



**RISK AND CAPITAL MANAGEMENT
DISCLOSURES**

**FOR THE PERIOD ENDED
30 June 2019**

INTRODUCTION

This document presents the Pillar 3 disclosures on a consolidated basis as at 30 June 2019. The purpose of Pillar 3 disclosures is to allow market participants to assess key pieces of information on the Bank's capital, risk exposures and risk assessment process. The Bank is regulated by the Central Bank of Bahrain (CBB) and follows the Pillar 3 disclosure requirements as stated under the CBB guidelines.

The Bank views these 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. The Pillar 3 disclosures are to be read in conjunction with the Reviewed Financial Statements as of 30 June 2019.

REGULATORY FRAMEWORK

The Bank assesses its capital adequacy based on the rules published by the CBB. The framework is structured around the following three Pillars:

- Pillar 1 on minimum capital requirements for credit, market and operational risk.
- Pillar 2 on the supervisory review process and the Internal Capital Adequacy Assessment Process (ICAAP).
- Pillar 3 on market discipline including terms for disclosure of risk management and capital adequacy

2.1 Pillar 1 – Minimum Capital Requirement

Pillar 1 defines the total minimum capital requirements for credit, market and operational risk. NBB currently employs the standardized approach for assessment of Credit and Market Risk weighted assets (RWAs), whilst using the Basic Indicator Approach for assessment of Operational RWAs

The CBB capital adequacy rules provides guidance on the risk measurements for the calculation of capital adequacy requirements (CAR). Conventional bank licenses are required to meet the following minimum CAR requirements:

Components of consolidated CARs				
	Limit	Minimum ratio required	Capital conservation buffer (CCB)	CAR including CCB
Common equity tier 1 (CET1)		6.5 %	2.5 % comprising of CET1	9.0 %
Additional tier 1 (AT1)	1.5 %			10.5 %
Tier 1		8.0 %		
Tier 2	2.0 %			
Total capital		10.0 %		

The regulatory adjustments (i.e. deductions) including amounts above the aggregate 15% limit for significant investments in financial institutions, mortgage service rights, and deferred tax assets from temporary differences, are fully deducted from CET1 effective 1 January 2019. This regulatory adjustment was at 20% of the required adjustments to CET 1 on 1 January 2015, 40% on 1 January 2016, 60% on 1 January 2017, 80% on 1 January 2018, and reached 100% on 1 January 2019. During the transition period, the remainder not deducted from CET1, continued to be risk weighted as per the rulebook.

Banks are required to maintain a capital conservation buffer (CCB) of 2.5%, comprising of CET1 above the regulatory minimum total capital ratio of 10.0%. Capital distribution constraints will be imposed when the CCB falls below 2.5%. The constraints imposed only relate to distribution, and not the operations of the licensed banks.

As at 30 June 2019, the Bank's total risk weighted assets amounted to BHD 1,340.0 million; common equity tier 1 (CET1) and total regulatory capital amounted to BHD 465.3 million and BHD 474.3 million respectively. Accordingly, the CET1 capital adequacy ratio and the total capital adequacy ratio were 34.7 percent and 35.4 percent respectively. These ratios exceed the minimum capital requirements under the CBB's Basel III framework.

CBB CAPITAL ADEQUACY RULES

RISK AND CAPITAL MANAGEMENT

The Bank is exposed to the following types of risks:

- credit risk
- liquidity risk
- market 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, operational, and market risk policies that form part of its risk management framework, 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 risk group of the Bank provides the necessary support to senior management and the business units in all areas of risk management. The risk group functions independent of the business units and reports directly to the board risk committee and administratively to the Chief Executive Officer. The risk group comprises of a credit risk department (responsible for independent 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), liquidity and market risk management department, operational risk management department, and information security risk department.

The board risk committee is responsible for identifying, optimising and ensuring appropriate mitigation of risks within the framework of the risk appetite established by the Bank's board of directors. This includes reviewing and reporting its conclusions and recommendations to the board on:

- The Bank's current and future risk appetite (i.e. in relation to the extent and categories of risk which the board regards as acceptable for the Bank to bear);
- The Bank's risk management framework (embracing principles, policies, methodologies, systems, processes, procedures and people); and
- The Bank's risk culture to ensure that it supports the Bank's risk appetite. In this regard, the committee will take a forward-looking perspective, seeking to anticipate changes in business conditions.

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 and counterparty groups. Stringent criteria are used by the credit risk department in setting such limits and these have ensured that the impact of any adverse developments on the Bank's income generation and capital strength is limited. 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, to not only appraise but also regularly monitor credit risk. Credit appraisal is based on the financial information 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 credit risk department 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 in accordance with the stipulated policy requirements. Credit facilities in excess of certain levels or falling outside pre-approved product criteria are independently reviewed by the credit risk department, which 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 identification of any deterioration in credit risk and consequent implementation of corrective action.

The Bank's internal ratings are based on a 16-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 on at least 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.

The Bank also uses the ratings by established rating agencies as part of the appraisal process while considering exposures to rated entities.

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

<u>Internal ratings scale</u>	<u>Fitch rating</u>	<u>S&P rating</u>	<u>Moody's rating</u>
1	AAA	AAA	Aaa
2	AA+	AA+	Aa1
3	AA	AA	Aa2
4+	AA-	AA-	Aa3
4	A+	A+	A1
4-	A	A	A2
5+	A-	A-	A3
5	BBB+	BBB+	Baa1
5-	BBB	BBB	Baa2
6+	BBB-	BBB-	Baa3
6	BB+	BB+	Ba1
6-	BB to BB-	BB to BB-	Ba2 to Ba3
7	B+ to B-	B+ to B-	B1 to B3
8-10	CCC+ to D	CCC+ to D	Caa1 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 standardised method for allocating market risk capital based on the risk assessed for underlying factors of interest rate risk, equity risk, foreign exchange risk, options risk and commodity risk. Daily reports in this regard are submitted to senior management for review and decision making purposes.

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 percent 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 to achieving our strategy or objectives as a result of inadequate or failed internal processes, people and systems or from external events. Operational risk arises from day-to-day operations or external events and is relevant to every aspect of our business.

Operational risk is:

- Measured using the risk and control assessment process, which assesses the level of risk and the effectiveness of controls, and measured for capital management using risk event losses;
- Monitored using key risk indicators and other internal control activities; and
- Managed primarily by business and functional managers who identify and assess risks, implement controls to manage them and monitor the effectiveness of these controls using the operational risk management framework.

The objective of our operational risk management framework (ORMF) is to manage and control operational risk in a cost-effective manner within targeted levels of operational risk consistent with our risk appetite. The ORMF defines minimum standards and processes, and the governance structure for the management of operational risk and internal control in Bahrain and at our overseas branches. The ORMF has been codified in a high-level operational risk management policy, supplemented with the detailed procedure, which describes our approach to identifying, assessing, monitoring and controlling operational risk and gives guidance on mitigating action to be taken when weaknesses are identified.

We have a dedicated Operational Risk Management Department (ORMD) within our Risk Group Division. It is responsible for leading the embedding of the ORMF and assuring adherence to associated policies and processes across the first and second lines of defence. It supports the Chief Risk Officer and the Operational Risk Management Committee (ORMC), which meets on a monthly basis to discuss key risk issues and review the implementation of the ORMF.

Heads of Departments and Functions throughout the Bank are responsible for maintaining an acceptable level of internal control commensurate with the scale and nature of operations, and for identifying and assessing risks, designing controls and monitoring the effectiveness of these controls. The ORMF helps managers to fulfill these responsibilities by defining a standard risk assessment methodology and providing a tool for the systematic reporting of operational loss data. Operational risk and control self-assessments, along with issue and action plans are facilitated, guided and monitored by ORMD and maintained by Business

Units. To help ensure that operational risk losses are consistently reported and monitored all Business Units are required to report individual losses or near-misses to ORMD.

In 2019 we continued our ongoing work to strengthen those controls that manage our most material risks. Among other measures, we are:

- Further developing controls to help ensure that we know our customers, ask the right questions, monitor transactions and escalate concerns to detect, prevent and deter fraud risk;
- Improving controls and security to protect customers when using digital channels;
- Increasing monitoring and enhancing detective controls to manage those fraud risks which arise from new technologies and new ways of banking.

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 are 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 monthly basis. In addition, stress testing on capital adequacy is undertaken once a year or more frequently in times of need and communicated to the board of directors and 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 shareholders' 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 sufficient capital 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 the capital requirement and planning to ensure that the Bank is adequately capitalised 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 year.

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

Capital structure, minimum capital 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.

All amounts are presented at 30 June 2019 unless specified otherwise.

	BHD millions
Common equity tier 1 (CET1)	
Share capital	154.3
Shares unallocated under share incentive scheme	(1.4)
Share premium	6.3
Statutory reserve	77.2
General reserves	32.4
Other reserves and retained earnings	217.7
Total equity	486.5
Addition unrealised loss in cash flow hedge reserve not eligible for regulatory capital	-
Total regulatory capital	486.5
Deduction from CET 1 (significant investments in common stock of financial entities)	(21.2)
Total common equity tier 1 (CET1)	465.3
Additional tier 1	-
Total tier 1	465.3
Tier 2 capital	
Expected credit loss subject to 1.25% of credit risk weighted assets	9.0
Total tier 2	9.0
Total capital base (tier 1 + tier 2)	474.3

CREDIT RISK

The Bank has a diversified on and off-balance sheet credit portfolio, which is divided into counterparty exposure classes in accordance with the CBB's Basel III capital adequacy framework. A high-level description of the counterparty exposure classes and the risk weights used to derive the risk weighted assets are as follows:

Sovereign portfolio

The sovereign portfolio comprises exposures to governments and their respective central banks. The risk weights are 0 percent 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 percent risk weighting.

PSE portfolio

Public sector entities (PSEs) are risk weighted according to their external ratings except for Bahrain PSEs and domestic currency claims on other PSEs that are assigned a 0 percent risk weight by their respective country regulator, which are risk weighted at 0 percent.

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 foreign banks licensed in Bahrain. 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 applied on exposures in Bahraini Dinar and 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 percent 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 percent risk weight.

Regulatory retail portfolio

Claims on individuals or to a small business with an annual turnover below BHD 2.0 million and where the maximum aggregated retail exposure to one counterpart is below BHD 250 thousand are risk weighted at 75 percent.

Residential mortgages

Lending fully secured by first mortgages on residential property that is, or will be, occupied by the borrower or that is leased are risk weighted at 75 percent.

Equities/funds portfolio

The equities portfolio comprises equity investments in the banking book, i.e. categorised as fair value through other comprehensive income. The credit (specific) risk for equities in the trading book is included in market risk for regulatory capital adequacy calculation purposes.

A 100 percent risk weight is assigned to listed equities and funds. Unlisted equities and funds are risk weighted at 150 percent. Investments in rated funds are risk weighted according to the external credit rating. Significant investments in listed and unlisted equities of financial entities are aggregated and the excess above the 10 percent of CET1 is deducted from equity; the amount not deducted is risk weighted at 250 percent.

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

In addition to the above 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 percent or 150 percent is applied depending on the level of specific provision maintained against the exposure.

Other assets

Other assets are risk weighted at 100 percent. A credit valuation adjustment (CVA) is applied to applicable derivative exposures and included under other assets.

External credit assessment institutions (ECAI)

The Bank uses ratings issued by external rating agencies to derive the risk weightings under the CBB's Basel III capital adequacy framework. As required by the CBB, where there are two assessments by eligible ECAs which map into different risk weights, the higher risk weight is applied. If there are three or more assessments by eligible ECAs which map into different risk weights, the assessments corresponding to the two lowest risk weights must be referred to and the higher of those two risk weights must be applied.

	Credit exposure before CRM	Eligible CRM	Credit exposure after CRM	Average risk weight percentage	Risk weighted exposure	Capital requirement at 12.5 %
BHD millions						
Sovereign portfolio	1,732.1	-	1,732.1	0%	-	-
PSE portfolio	0.2	-	0.2	0%	-	-
Banks portfolio	202.0	46.4	155.6	48%	75.3	9.4
Corporates portfolio	399.8	65.1	334.7	98%	328.7	41.1
Regulatory retail portfolio	419.5	0.3	419.2	75%	314.4	39.3
Residential mortgages portfolio	29.6	-	29.6	75%	22.2	2.8
Equities/funds portfolio	99.6	-	99.6	186%	185.6	23.2
Past due exposures portfolio	73.7	3.1	70.6	110%	77.7	9.7
Others assets	85.5	-	85.5	100%	85.5	10.7
Total credit risk exposure	3,042.0	114.9	2,927.0		1,089.4	136.2
Market risk					58.1	7.3
Operational risk					192.5	24.1
Total risk weighted assets					1,340.0	167.6
CET1 capital adequacy ratio					34.7%	
Capital adequacy ratio					35.4%	

CRM is credit risk mitigants such as lien over deposits, mortgage over properties and/or shares and financial instruments.

According to Central Bank of Bahrain rulebook, banks designated as D-SIBs must hold designated HLA (high loss absorbency) expressed as common equity tier 1 capital at 1.5 percent of the total risk weighted assets, as calculated for the purposes of capital adequacy. As at 30 June 2019, the Bank common equity tier 1 capital ratio was 34.7% exceeding the minimum common capital tier 1 ratio and D-SIB buffer requirement of 9.0% and 1.5% respectively.

Credit risk exposures

The following are gross credit exposures, presented before the application of any credit risk mitigation techniques:

In BHD millions	As at 30 June 2019	2019 Daily average
Balances at central banks	95.4	81.5
Treasury bills	439.6	422.1
Placements with banks and other financial institutions	103.4	178.8
Loans and advances	1,214.1	1,272.4
Investment securities	1,139.9	1,156.4
Other assets	48.7	86.0
Total assets	3,041.1	3,197.2
Non-derivative banking commitments and contingent liabilities	190.6	221.5
Derivatives (replacement cost)	4.3	7.3
Total	2,326.0	3,426.0

INDUSTRY OR SECTOR EXPOSURE

In BHD millions	Government			Manufacturing / trading	Banks / financial	Construction	Personal	Others	Total
	Bahrain	Other countries							
Assets									
Balances at central banks	-	-	-	95.4	-	-	-	-	95.4
Treasury bills	439.6	-	-	-	-	-	-	-	439.6
Placements with banks and other financial institutions	-	-	-	103.4	-	-	-	-	103.4
Loans and advances	83.1	-	175.3	100.3	103.0	484.7	267.6	1,214.1	
Investment securities - debt instruments	1,063.5	34.6	-	35.9	-	-	6.0	1,139.9	
Interest receivable and other assets	17.1	0.5	1.3	4.7	0.3	0.9	23.9	48.7	
Total assets	1,603.3	35.1	176.6	339.7	103.3	485.6	297.5	3,041.1	
Contingent liabilities and banking commitments	35.8	-	48.9	50.4	48.0	1.4	6.1	190.6	
Derivatives (replacement cost)	0.6	-	-	3.7	-	-	-	4.3	
Total	1,639.7	35.1	225.5	393.8	151.3	487.0	303.6	3,236.0	

The above includes certain exposures to customers/counter-parties, which are in excess of 15 percent of the Bank's capital base. These exposures have the approval of the Central Bank of Bahrain or are exempt exposures under the large exposures policy of the Central Bank of Bahrain. The table below gives details of these exposures:

Counterparty	Counterparty type	Total exposure (In BHD millions)
Counterparty A	Sovereign	1,550.9
Counterparty B	Central Bank	136.5
Counterparty C	Sovereign	79.8
Counterparty D	Sovereign	75.9

GEOGRAPHIC DISTRIBUTION OF EXPOSURE

In BHD millions

	GCC	USA	Europe	Rest of the World	Total
Assets					
Balances at central banks	95.4	-	-	-	95.4
Treasury bills	439.6	-	-	-	439.6
Placements with banks and other financial institutions	94.6	3.1	5.2	0.5	103.4
Loans and advances	1,131.9	74.7	-	7.5	1,214.1
Investment securities	1,116.1	16.8	-	7.0	1,139.9
Interest receivable and other assets	43.9	2.2	2.6	-	48.7
Total assets	2,921.5	96.8	7.8	15.0	3,041.1
Contingent liabilities and banking commitments	171.6	0.1	14.1	4.8	190.6
Derivatives (replacement cost)	4.1	-	-	0.2	4.3
Total	3,097.2	96.9	21.9	20.0	3,236.0

RESIDUAL CONTRACTUAL MATURITY

In BHD millions

	Up to 3 months	3 to 6 months	6 months to 1 year	1 to 3 years	3 to 5 years	5 to 10 years	10 to 20 years	Over 20 years	Total
Assets									
Balances at central banks	95.4	-	-	-	-	-	-	-	95.4
Treasury bills	245.4	60.9	133.3	-	-	-	-	-	439.6
Placements with banks and other financial institutions	103.4	-	-	-	-	-	-	-	103.4
Loans and advances	298.0	86.1	87.0	355.1	215.6	151.9	18.3	2.1	1,214.1
Investment securities	104.2	112.2	210.3	384.6	233.5	95.1	-	-	1,139.9
Interest receivable and other assets	8.1	0.9	1.9	10.9	4.4	1.9	-	20.6	48.7
Total assets	854.5	260.1	432.5	750.6	453.5	248.9	18.3	22.7	3,041.1
Contingent liabilities and banking commitments	67.9	30.0	27.6	62.5	2.4	0.2	-	-	190.6
Derivatives (replacement cost)	1.5	1.4	1.2	0.2	-	-	-	-	4.3
Total	923.9	291.5	461.3	813.3	455.9	249.1	18.3	22.7	3,236.0

Shari'a compliant credit facilities

As at 30 June 2019, the Bank held Shari'a compliant credit facilities amounting to BHD 252.3 million.

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 over 90 days past due, are defined as non-performing.

Days past due represent the number of days since the earliest elapsed due date in respect of which full payment has not been received. Due dates are determined without considering any grace period that might be available to the borrower.

The Bank has systems and procedures in place to identify 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. The 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.

All non-performing loans and advances are assessed for impairment as stage 3. Under stage 3, lifetime ECL is recognised based on discounted cash flow methods based on the difference between the net carrying amount and the recoverable amount of the financial asset. The recoverable amount is measured as the present value of expected future cash flows, including amounts recoverable from guarantees and collateral, discounted based on the interest rate at the inception of the credit facility or, for debt instruments, at the current market rate of interest for a similar financial asset.

Impairment charges on the wider portfolio of financial assets which are not individually identified as impaired is now a forward-looking calculation and is established based on various factors. These factors include internal risk ratings, historical default rates adjusted considering multiple scenarios of the future macroeconomic outlook, loss ratios given an event of default, and rating migrations.

Ageing analysis of impaired and past due loans and advances:

	BHD millions
Up to 3 months (subject to cooling off period)	<u>53.6</u>
Over 3 months to 1 year	29.8
1 to 3 years	26.1
Over 3 years	<u>9.8</u>
	65.7
Total	119.3
Fair market value of collateral	112.8
Stage 3 impairment provision	45.6

Geographical location of impaired and past due loans and advances:

In BHD millions	Loan amount	Stage 3/Specific provision for impairment	Collateral market value	ECL stage 1 and stage 2
Bahrain	114.6	43.2	112.8	8.3
Other GCC countries	4.7	2.4	-	0.1
Total	119.3	45.6	112.8	8.4

Industry breakdown of impaired and past due loans and advances:

In BHD millions	Impaired loans	Stage 3/Specific provision for impairment	Collateral market value	ECL stage 1 and stage 2
Manufacturing/ trading	20.5	0.5	6.6	0.9
Construction	44.6	14.2	57.0	0.1
Personal	11.9	10.4	19.4	5.4
Others	42.3	20.4	29.7	2.0
Total	119.3	45.6	112.8	8.4

Movement in impairment provision for loans and advances:

In BHD millions	Stage 1	Stage 2	Stage 3	Total
Impairment at 1 January 2019	6.6	6.3	36.5	49.4
Net transfer between stages	(0.5)	(4.7)	5.2	-
Write off during the year	-	-	(0.4)	(0.4)
Charge for the year (net)	(0.2)	0.9	4.3	5.0
Impairment at 30 June 2019	5.9	2.5	45.6	54.0

Restructuring

During 2019, credit facilities amounting to BHD 2.9 million were restructured. Restructuring concessions mainly related to deferral of loan installments to assist customers overcome temporary cash flow situations or to realign the repayment with the borrower's revised cash flow projections, and amending the terms of loan covenants. Due to the minor nature of concessions, there was no significant impact on the Bank's impairment charge or the future earnings. In accordance with the Central Bank of Bahrain guidelines, loans that have been restructured should be reported as stage 2 for not less than 1 year from the date of restructuring.

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 recognised 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).

Substitution of counterparty: The substitution method is used for eligible guarantees (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

Collaterals taken for risk mitigation on credit exposures include: deposits held by customers, pledge of quoted shares, residential/commercial property mortgages, 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 collateral recognised under Basel III is taken into consideration.

The Bank's credit policy defines the types of acceptable collateral and the applicable haircuts or loan-to-value ratio. The Bank has a policy of independent valuation of collateral. In the case of real estate, valuation is done by independent valuers annually at the time of reviews 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 as required 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 presented by portfolio is as follows:

In BHD millions	Gross credit exposure	Financial collateral	Credit exposure after risk mitigation
Sovereign portfolio	1,732.1	-	1,732.1
PSE portfolio	0.2	-	0.2
Banks portfolio	202.0	46.4	155.6
Corporates portfolio	399.8	65.1	334.7
Regulatory retail portfolio	419.5	0.3	419.2
Residential mortgages portfolio	29.6	-	29.6
Equities/funds portfolio	99.6	-	99.6
Past due exposures portfolio	73.7	3.1	70.6
Others assets	85.5	-	85.5
	3,042.0	114.9	2,927.1

On and off-balance sheet netting:

The bank enters into netting agreements during the normal course of business, the agreements provide the bank with the legal rights to set off balances from specific counterparties, for both on and off-balance sheet exposure.

The amount of financial assets and financial liabilities set off under netting agreements amounted to BHD 58.7 million at 30 June 2019.

MARKET RISK

The Bank applies the standardised method for allocating market risk capital. 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 treasury front office, is responsible for valuation. Valuation is performed on a daily basis, based on quoted market prices from stock exchanges, independent third parties or amounts derived from cash flow models, as appropriate.

Amounts in BHD millions	Capital Charge			
	Amount	Maximum	Minimum	Average
Risk type				
Interest rate risk	4.6	7.1	1.5	4.0
Foreign exchange risk	-	-	-	-
Total minimum capital required for market risk	4.6			
Multiplier	12.5			
Market risk weighted exposure under the standardised method	58.1			

OPERATIONAL RISK

Whilst the Bank recognises 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 applies the basic indicator approach for assessing the capital requirement for operational risk. The capital requirement of BHD 192.5 million is based on the gross operating income (excluding profit/loss on debt instruments classified as fair value through other comprehensive income, amortised cost categories and any exceptional items of income) for the last 3 years multiplied by 12.5 to arrive at the operational risk-weighted exposure.

EQUITY POSITION IN THE BANKING BOOK

The Bank holds certain investments in equity securities as part of its strategic holdings (including investment in associates) and others are held with the objective of capital appreciation and realising gains on sale thereof. The accounting policies for "FVOCI" and "Investment in associates" are described in detail in the financial statements under "Significant Accounting Policies".

Details of equity investments

	Amount	Amount subject to risk weight	Minimum capital requirement at 12.5%
In BHD millions			
Non-significant investment in the common shares			
Listed equities	31.2	31.2	3.9
Unlisted equities	3.0	3.0	0.6
Significant investment in the common shares of financial entities >10%	48.6	48.6	15.2
	82.8	82.8	19.7
Unrealised gains from equities fair value	21.8		
Deduction from CET 1 (Significant investments in common stock of financial entities)	21.2		

INTEREST RATE RISK IN THE BANKING BOOK

Interest rate risk positions are managed by the treasury department. 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 (at least on a monthly basis) 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 percent change in yield. Modified duration of the Bank's unhedged fixed income portfolio was 0.97 percent on 30 June 2019 implying that a 1 percent parallel upward shift in the yield curve could result in a drop in the value of the portfolio by BHD 4.7 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.

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:

	Upto 3 months	3 to 6 months	6 months to 1 year	1 year to 5 years	Over 5 years	Rate insensitive	Total
In BHD millions							
Cash and balances at central banks	-	-	-	-	-	121.1	121.1
Treasury bills	245.5	60.9	133.3	-	-		439.6
Placements with banks and other financial institutions	87.8	-	-	-	-	15.6	103.4
Loans and advances	377.7	84.4	66.7	545.0	140.3	-	1,214.1
Investment securities	104.2	112.2	210.3	618.1	95.1	62.6	1,202.6
Investment in associates and Other assets	-	-	-	-	-	127.7	127.7
Total assets	815.2	257.5	410.3	1,163.1	235.4	327.0	3,208.5
Liabilities and equity							
Due to banks and financial institutions	372.1	4.9	36.3	-	-	31.7	445.0
Borrowings under repurchase agreements	100.0	-	-	-	-	-	100.0
Customers deposits	745.5	275.7	138.9	0.4	-	965.5	2,126.0
Other Liabilities	-	-	-	-	-	51.1	51.1
Equity	-	-	-	-	-	486.4	486.4
Total liabilities and equity	1,217.6	280.6	175.2	0.4	-	1,534.7	3,208.5
On Balance-sheet interest rate sensitivity gap	(402.4)	(23.1)	235.1	1,162.7	235.4	(1,207.7)	-
Off Balance-sheet interest rate gap	601.7	(6.3)	-	(438.1)	(157.3)	-	-
Cumulative Interest rate sensitivity gap	199.3	(29.4)	235.1	724.6	78.1	-	-

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 on the balance sheet. 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 BHD millions	200 bps parallel increase	200 bps parallel decrease
As at year ended above	(1.8)	1.8
Average for the year	(2.3)	2.3
Minimum for the year	(7.0)	7.0
Maximum for the year	5.7	(5.7)

RELATED PARTY

Certain related parties (major shareholders, directors of the Bank and families and companies of which they are principal owners, key management personnel and associates) were customers of the Bank in the ordinary course of business. The transactions with these parties were made on an arm's length basis. Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the Bank. Typically, key management personnel include the Chief Executive Officer and persons directly reporting to this position. Significant balances at the reporting date in regard to related parties and transactions during the year with related parties are as below:

The Bank qualifies as a government related entity under the definitions provided in IAS 24 as its significant shareholders is government owned. In addition to the government exposures reported below, in its normal course of business, the Bank provides commercial lending, liquidity management and other banking services to, and also avails services from, various semi-governmental organisations and government owned companies in the Kingdom of Bahrain.

	Major shareholder and related entities	Directors and key personal management	Associates
In BHD millions			
Loans and advances	266.0	7.5	-
Treasury bills, bonds and equities	1,499.5	-	52.4
Customers' deposits	112.2	41.3	5.9
Contingent liabilities for irrevocable commitments, guarantees and other contingencies	55.8	13.5	-
<i>For the period ended 30 June 2019</i>			
Loans advanced	43.7	2.1	-
Loans repaid	61.2	1.0	-
Net increase / (decrease) in overdrafts	120.6	2.2	-
Treasury bills, bonds and equities purchased	545.1	-	-
Treasury bills, bonds and equities matured/sold	442.6	-	-
Interest income	44.9	0.5	-
Interest expense	1.1	0.4	0.0
Share of profit of associates	-		2.5
Dividend income	-		-
Directors remuneration and sitting fees	0.1	0.2	-
Short term employee benefits	-	1.9	-
Post employment retirement benefits	-	0.1	-

During the year, impairment provision of BHD 3.8 million (USD 10.1 million) have been recorded against outstanding balances with related parties.

Certain transactions were approved by the Board of Directors under Article 189(b) of the Commercial Companies Law in the quarter ended 30 June 2019 where the chairman, directors or managers had a direct or indirect interest in the contracts or transactions which have been approved by the Board.

SIGNIFICANT NET OPEN FOREIGN CURRENCY POSITIONS

	BHD million	USD million
US Dollar (short position) - unhedged	0.8	2.1
UAE Dirhams (long position) - unhedged	24.3	64.6
Saudi Riyal (long position) - unhedged	10.3	27.4
Qatari Riyal (long position) - unhedged	0.3	0.8

The Bahraini dinar has a fixed rate of exchange against the US dollar.

DERIVATIVE AND FOREIGN EXCHANGE FINANCIAL INSTRUMENTS

The following table summarises for each type of derivative and foreign exchange financial instrument, the aggregate notional amounts, the replacement cost and the fair value:

In BHD millions	Contract/ Nominal Amount	Replacement cost	Fair value
Interest rate contracts			
Interest rate swaps	601.7	-	-
Sub-total	601.7	-	-
Foreign exchange contracts			
Outright spot and forward contracts	92.4	0.4	0.2
Swap agreements	1,823.0	3.9	3.1
Options	8.6	-	-
Sub-total	1,924.0	4.3	3.3
Total	2,525.7	4.3	3.3

The remaining maturity profile by each class of derivative and foreign exchange financial instrument based on contract/notional principal amounts is as follows:

In BHD millions	Up to 1 year	More than one year	Total
Interest rate contracts			
Interest rate swaps	6.3	595.4	601.7
Sub-total	6.3	595.4	601.7
Foreign exchange contracts			
Outright spot and forward contracts	92.4	-	92.4
Swap agreements	1,785.2	37.8	1,823.0
Options	8.6	-	8.6
Sub-total	1,886.2	37.8	1,924.0
Total	1,892.5	633.2	2,525.7

LEGAL CLAIMS

As at 30 June 2019, legal suits pending against the Bank aggregated to BHD 0.8 million (USD 2.1 million). Based on the opinion of the Bank's legal advisors and pending final judgment on these suits, adequate provision as assessed by management is maintained.