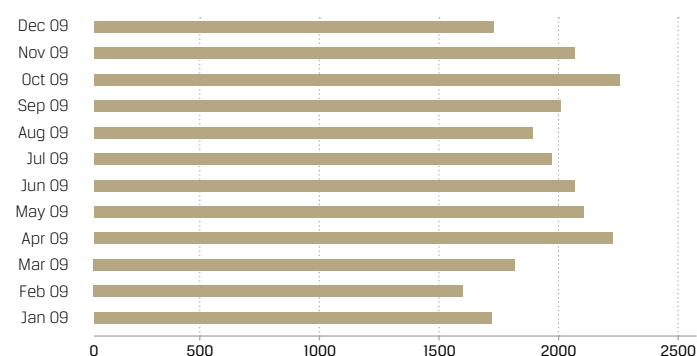
The Bank uses the Internal Model Approach for assessing the capital requirement for market risk, which includes capital charge for both general and specific risk. The principal tool used to measure and control market risk exposure is Value-at-Risk (VaR). The VaR is the estimated loss that will arise 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:

BD 000's	At 31 December 2009	During the year ended 31 December 2009		
		Average	Maximum	Minimum
Foreign currency risk	1,025	1,377	1,704	912
Interest rate risk	440	256	548	17
Other price risk	258	254	269	218
Total	1,723	1,887		

The chart below shows a monthly trend of VaR from January to December 2009. During this period, the maximum VaR was BD 2.27 million on 29 October 2009 while the minimum VaR was BD 1.45 million on 11 March 2009.

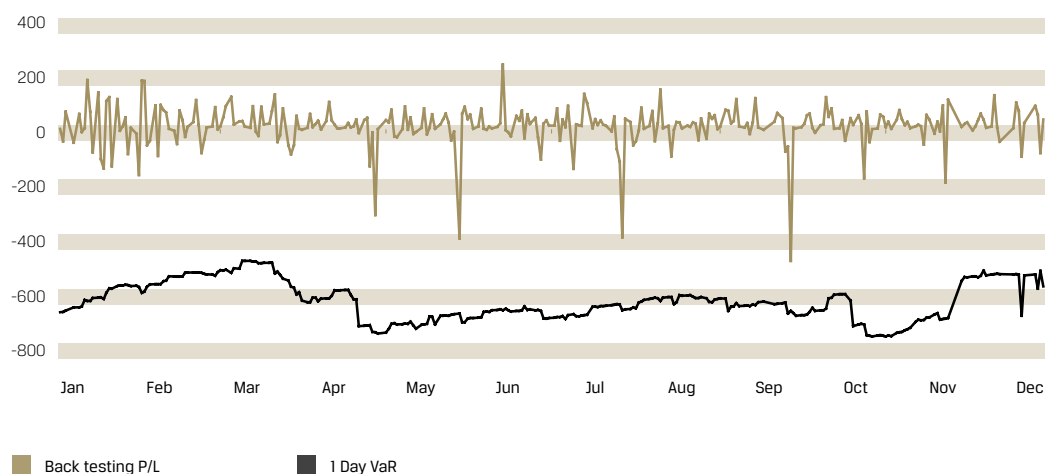


VALUE-AT-RISK AT MONTH END - 2009
BD '000

RISK AND CAPITAL MANAGEMENT DISCLOSURES

For the year ended 31 December 2009

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 2009
BD '000

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 14.4 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.

RISK AND CAPITAL MANAGEMENT DISCLOSURES

For the year ended 31 December 2009

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 realising 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 2009		
BD '000s		
Details of Equity Investments:	Balance Sheet Value	Capital Requirement @12% of Risk Weighted Assets
Quoted Equities:	49,729	3,986
Unquoted Equities:	14,828	2,660
Total	64,557	6,646

	BD 000's
Realised gains (recorded in Income Statement during the year)	312
Unrealised gains recognised in Equity	28,991
Unrealised losses deducted from Tier 1 Capital	3,286
45 % of unrealised gains recognised under Tier 2 Capital	14,524

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 1.31% on 31.12.2009, 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 4.8 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 prepayments are factored for computation of interest rate risk in the banking book.

RISK AND CAPITAL MANAGEMENT DISCLOSURES

For the year ended 31 December 2009

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 2009 BD '000s	Upto 3 months	3 to 6 months	6 to 12 months	1 to 5 years	Over 5 years	Rate insensitive	Total
Assets							
Cash and balances at central banks	–	–	–	–	–	81,213	81,213
Treasury Bills	114,915	10,012	–	–	–	–	124,927
Placements with banks/ financial institutions	207,793	31,170	–	–	–	7,128	246,091
Trading securities	1,246	–	–	–	–	391	1,637
Loans and advances*	580,816	86,713	128,266	280,275	75,353	–	1,151,423
Investment securities	164,830	13,816	22,652	205,524	3,762	72,537	483,121
Accrued interest receivable, other assets and property & equipment	–	–	–	–	–	29,336	29,336
Total assets	1,069,600	141,711	150,918	485,799	79,115	190,605	2,117,748
Liabilities and equity							
Due to banks and financial institutions	240,317	–	216	–	–	19,283	259,816
Borrowings under repurchase agreements	125,586	–	–	–	–	–	125,586
Customers' deposits	838,198	132,162	27,092	160	–	482,780	1,480,392
Other liabilities	–	–	–	–	–	10,589	10,589
Equity	–	–	–	–	–	241,365	241,365
Total liabilities and equity	1,204,101	132,162	27,308	160	–	754,017	2,117,748
Interest rate sensitivity gap	(134,501)	9,549	123,610	485,639	79,115	(563,412)	–
Cumulative interest rate sensitivity gap	(134,501)	(124,952)	(1,342)	484,297	563,412	–	–

*Net of collective impairment provision of BD 8,231.

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:

Year 2009 In BD '000s	200 bp parallel increase	200 bp parallel decrease
As at 31 December	(9,582)	9,582
Average for the year	(8,328)	8,328
Minimum for the year	(5,470)	5,470
Maximum for the year	(9,764)	9,764