RISK MANAGEMENT

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CREDIT POLICY & RISK MANAGEMENT

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RISK MANAGEMENT

In a world characterised by high integration of global financial markets, innovation in financial products, extensive use of derivatives, market volatility and large scale regulatory changes, the management of risk has become a key issue for every bank. NBB has over the years, developed risk management into a core competence and remains well positioned to meet these challenges. The Bank evaluates risk in terms of the impact on income and asset values. 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 NBB has always been conservative and proactive with the objective of achieving a balanced relation between risk appetite and expected returns.

Risk arises from the Bank's lending and investment activities as carried out by the various units. Corporate Banking is responsible for lending to large corporate entities in Bahrain. Regional Banking handles credit facilities to leading corporates in other countries of the GCC. The Trade Finance and Financial Institutions unit is involved in identifying and financing trade flows between the GCC region and the rest of the world. Commercial Banking's responsibilities cover the borrowing requirements of the small to medium-sized companies based in Bahrain. Personal Banking controls the lending portfolio to individuals in Bahrain and other retail services. Treasury and Investments is responsible for all the treasury and capital market related activities of the Bank, and the Abu Dhabi and Riyadh Branches serve the UAE and Saudi Arabian markets respectively.

The overall authority for risk management in the Bank is vested in the Board of Directors. The Board authorises appropriate credit and market risk policies as well as suitable operational guidelines based on the recommendation of Management. Approval authorities are delegated to different functionaries in the hierarchy depending on the amount, type of risk and collateral security. The Bank has established committees that decide on all risk issues and authorities are properly structured.

Integral to the Bank's risk management system is the internal audit department that plays a role in evaluating the independence and overall effectiveness of the Bank's risk management functions. A periodic review of risk assets is conducted by the department to confirm that established policies, procedures and approved terms are complied with, and to review asset quality and highlight areas of concern so that corrective action can be taken in time.

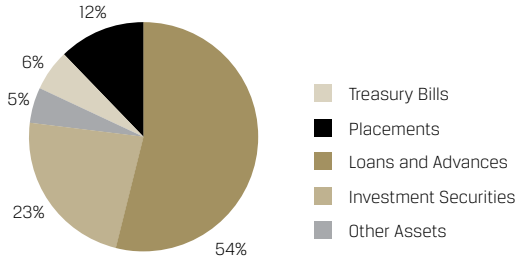
The Credit Policy and Risk Management (CPRM) division of the Bank provides the necessary support to Senior Management and the business units in all areas of risk management. This division functions independently of the business units to analyse risks and put forth its recommendations prior to approval by the delegated authorities. The Bank promotes healthy debate among the business units and CPRM to achieve an optimum balance between risk and return.

The Bank's risk management process encompasses the various dimensions of risk as follows:

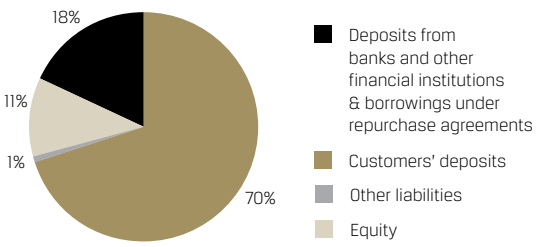
CREDIT RISK

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

NBB has developed risk management into a core competence and remains well positioned to meet these challenges



COMPOSITION OF TOTAL ASSETS
Per cent



COMPOSITION OF TOTAL LIABILITY AND EQUITY
Per cent

The Bank has well laid out procedures, not only to appraise but also regularly monitor credit risk. Regular reviews are carried out for each account and risks identified are mitigated in a number of ways which include obtention of 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.

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 a deterioration in risk profile.

The Bank follows stringent criteria in setting credit limits for countries and international financial institutions. Prudent norms have also been implemented to govern the Bank's investment activities. 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 ensures timely identification of any event affecting the risk profile.

The Bank enters into derivative contracts in the normal course of business to meet customer requirements and to manage its own exposure to fluctuations in interest and exchange rates. The credit risk arising from a derivative contract is calculated by taking the cost of replacing the contract, where its mark to market value is positive, together with an estimate for the potential future change in the value of the contract. The credit risk on contracts with a negative mark to market value is restricted to the potential future change in their market value. Details of derivative contracts are contained in Note 16 to the Financial Statements.

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. Adequate provisions are carried to guard against inherent risks in the portfolio. At year-end 2009, the Bank's provisions exceeded the entire non-performing portfolio.

LEGAL RISK

Legal risk management systems supplement the above credit procedures and guard against the inability of the Bank to enforce claims against counterparties and borrowers.

In-house expertise together with firms of international repute retained by the Bank ensures that the facility documentation encompasses eventualities that might affect the implementation of stipulated terms and conditions.

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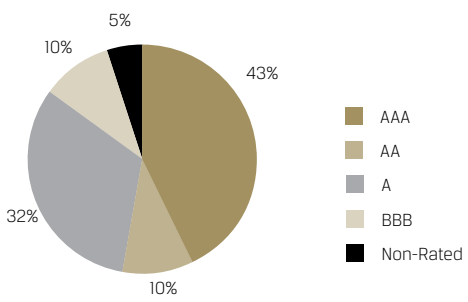
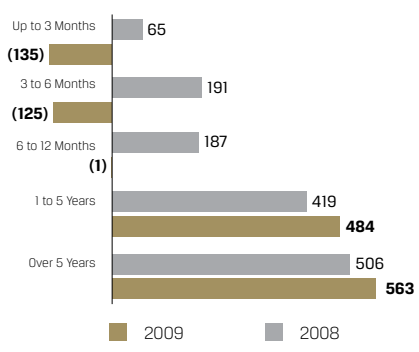
The Bank's ability to maintain a stable liquidity profile is primarily on account of its success in retaining and growing its customer deposit base.



INVESTMENT SECURITIES BY RATING
Per cent



CUMULATIVE INTEREST RATE SENSITIVE GAP
BD Millions

LIQUIDITY RISK

Liquidity Risk is classified as 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/liabilities management policies of the Bank define the proportion of liquid assets to total assets with the aim of minimising liquidity risk.

The Bank has maintained adequate investments in liquid assets, such as inter-bank placements and treasury bills. In addition, the Bank also relies on trading assets and other marketable securities to provide for secondary sources of liquidity. The ratio of liquid assets to total assets as at 31 December 2009 was 21.4 per cent. The high level of liquidity enables the Bank to meet fluctuating customer borrowings and drawdowns comfortably.

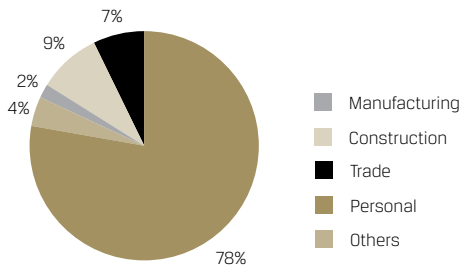
The Bank's ability to maintain a stable liquidity profile is primarily on account of its success in retaining and growing its customer deposit base. The marketing strategy of the Bank has ensured a balanced mix of demand and time deposits. As a result of its successful deposit and asset-liability management strategies, the Bank is a net lender in the interbank market and is not dependent on volatile short-term borrowings.

The Treasurer closely monitors the maturity profile of assets and liabilities so that adequate liquidity is maintained at all times. The asset and liability maturity profile by individual asset and liability category based on contractual repayment arrangements is detailed in Note 34 to the Financial Statements. As at 31 December 2009, 31.4 per cent of assets were scheduled to mature within three months. Substantial 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. Proper contingency plans exist and can be implemented on a timely basis to minimise the risk associated with dramatic changes in market conditions. 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.

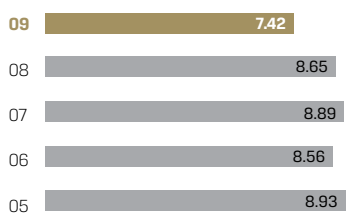
INTEREST RATE RISK

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. 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 repricing 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 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. The interest rate sensitivity graph illustrates the Bank's repricing gap structure as at 31 December 2009. A negative gap



SECTOR PROFILE OF NON-PERFORMING LOANS AND ADVANCES
Per cent



NON-PERFORMING LOANS AND ADVANCES
BD Millions

denotes liability sensitivity and a positive gap denotes asset sensitivity. Note 31 to the Financial Statements gives details of the Bank's 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. Modified Duration of the Bank's fixed income portfolio was 1.31 per cent on 31 December 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 4.79 Million. Interest rate swaps and forward rate agreements are used to manage the interest rate risk. The Treasurer is primarily responsible for managing the interest rate risk. Reports on overall positions 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. Strategic decisions are made with the objective of producing a strong and stable interest income over time.

MARKET RISK

Market Risk is classified as the risk to the value of the trading portfolio arising from changes in interest rates, foreign exchange, commodities and equity prices. The Bank's trading activities are governed by conservative policies, by adherence to limits 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 measure determines the BD value of the price sensitivity of market-traded instruments to market risk factors for a certain degree of confidence over a pre-defined time horizon. Based on the approval of the Central Bank of Bahrain in 1999, the Bank has been computing its market risk using an internal model based on RiskMetrics methodology.

The value 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 uses exponentially weighted RiskMetrics datasets on volatilities and correlations in estimating the VaR for its trading portfolio. A 99 per cent level of confidence is used to determine the maximum potential loss in the portfolio over the relevant time horizon. It implies 1 per cent likelihood of the loss exceeding the VaR limit.

The VaR for the trading portfolio calculated as at 31 December 2009 was BD 1.72 Million for a 99 per cent confidence level and a 10 day time horizon. The average VaR for the last 60 days of 2009 was BD 1.92 Million.

The Value-at-Risk at month end chart 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

The Value-at-Risk back-testing chart shows the Bank's 1-day VaR compared to its daily trading profit and loss from January to December 2009. The Bank uses back-testing to validate the VaR model. VaR is compared

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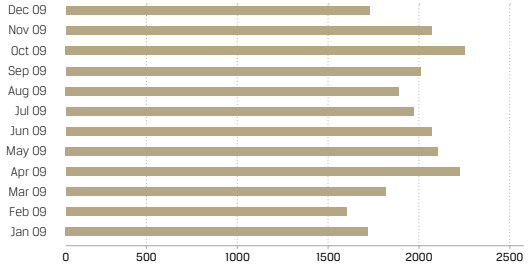
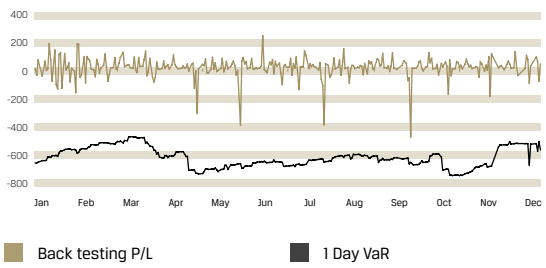


VALUE-AT-RISK AT MONTH END - 2009
BD '000



VALUE-AT-RISK BACKTESTING JANUARY-DECEMBER 2009
BD '000

with 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 confirm that the internal model adequately captures risk within the Bank's trading portfolio

OPERATIONAL RISK

Operational Risk is the risk of monetary loss on account of human error, fraud, systems failures or the failure to record transactions. The Bank has well laid out procedures and systems that set out the methodologies for carrying out specific tasks. These systems and procedures are constantly reviewed and revised to address potential risks.

During 2009, the Bank set up 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 established a dedicated Operational Risk Management Committee to supervise, monitor and review operational risk issues and ensure that adequate mitgants are developed and implemented for all operational risk issues. This Committee is assisted by the Operational Risk Management department.

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 well-established off-site computer back-up centre that provides full system support to the Bank's operations in case of an emergency in the information technology systems. The computer back-up centre is regularly tested to ensure its readiness for a seamless switchover in case of any emergency.

The necessary precautions have been put in place to protect the Bank from money laundering activities.

All the aspects of risk mentioned above are reviewed regularly at each meeting of the Board of Directors and the Executive Committee, based on a comprehensive risk report. This integrated approach to risk management also serves the Bank in achieving its objective of protecting the interests of shareholders and customers.