ARAB BANKING CORPORATION (B.S.C.)

BASEL II - PILLAR III DISCLOSURES
30 June 2010

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1. Introduction

The Central Bank of Bahrain [the CBB] requirements, which act as a common framework for the implementation of the Basel II Accord in the Kingdom of Bahrain, came into effect on 1 January 2008.

The Basel II Accord is built on three pillars:

- **Pillar I** defines the regulatory minimum capital requirements by providing rules and regulations for measurement of credit risk, market risk and operational risk. The requirement of capital has to be covered by the bank's own regulatory funds.
- **Pillar II** addresses a bank's internal processes for assessing overall capital adequacy in relation to risks (ICAAP). Pillar II also introduces the Supervisory Review and Evaluation Process (SREP), which assesses the internal capital adequacy.
- **Pillar III** complements the other two pillars and focuses on enhanced transparency in information disclosure, covering risk and capital management, including capital adequacy.

In November 2007, the CBB issued directives on the Pillar III disclosures under the Basel II framework applicable to licensed banks in the Kingdom of Bahrain. These directives set out the enhanced disclosure requirements under Basel II framework. This document gathers together all the elements of the disclosure required under Pillar III and is organized as follows:

- Firstly, it gives an overview of the approach taken by Arab Banking Corporation (B.S.C.) [the Bank] and its subsidiaries [together the Group] to Pillar I and provides the profile of the risk weighted assets according to the "standard portfolio" as defined by the CBB.
- Secondly, an overview of risk management practices and framework at the Bank is presented with specific emphasis on credit, market and operational risks and sets out the related monitoring processes and credit mitigation initiatives.
- Finally, this document provides all other disclosures required under the Public Disclosure Module of the CBB.

The disclosures in this report are in addition to the interim condensed consolidated financial statements prepared in accordance with International Accounting Standard 34 '*Interim Reporting'*.

However, the credit risk exposures considered in this document differ from the credit risk exposures reported in the interim condensed consolidated financial statements due to the application of different methodologies under Basel II and International Financial Reporting Standards as follows:

- Under the Basel II framework, for credit-related contingent items, the nominal value is converted to an exposure through the application of a credit conversion factor [CCF]. The CCF is at 20%, 50% or 100% depending on the type of contingent item, and is used to convert off-balance sheet notional amounts into an equivalent statement of financial position exposure. In the interim condensed consolidated financial statements, the nominal values of credit-related contingent items are considered off-balance sheet.

1. Introduction (continued)

- Under this section, the credit exposures are classified as per the Standard Portfolio approach set out in the CBB's Basel II capital adequacy framework covering the Standardised Approach for credit risk. In the case of guaranteed exposures, the exposures would normally be reported based on the guarantor. However, in the interim condensed consolidated financial statements the assets are presented based on asset class (i.e. securities, loans and advances, etc.).

- Eligible collateral is taken into consideration in arriving at the net exposure under the Basel II framework, whereas collateral is not netted in the interim condensed consolidated financial statements.

- Securities in the non-trading securities portfolio are considered at cost under the Basel II framework, whereas they are considered at fair value in the interim condensed consolidated financial statements.

- Under the Basel II framework, certain items are considered as a part of the regulatory capital base, whereas these items are netted off against assets in the interim condensed consolidated financial statements.

2. Group structure

The parent bank, Arab Banking Corporation (B.S.C.), was incorporated in 1980 in the Kingdom of Bahrain by an Amiri decree and operates under a conventional wholesale banking license issued by the CBB.

The financial statements and capital adequacy regulatory reports of Arab Banking Corporation (B.S.C.) and its subsidiaries [together the Group] have been prepared and consolidated on a consistent basis.

The principal subsidiaries as at 30 June 2010, all of which have 31 December as their year end, are as follows:

	Country of incorporation	**Shareholding % of Arab Banking Corporation (B.S.C.)**
ABC International Bank plc	United Kingdom	100
ABC Islamic Bank (E.C.)	Bahrain	100
Arab Banking Corporation (ABC) – Jordan	Jordan	87
Banco ABC Brasil S.A.	Brazil	56
ABC Algeria	Algeria	88
Arab Banking Corporation - Egypt [S.A.E.]	Egypt	98
ABC Tunisie	Tunisia	100
Arab Financial Services Company B.S.C. (c)	Bahrain	55

3. Capital structure

The Group's capital base comprises (a) Tier 1 capital which includes share capital, reserves, retained earnings and non-controlling interests, and (b) Tier 2 capital which consists of the subordinated term debt, collective impairment provisions, profit for the current period and equity revaluation reserves.

The issued and paid up share capital of the Bank is US$ 3,110 million at 30 June 2010, comprising of 3,110 million shares of US$ 1 each.

The subordinated term debt, amounting to US$ 500 million was raised under its US$ 2,500,000,000 Euro Medium Term Deposit Note Programme and represents unsecured obligations of the Group and is subordinated in the right of payment to the claims of all depositors and creditors of the Group. These are issued for ten years with a call option which can only be exercised after five years. The inclusion of the subordinated term debt in Tier 2 capital base and the subsequent buy-back has been approved by the CBB.

In addition, during the period ended 30 June 2010, subordinated debt of a nominal amount of US$ 300 million (2009: nil) was raised by a subsidiary of the Bank. These are issued for ten years without an investor put option.

The Group's capital base of US$ 4,672 million comprises Tier 1 capital of US$ 3,746 million and Tier 2 capital of US$ 926 million as detailed below:

Breakdown of Capital Base

US$ million	**Tier 1**	**Tier 2**	**Total**
Share capital	3,110	-	3,110
Statutory reserve	321	-	321
General reserve	150	-	150
Retained earnings brought forward	(151)	-	(151)
Profit for the period	-	75	75
Non-controlling interests in consolidated subsidiaries	384	-	384
Foreign currency translation adjustment	(55)	-	(55)
Unrealized gains from fair value of equity securities	-	1	1
Collective impairment provision	-	167	167
Subordinated term debt	-	696	696
Capital before deductions	**3,759**	**939**	**4,698**
Significant minority investments in banking, securities and other financial entities	(10)	(10)	(20)
Other deductions – Unamortized IT costs	(3)	(3)	(6)
Capital base	**3,746**	**926**	**4,672**

Risk weighted assets (RWA)	
Credit risk	17,031
Market risk	1,211
Operational risk	1,311
	19,553
Tier 1 ratio	**19.2%**
Capital adequacy ratio	**23.9%**

4. Capital adequacy ratios (CAR)

The purpose of capital management at the Group is to ensure the efficient utilization of capital in relation to business requirements and growth, risk profile and shareholders' returns and expectations.

The Group manages its capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of its activities. In order to maintain or adjust the capital structure, the Group may issue capital/Tier 2 securities and/or adjust the amount of dividend payment to shareholders. No changes have been made in the objectives, policies and processes from the previous year.

In order to augment the Group's capital resources, the Board of Directors at its meeting held on 23 December 2009 resolved to convene an Extraordinary General Meeting to increase the authorised, issued and paid up share capital of the Bank from US$ 2,000 million to US$ 3,110 million by way of a priority rights offer to existing shareholders. This was approved by the shareholders at an Extraordinary General Meeting held on 28 January 2010. The priority rights share issue, amounting to US$ 1,110 million, was closed on 24 March 2010 and legal formalities relating to the issue have been completed. The rights issue was fully underwritten by the Central Bank of Libya. The underwriting fee of US$ 110 million has been adjusted against the share premium outstanding as at 31 December 2009.

Management expects the change in capital structure to have a positive impact on the earnings of the Group. The determination to pay dividends on an on-going basis and the amount thereof will depend upon, among other things, the Group's earnings, its dividend policy, the requirement to set aside minimum statutory reserves, capital requirements to support the growth (organic and inorganic), regulatory capital requirements, approval from the CBB and applicable requirements under Bahrain Commercial Companies Law and such other factors as the Board of Directors and the shareholders may deem relevant.

The Group's total capital adequacy ratio as at 30 June 2010 was 23.9% compared with the minimum regulatory requirement of 12%. The Tier 1 ratio was 19.2% for the Group. The Group ensures adherence to the CBB's requirements by monitoring its capital adequacy against higher internal limits.

Each banking subsidiary in the Group is directly regulated by its local banking supervisor which sets and monitors local capital adequacy requirements. The Group ensures that each subsidiary maintains sufficient capital levels for legal and regulatory compliance purposes. There have been no instances of deficiencies in the banking subsidiaries' local capital adequacy requirements. The Tier 1 and total capital adequacy ratios of the significant banking subsidiaries (those whose regulatory capital amounts to over 5% of the Group's consolidated regulatory capital) under the local regulations were as follows:

Subsidiaries (over 5% of Group's consolidated regulatory capital)	Tier 1 ratio	CAR
ABC Islamic Bank (E.C.)	21.5%	21.7%
ABC International Bank Plc*	15.2%	18.9%
Banco ABC Brasil S.A.*	12.5%	17.8 %

* CAR based on local capital adequacy requirements has been computed after mandatory deductions from total of Tier 1 and Tier 2 capital. Other than restrictions over transfers to ensure minimum regulatory capital requirements at the local level, management believes that there are no further impediments on the transfer of funds or reallocation of regulatory capital within the Group.

5. Profile of risk-weighted assets and capital charge

The Group has adopted the standardised approach for credit risk, market risk and operational risk for regulatory reporting purposes. The Group's risk-weighted capital requirements for credit, market and operational risks are given below:

5.1 Credit risk

a) Definition of exposure classes per Standard Portfolio

The Group has a diversified funded and unfunded credit portfolio. The exposures are classified as per the Standard Portfolio approach under the CBB's Basel II capital adequacy framework covering the standardised approach for credit risk.

The descriptions of the counterparty classes along with the risk weights to be used to derive the risk weighted assets are as follows:

i. Claims on sovereigns

These pertain to exposures to governments and their central banks. Claims on Bahrain and other GCC sovereigns are risk weighted at 0%. Claims on all other sovereigns are given a risk weighting of 0% where such claims are denominated and funded in the relevant domestic currency of that sovereign. Claims on sovereigns, other than those mentioned above are risk weighted based on their credit ratings.

ii. Claims on public sector entities (PSEs)

Listed Bahrain PSEs are assigned a 0% risk weighting. Other sovereign PSE's, where claims are denominated in the relevant domestic currency and for which the local regulator has assigned risk weighting of 0%, are assigned 0% risk weighting by the CBB. PSEs other than those mentioned above are risk weighted based on their credit ratings.

iii. Claims on multilateral development banks (MDBs)

All MDBs are risk weighted in accordance with the banks' credit rating except for those members listed in the World Bank Group which are risk weighted at 0%.

iv. Claims on banks

Claims on banks are risk weighted based on the ratings assigned to them by external rating agencies; however, short-term claims on locally incorporated banks are assigned a risk weighting of 20% where such claims on the banks are of an original maturity of three months or less and are denominated and funded in either Bahraini Dinars or US Dollars.

Preferential risk weights that are one category more favorable than the standard risk weighting are assigned to claims on foreign banks licensed in Bahrain with an original maturity of three months or less and denominated and funded in the relevant domestic currency. Such preferential risk weights for short-term claims on banks licensed in other jurisdictions are allowed only if the relevant supervisor also allows this preferential risk weighting to short-term claims on its banks.

5. Profile of risk-weighted assets and capital charge (continued)

5.1 Credit risk (continued)

iv. Claims on banks (continued)

No claim on an unrated bank would receive a risk weight lower than that applied to claims on its sovereign of incorporation.

Investment in subordinated debt of banking, securities and financial entities are risk weighted at a minimum risk weight of 100% for listed entities or 150% for unlisted entities, unless such investments exceed 20% of the eligible capital of the investee entity, in which case they are deducted from the Group's capital.

v. Claims on the corporate portfolio

Claims on the corporate portfolio are risk weighted based on credit ratings. Risk weightings for unrated corporate claims are assigned at 100%.

vi. Claims on regulatory retail exposures

Retail claims that are included in the regulatory retail portfolio are assigned risk weights of 75% (except for past due loans), provided they meet the criteria stipulated in the CBB's Rule Book.

vii. Past due loans

The unsecured portion of any loan (other than a qualifying residential mortgage loan) that is past due for more than 90 days, net of specific provisions (including partial write-offs), is risk-weighted as follows:

- 150% risk weighting when specific provisions are less than 20% of the outstanding amount of the loan; and
- 100% risk weighting when specific provisions are greater than 20% of the outstanding amount of the loan.

viii. Residential retail portfolio

Lending fully secured by first mortgages on residential property that is or will be occupied by the borrower, or that is leased, is risk weighted at 75%. However, where foreclosure or repossession with respect of a claim can be justified, the risk weighting is 35%.

ix. Equity portfolios

Investments in listed equities are risk weighted at 100% while those in unlisted equities are risk weighted at 150%.

x. Other exposures

These are risk weighted at 100%.

5. Profile of risk-weighted assets and capital charge (continued)

5.1 Credit risk (continued)

b) Credit exposure and risk weighted assets

US$ million	Gross credit exposure	Funded exposure	Unfunded exposure	Cash collateral	Eligible guarantees	Risk-weighted assets	Capital charge
Cash	66	66	-	-	-	5	1
Claims on sovereigns*	4,942	4,278	664	-	97	504	60
Claims on public sector entities **	4,804	4,715	89	56	89	2,447	294
Claims on multilateral development banks	90	89	1	-	-	-	-
Claims on banks	9,355	7,542	1,813	916	363	4,332	520
Claims on corporate portfolio	10,767	8,940	1,827	1,106	47	9,058	1,087
Regulatory retail exposures	240	235	5	-	-	180	21
Past due loans	132	132	-	-	-	167	20
Residential retail portfolio	15	15	-	15	-	5	1
Equity portfolios	66	66	-	-	-	86	10
Other exposures	247	247	-	-	-	247	30
	30,724	**26,325**	**4,399**	**2,093**	**596**	**17,031**	**2,044**

* Includes Ginnie Mae & and Small Business Administration pools

** Includes exposures to Collateralized Mortgage Obligations [CMOs] of Freddie Mac and Fannie Mae, both of which are deemed to be Government Sponsored Enterprises [GSE].

Monthly average gross exposures and the risk weighted assets for the period ended 30 June 2010 were US$ 30,527 million and US$ 16,983 million respectively.

Refer to note 6.7 for details of unfunded exposures.

5. Profile of risk-weighted assets and capital charge (continued)

5.2 Market risk

US$ million	**RWA**	**Period-end capital charge**	**Capital charge – Minimum***	**Capital charge – Maximum***
Interest rate risk				
- Specific interest rate risk	5	1	-	1
- General interest rate risk	94	11	6	12
Equity position risk	13	2	1	2
Foreign exchange risk	1,095	131	131	164
Options risk	4	-	-	1
Total market risk	**1,211**	**145**		

* The information in these columns shows the minimum and maximum capital charge of each of the market risk categories during the six-month period ended 30 June 2010.

5.3 Operational risk

In accordance with the standardised methodology, the total capital charge in respect of operational risk was US$ 157 million as at 30 June 2010. This capital charge was computed by categorising the Group's activities into eight business lines (as defined by the Basel II framework) and multiplying each business line's three - year average gross income by a pre-defined beta factor.

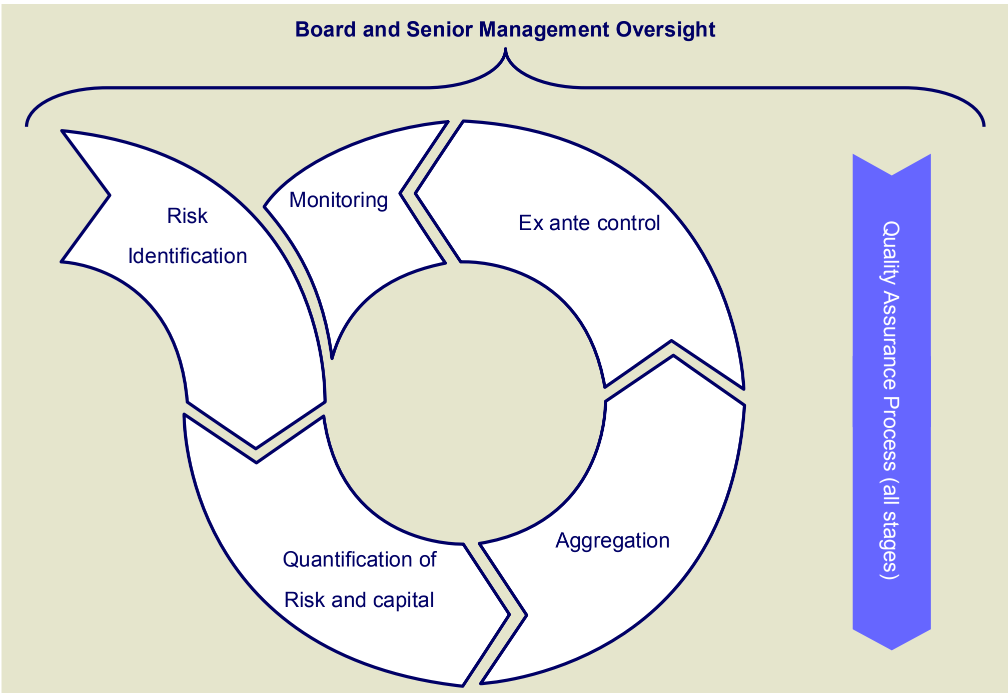
6. Risk management

6.1 Introduction

Risk is inherent in the Group's activities and is managed through a process of ongoing identification, measurement and monitoring, subject to risk limits and other controls. The Group is exposed to credit risk, market risk, liquidity risk, interest rate risk, operational risk, legal and strategic risk as well as other forms of risk inherent in its financial operations.

Over the last few years the Group has invested heavily into developing a comprehensive and robust risk management infrastructure. This includes risk identification processes under credit, market and operational risk spectrums, risk measurement models and rating systems as well as a strong business process to monitor and control these risks. Figure 1 outlines the various congruous stages of the risk process.

Figure 1:



6.2 Risk management structure

Executive Management is responsible for implementing the Group's Risk Strategy/Appetite and Policy Guidelines set by the Board Risk Committee (BRC), including the identification and evaluation on a continuous basis of all significant risks to the business and the design and implementation of appropriate internal controls to minimize them. This is done through the BRC, senior management committees and the Credit & Risk Group in the Head Office, as follows:

6. Risk management (continued)

6.2 Risk management structure (continued)

Figure 2:

Within the broader governance infrastructure, the Board committees carry the main responsibility of best practice management and risk oversight. At this level, the BRC oversees the definition of risk appetite, risk tolerance standards, and risk process standards to be kept in place. The BRC is also responsible for coordinating with other Board Committees in monitoring compliance with the requirements of the regulatory authorities in the various countries in which the Group operates.

The Head Office Consumer Credit Committee (HOCCC) is responsible for credit decisions at the higher levels of the Group's consumer lending portfolio, setting country and other high level Group limits, dealing with impaired assets and general credit policy matters.

ALCO is mainly responsible for defining long-term strategic plans and short-term tactical initiatives for directing asset and liability allocation prudently for the achievement of the Group's strategic goals. ALCO monitors the Group's liquidity and market risks and the Group's risk profile in the context of economic developments and market fluctuations, to ensure that the Group's ongoing activities are compatible with the risk/reward guidelines approved by the BRC.

6. Risk management (continued)

6.2 Risk management structure (continued)

The Operational Risk Management Committee (ORCO) is responsible for defining long-term strategic plans and short-term tactical initiatives for operational risk. It also has the overall responsibility to monitor and prudently manage exposure to operational risks including strategic and reputation risk.

The Risk Management Committee (RMC) reviews risk methodology and parameters including credit, market, operational, liquidity, retail, etc.

The Head Office Credit Committee (HOCC) is responsible for credit decisions at the higher levels of the Group's lending portfolio, setting country and other high level Group limits, dealing with impaired assets, provisioning and general credit policy matters.

The Credit & Risk Group (CRG) has overall responsibility for centralised credit policy and procedure formulation, country risk and counterparty analysis, approval/review and exposure reporting, control and risk-related regulatory compliance, remedial loans management and the provision of analytical resources to senior management. It is also responsible for identifying market and operational risks arising from the Group's activities, recommending to the relevant central committees appropriate policies and procedures for managing exposure to such risks and establishing the systems necessary to implement effective controls.

The management structure explained above, supported by teams of risk and credit analysts and the Group's IT systems, therefore provides a coherent infrastructure for the management of the Group's credit and risk functions.

Each subsidiary within is responsible for managing its own risks and has its own subsidiary Board Risk Committee, Credit Committee and (in the case of major subsidiaries) ALCO or equivalent, with responsibilities generally analogous to the Group committees.

Credit risk concentrations and thresholds

The first level of protection against undue credit risk is through country, industry and customer group credit threshold limits set by the BRC and the HOCC and allocated between the Bank and its banking subsidiaries. Credit exposure to individual customers or customer groups is then controlled through a tiered hierarchy of delegated approval authorities based on the risk rating of the customer under the Group's internal credit rating system. Where unsecured facilities sought are considered to be beyond prudential limits, Group policies require collateral to mitigate the credit risk in the form of cash, securities, legal charges over the customer's assets or third-party guarantees. The amount and type of collateral depends on an assessment of the credit risk of the counterparty. Management monitors the market value of collateral, requesting additional collateral where required in accordance with the underlying agreement. Management also monitors the market value of collateral held during its review of the adequacy of the allowance for impairment losses. The Group also makes use of master netting agreements with counterparties.

6. Risk management (continued)

6.2 Risk management structure (continued)

The Group employs Risk Adjusted Return on Capital (RAROC) as a measure to evaluate the risk/reward relationship at the transaction approval stage. RAROC analysis is also conducted on a portfolio basis, aggregated for each business segment, business unit and for the group as a whole.

Single name concentrations are monitored on an individual basis. The Group's internal economic capital methodology for credit risk addresses concentration risk through the application of single-name concentration add-on. Under the CBB's single obligor regulations, banks incorporated in Bahrain are required to obtain the CBB's approval for any planned exposure to a single counterparty, or group of connected counterparties exceeding 15 % of the regulatory capital base.

As at 30 June 2010, the Group's exposures in excess of 15% of the obligor limits to individual counterparties are shown below:

US$ million	**On-balance sheet exposure**	**Off-balance sheet exposure**	**Total exposure**
Counterparty A	1,387	-	1,387
Counterparty B	1	1,270	1,271
Counterparty C	1,224	-	1,224

6. Risk management (continued)

6.2 Risk management structure (continued)

Excessive risk concentration

Concentrations arise when a number of counterparties are engaged in similar business activities or activities in the same geographic region or have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions. Concentrations indicate the relative sensitivity of the Group's performance to developments affecting a particular industry or geographical location.

In order to avoid excessive concentrations of risk, Group policies and procedures include specific guidelines to focus on country and counterparty limits and the importance of maintaining a diversified portfolio. Identified concentrations of credit risks are controlled and managed accordingly.

Risk mitigation, collateral and other credit enhancements

The amount and type of collateral depends on the counterparty credit risk assessment. The types of collateral mainly include cash and guarantees from banks and other eligible counterparties widespread across various regions.

Management monitors the market value of collateral, requests additional collateral in accordance with the underlying agreement and monitors the market value of collateral obtained during its review of the adequacy of the allowance for impairment losses. The Group also makes use of master netting agreements with counterparties.

As part of its overall risk management, the Group also uses derivatives and other instruments to manage exposures resulting from changes in interest rates, foreign currencies, equity risks, credit risks, and exposures arising from forecast transactions.

The risk profile is assessed before entering into hedge transactions, which are authorised by the appropriate level of seniority within the Group. The effectiveness of hedges is monitored monthly by the Group.

6. Risk management (continued)

6.3 Geographical distribution of exposures

a) The Group's classification of geographical areas is according to the distribution of its portfolios. The geographical distribution of exposures, impaired assets and the related impairment provisions can be analyzed as follows:

US$ million	**Gross credit exposure**	**Impaired loans**	**Specific provision - impaired loans**	**Impaired securities**	**Specific provision - impaired securities**
North America	6,699	-	-	460	447
Western Europe	4,744	67	30	-	-
Other Europe	44	-	-	-	-
Arab World	12,097	334	241	52	35
Other Africa	18	-	-	-	-
Asia	1,378	-	-	37	6
Australia / New Zealand	146	-	-	-	-
Latin America	5,598	12	10	-	-
	30,724	**413**	**281**	**549**	**488**

In addition to the above specific provisions against impaired loans, the Group has collective impairment provisions amounting to US$ 167 million.

6. Risk management (continued)

6.3 Geographical distribution of exposures (continued)

b) The geographical distribution of gross credit exposures by major type of credit exposures can be analyzed as follows:

US$ million	North America	Western Europe	Other Europe	Arab World	Other Africa	Asia	Australia /New Zealand	Latin America	Total
Cash	-	-	-	66	-	-	-	-	**66**
Claims on sovereigns*	2,089	348	-	1,862	-	86	-	557	**4,942**
Claims on public sector entities **	2,705	87	-	1,910	-	89	-	13	**4,804**
Claims on multilateral development banks	1	39	-	50	-	-	-	-	**90**
Claims on banks	881	3,353	2	3,525	2	699	143	750	**9,355**
Claims on corporate portfolio	977	781	42	4,234	16	491	3	4,223	**10,767**
Regulatory retail exposures	-	6	-	188	-	-	-	46	**240**
Past due loans	-	34	-	98	-	-	-	-	**132**
Residential retail portfolio	-	13	-	2	-	-	-	-	**15**
Equity portfolios	26	1	-	26	-	13	-	-	**66**
Other exposures	20	82	-	136	-	-	-	9	**247**
	6,699	**4,744**	**44**	**12,097**	**18**	**1,378**	**146**	**5,598**	**30,724**

* Includes Ginnie Mae & and Small Business Administration pools.

** Includes exposures to CMOs of Freddie Mac and Fannie Mae, both of which are deemed to be GSE.

6. Risk management (continued)

6.4 Industrial sector analysis of exposures

a) The industrial sector analysis of exposures, impaired assets and the related impairment provisions can be analyzed as follows:

US$ million	Gross exposure	Funded exposure	Unfunded exposure	Impaired loans	Specific provision - impaired loans	Impaired securities	Specific provision- impaired securities
Manufacturing	4,593	3,706	887	78	51	2	1
Mining and quarrying	79	69	10	2	2	-	-
Agriculture, fishing and forestry	52	49	3	-	-	-	-
Construction	818	586	232	1	1	-	-
Financial	12,033	10,123	1,910	166	111	490	464
Trade	480	389	91	88	66	-	-
Personal / consumer finance	651	593	58	13	10	-	-
Commercial real estate financing	243	243	-	24	-	-	-
Residential mortgage	15	15	-	1	-	-	-
Government	7,591	6,943	648	29	29	24	6
Technology, media & telecommunications	302	203	99	2	2	2	1
Transport	691	621	70	1	1	-	-
Other sectors	3,176	2,785	391	8	8	31	16
	30,724	**26,325**	**4,399**	**413**	**281**	**549**	**488**

6. Risk management (continued)

6.4 Industrial sector analysis of exposures (continued)

b) The industrial sector analysis of gross credit exposures by major types of credit exposures can be analyzed as follows:

US$ million	Manufacturing	Mining and quarrying	Agriculture, fishing and forestry	Construction	Financial	Trade	Personal / consumer finance	Commercial real estate financing	Residential mortgage	Government	Technology, media & telecommunications	Transport	Other sectors	Total
Cash	-	-	-	-	66	-	-	-	-	-	-	-	-	**66**
Claims on sovereigns*	52	-	-	-	48	-	-	-	-	4,840	-	2	-	**4,942**
Claims on public sector entities **	828	-	-	-	940	45	-	-	-	2,731	-	71	189	**4,804**
Claims on multilateral development banks	-	-	-	-	90	-	-	-	-	-	-	-	-	**90**
Claims on banks	-	-	-	-	9,354	-	-	-	-	1	-	-	-	**9,355**
Claims on corporate portfolio	3,686	79	52	818	1,540	413	414	218	-	-	301	618	2,628	**10,767**
Regulatory retail exposures	1	-	-	-	-	-	231	-	-	-	-	-	8	**240**
Past due loans	25	-	-	-	3	22	6	24	-	19	-	-	33	**132**
Residential retail portfolio	-	-	-	-	-	-	-	-	15	-	-	-	-	**15**
Equity portfolios	1	-	-	-	58	-	-	1	-	-	1	-	5	**66**
Other exposures	-	-	-	-	-	-	-	-	-	-	-	-	247	**247**
	4,593	**79**	**52**	**818**	**12,099**	**480**	**651**	**243**	**15**	**7,591**	**302**	**691**	**3,110**	**30,724**

* Includes Ginnie Mae & and Small Business Administration pools.

** Includes exposures to CMOs of Freddie Mac and Fannie Mae, both of which are deemed to be GSE.

6. Risk management (continued)

6.5 Exposure by external credit rating

The Group uses external ratings from Standard & Poor's, Moody's, Fitch Ratings and Capital Intelligence (accredited External Credit Assessment Institutions) [ECAIs]. The breakdown of the Group's exposure into rated and unrated categories is as follows:

US$ million	Net credit exposure (after credit risk mitigation)	Rated exposure	Unrated exposure
Cash	66	-	66
Claims on sovereigns*	4,942	4,566	376
Claims on public sector entities**	4,748	2,908	1,840
Claims on multilateral development banks	90	90	-
Claims on banks	8,439	6,717	1,722
Claims on corporate portfolio	9,661	1,276	8,385
Regulatory retail exposure	240	-	240
Past due loans	132	5	127
Equity portfolios	66	-	66
Other exposures	247	-	247
	28,631	**15,562**	**13,069**

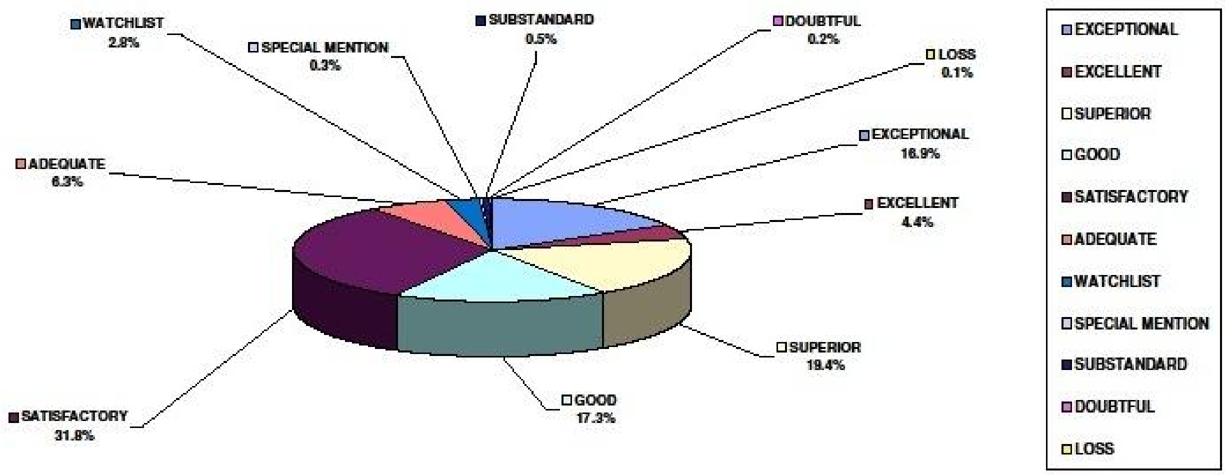
* Includes Ginnie Mae & and Small Business Administration pools.

** Includes exposures to CMOs of Freddie Mac and Fannie Mae, both of which are deemed to be GSE.

6. Risk management (continued)

6.5 Exposure by external credit rating (continued)

It is the Group's policy to maintain accurate and consistent risk ratings across the credit portfolio through an internal risk rating system. Risk ratings are supported by a variety of financial analytics, combined with processed market information, to provide the main inputs for the measurement of counterparty credit risk. All internal ratings are tailored to the various categories and are derived in accordance with the Group's Credit Policy, and are assessed and updated regularly. Each risk rating class is mapped to grades equivalent to Standard & Poor's, Moody's, Fitch Ratings and Capital Intelligence rating agencies.



Percentages have been calculated internally based on the sum of funded and unfunded exposures before applying credit conversion factors.

6. Risk management (continued)

6.6 Maturity analysis of funded exposures

Residual contractual maturity of the Group's major types of funded credit exposures, except for CMOs and Small Business Administration pools amounting to US$ 4,101 million which are based on expected realization or settlement, is as follows:

US$ million	within 1 month	1 - 3 months	3 - 6 months	6 - 12 months	Total within 12 months	1 – 5 years	5-10 years	10 - 20 years	Over 20 years	Undated	Total over 12 months	Total
Cash	66	-	-	-	66	-	-	-	-	-	-	66
Claims on sovereigns*	3,238	66	210	65	3,579	624	64	-	-	11	699	4,278
Claims on public sector entities**	3,385	194	5	52	3,636	180	528	354	-	17	1,079	4,715
Claims on multilateral development banks	50	39	-	-	89	-	-	-	-	-	-	89
Claims on banks	3,062	321	925	910	5,218	1,902	326	-	-	96	2,324	7,542
Claims on corporate portfolio	1,260	1,139	989	716	4,104	3,788	773	10	27	238	4,836	8,940
Regulatory retail exposures	-	26	4	8	38	104	90	2	-	1	197	235
Past due loans	38	62	-	1	101	29	1	-	1	-	31	132
Residential retail portfolio	-	-	-	-	-	-	1	2	12	-	15	15
Equity portfolios	-	-	-	-	-	-	-	-	-	66	66	66
Other exposures	-	-	-	-	-	-	-	-	-	247	247	247
	11,099	**1,847**	**2,133**	**1,752**	**16,831**	**6,627**	**1,783**	**368**	**40**	**676**	**9,494**	**26,325**

* Includes exposures to Ginnie Mae & and Small Business Administration pools.

** Includes exposures to CMOs of Freddie Mac and Fannie Mae, both of which are deemed to be GSE.

6. Risk management (continued)

6.7 Maturity analysis of unfunded exposures

The residual contractual maturity analysis of unfunded exposures is as follows:

US$ million	within 1 month	1-3 months	3-6 months	6 – 12 months	Total within 12 months	1 – 5 years	5-10 years	10 - 20 years	Over 20 years	Undated	Total over 12 months	Total
Claims on sovereigns	11	30	333	70	444	219	1	-	-	-	220	664
Claims on public sector entities	3	2	4	35	44	29	16	-	-	-	45	89
Claims on multilateral development banks	-	-	1	-	1	-	-	-	-	-	-	1
Claims on banks	295	322	248	369	1,234	469	104	-	6	-	579	1,813
Claims on corporate portfolio	122	330	235	433	1,120	577	75	40	15	-	707	1,827
Regulatory retail exposures	-	2	-	2	4	1	-	-	-	-	1	5
	431	**686**	**821**	**909**	**2,847**	**1,295**	**196**	**40**	**21**	**-**	**1,552**	**4,399**

Unfunded exposures are divided into the following exposure types in accordance with the calculation of credit risk weighted assets in the CBB's Basel II capital adequacy framework:

(a) **Credit-related contingent items** comprise letters of credit, acceptances, guarantees and commitments.

(b) **Derivatives** which are contracts, the values of which are derived from one or more underlying financial instruments or indices, and include futures, forwards, swaps and options in the interest rate, foreign exchange, equity and credit markets.

In addition to counterparty credit risk in accordance with the Basel II Accord, derivatives are also exposed to market risk, which requires a separate capital charge.

6. Risk management (continued)

6.7 Maturity analysis of unfunded exposures (continued)

a. Credit-related contingent items

For credit-related contingent items, the nominal value is converted to an exposure through the application of a credit conversion factor (CCF). The CCF is at 20%, 50% or 100% depending on the type of contingent item, and is used to convert off-balance sheet notional amounts into an equivalent on-balance sheet exposure.

Undrawn loans and other commitments represent commitments that have not been drawn down or utilized at the reporting date. The nominal amount is the base upon which a CCF is applied for calculating the exposure. CCF ranges between 20% and 50% for commitments with original maturity of up to one year and over one year respectively, and 0% CCF is applicable to commitments which can be unconditionally cancelled at any time.

The table below summarizes the notional principal amounts and the relative exposures before the application of credit risk mitigation:

US$ million	**Notional Principal**	**Credit exposure***
Short-term self-liquidating trade and transaction-related contingent items	5,684	2,751
Direct credit substitutes, guarantees and acceptances	2,263	979
Undrawn loans and other commitments	1,012	490
	8,959	**4,220**
RWA		**2,885**

* Credit exposure is after applying CCF.

At 30 June 2010, the Group held eligible guarantees as collateral in relation to credit-related contingent items amounting to US$ 408 million.

b. Derivatives

Most of the Group's derivative trading activities relate to sales, positioning and arbitrage. Sales activities involve offering products to customers. Positioning involves managing market risk positions with the expectation of profiting from favorable movements in prices, rates or indices. Arbitrage involves identifying and profiting from price differentials between markets or products. Also included under this heading are those derivatives which do not meet IAS 39 hedging requirements.

6. Risk management (continued)

6.7 Maturity analysis of unfunded exposures (continued)

The Group uses forward foreign exchange contracts and currency swaps to hedge against specifically identified currency risks. In addition, the Group uses interest rate swaps and interest rate futures to hedge against the interest rate risk arising from specifically identified loans and securities bearing fixed interest rates. The Group participates in both exchange traded and over-the-counter derivative markets.

Credit risk in respect of derivative financial instruments arises from the potential for a counterparty to default on its contractual obligations and is limited to the positive fair value of instruments that are favorable to the Group. The majority of the Group's derivative contracts are entered into with other financial institutions and there was no significant concentration of credit risk in respect of contracts with positive fair value with any individual counterparty as at 30 June 2010.

The counterparty credit risk for derivative and foreign exchange instruments is subject to credit limits on the same basis as other credit exposures. Counterparty credit risk arises in both the trading book and the banking book.

For regulatory capital adequacy purposes, the Group uses the current exposure method to calculate the counterparty credit risk of derivative and foreign exchange instruments in accordance with the credit risk framework in the CBB's Basel II capital adequacy framework. Counterparty credit exposure comprises the sum of replacement cost and potential future exposure. The potential future exposure is an estimate that reflects possible changes in the market value of the individual contract during the remaining life of the contract, and is measured as the notional principal amount multiplied by an add-on factor.

The aggregate notional amounts for interest rate and foreign exchange contracts as at 30 June 2010 were as follows:

	Derivatives		
US$ million	**Interest rate contracts**	**Foreign exchange contracts**	**Total**
Notional – Trading book	3,606	7,202	10,808
Notional – Banking book	480	58	538
	4,086	**7,260**	**11,346**
Credit RWA (replacement cost plus potential future exposure)	114	65	179
Market RWA	93	1,099	1,192

6. Risk management (continued)

6.8 Impairment of assets

Impairment and uncollectability of financial assets

An assessment is made at each quarter to determine whether there is objective evidence that a specific financial asset or group of financial assets may be impaired. If such evidence exists, an impairment loss is recognized in the consolidated statement of income.

Evidence of impairment may include indications that the borrower or a group of borrowers is experiencing significant financial difficulty, default or delinquency in interest or principal payments, the probability that they will enter bankruptcy or other financial re-organization and, where observable data indicates, that there is a measurable decrease in the estimated future cash flows such as changes in arrears or economic conditions that correlate with defaults.

Impairment is determined as follows:

(a) for assets carried at amortized cost, impairment is based on the present value of estimated future cash flows discounted at the original effective interest rate;

(b) for assets carried at fair value, impairment is the difference between cost and fair value; and

(c) for assets carried at cost, impairment is based on the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset.

The Group uses the provision account to record impairments, except for equity and similar investments, which are written down, with future increases in their fair value being recognised directly in equity.

Impairment losses on financial assets

On a quarterly basis the Group assesses whether any provision for impairment should be recorded in the consolidated statement of income. In particular, considerable judgement by management is required in the estimation of the amount and timing of future cash flows when determining the level of provision required. Such estimates are necessarily based on assumptions about several factors involving varying degrees of judgment and uncertainty, and actual results may differ, resulting in future changes in such provisions.

Impairment against specific groups of financial assets

In addition to specific provisions against individually significant loans, advances and securities, the Group also makes a provision to cover impairment against specific groups of financial assets where there is a measurable decrease in estimated future cash flows. This provision is based on deterioration of the financial assets decided by putting the portfolio through rigorous credit risk scenario testing and averaging the existing Expected Loss [EL] with a severely stressed scenario EL. Further, the amount of provision is also based on the historical loss pattern for loans within each grading and is adjusted to reflect current economic changes.

The internal grading process takes into consideration factors such as collateral held deterioration in country risk, industry and technological obsolescence, as well as identified structural weakness or deterioration in cash flows.

6. Risk management (continued)

6.9 Market risk

Market risk is the risk that the Group's earnings or capital, or its ability to support its business strategy, will be impacted by changes in market rates or prices related to interest rates, equity prices, credit spreads, foreign exchange rates and commodity prices.

The Group has established risk management policies and limits within which exposure to market risk is monitored, measured and controlled by the RMD's Market Risk Management [MRM] unit with strategic oversight exercised by ALCO. MRM is responsible for developing and implementing market risk policy and risk measuring/monitoring methodology and for reviewing all new trading and investment products and product limits prior to ALCO approval. MRM's core responsibility is to measure, report, monitor and control market risk.

The Group classifies market risk into the following:

- **Trading Market Risk**

Trading market risk arises from movements in market risk factors in trading transactions where the main strategy is to trade in the short term.

- **Non-Trading Market Risk in Securities**

Non-trading market risk arises from market factors impacting securities that are held for long-term investment.

- **Asset and Liability Risk**

Non-trading asset and liability risk exposures arise where the re-pricing characteristics of the Group's assets do not match with those of its liabilities.

- **Liquidity Risk**

Liquidity risk is the risk that maturing and encashable assets may not cover cash flow obligations (liabilities).

As there is no specific measure that reflects all aspects of market risk, the Group analyses risk using various risk measures and reports the results to senior management.

The measurement techniques used to measure and control market risk are:

- Value-at-Risk (VaR)
- Basis Point Value (BPV)
- Stress Testing
- Non-Technical Risk Measures

On an annual basis, the BRC reviews and approves VaR Trading Guidance, BPV Trading and Investment Limits, Options Stress Testing Trading Limits, and Non-Technical Trading and Investment Limits.

6. Risk management (continued)

6.9 Market risk (continued)

a. Currency risk

The Group is exposed to foreign exchange rate risk through both its trading portfolios and its structural positions. Foreign exchange rate risk is managed by appropriate limits and stop loss parameters determined by each subsidiary's local ALCO and approved by its Board of Directors. Group's structural balance sheet positions, which relate to its net investment in its foreign subsidiaries, are reviewed regularly by ALCO in accordance with the Group's strategic plans and managed on a dynamic basis by Group Treasury, hedging such exposures, as appropriate.

b. Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect future profitability or the fair values of financial instruments. The Group is exposed to interest rate risk as a result of mismatches of interest rate re-pricing of assets and liabilities. The most prominent market risk factor for the Bank is interest rates. This risk is minimized as the Group's rate sensitive assets and liabilities are mostly floating rate, where the duration risk is lower.

Interest Rate Risk in the Banking Book (IRRBB)

The Bank uses the Basis Point Value [BPV] approach to control the IRRBB. BPV measures changes in economic value resulting from changes in interest rates. In the BPV methodology, the modified duration and, for some products, the effective duration approach is used to measure the IRRBB. Modified duration is a good measure of linear risk for interest rate sensitive products. Effective duration takes into consideration the fact that any embedded option has an impact on the sensitivity. The effective duration is typically a better representation of interest sensitivity than modified duration with products that have embedded options.

The BPV measure incorporates the entire rate sensitive segment of the balance sheet for the Group and is classified into appropriate buckets. Non-maturity interest rate sensitive assets and liabilities are bucketed in the short term. Equity is considered a non-interest sensitive component and is excluded from these computations.

As at 30 June 2010, an immediate shift up by 25 basis points in interest rates would potentially impact the Group's economic value by (-) US$ 26 million.

6. Risk management (continued)

6.10 Business risk

Business risk represents the earnings volatility inherent in all business activities due to the uncertainty of revenues and costs associated with changes in the economic and competitive environment. Business risk is evaluated through a Business and Strategy Development process. A Risk Budget is developed at the start of each year along with a Business Plan by each unit. Subsequently, the actual quarterly performance is compared with the detailed financial budget, including the historical volatility in earnings, which supports both the decision making and the planning process.

6.11 Equity position risk

Equity position risk arises from the possibility that changes in the prices of equities or equity indices will affect future profitability or the fair values of financial instruments. The Group is exposed to equity risk in the trading position and investment portfolio primarily in its core international and GCC markets.

6.12 Liquidity risk

The Group maintains liquid assets at prudential levels to ensure that cash can quickly be made available to honor all its obligations, even under adverse conditions. The Group is generally in a position of excess liquidity, its principal sources of liquidity being its deposit base, liquidity derived from its operations and inter-bank borrowings. It has specific policies regarding liquid assets coverage of short-term wholesale deposits and in particular the potential risk impact of withdrawals by large single depositors, ensuring that there is no reliance on any one customer or small group of customers.The Minimum Liquidity Guideline (MLG) is used to manage and monitor daily liquidity. The MLG represents the minimum number of days the Group can survive the combined outflow of all deposits and contractual drawdowns, under market value driven encashability scenarios.

In addition, an internal liquidity/maturity profile is generated to summarize the actual liquidity gaps versus the revised gaps based on internal assumptions.

6.13 Operational risk

Operational Risk is defined as *"the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events"*.

Operational risk is inherent in all business activities and can never be entirely eliminated; however, shareholder value can be preserved and enhanced by managing, mitigating and, in some cases, insuring against operational risk. Operational risk encompasses regulatory, reputational, documentation risk, etc. To manage the Group's operational risk, a framework has been implemented across the Group which includes identification, measurement, management, monitoring, and risk control/mitigation elements. A variety of underlying processes and controls have also been put in place to support this framework. These include Risk and Control Self-Assessments (RCSAs), Key Risk & Control Indicators (KRIs/KCIs), Loss Event Management, a New Product Review and Approval Process, and Business Continuity & Disaster Recovery Planning.

Operational risks are identified and assessed through the RCSA process, which assesses inherent and residual Risk Likelihood and Impact, taking into consideration the effectiveness of the controls in place to manage the risks identified. Monitoring of risks and controls is done through the use of key indicators (KIs), where appropriate, against thresholds /escalation triggers to ensure timely management action when a trigger is breached. Where required, corrective action plans are also formulated to address risks and control issues. A process to capture operational loss events is also in place, feeding into a historical Loss Event Database.

6. Risk management (continued)

6.13 Operational risk (continued)

The Group's goal is to make operational risk transparent throughout the enterprise. As such, processes for regular quarterly reporting of relevant operational risk management information to business management, senior management, ORCO, BRC and the Board of Directors are in place.

The Group is currently following the Standardized Approach for Operational Risk. As such, a detailed mapping of the Group's business lines and gross income to the Basel II Business Line Framework has been completed and implemented.

Group policy dictates that the operational functions of booking, recording and monitoring of transactions are carried out by staff that are independent of the individuals initiating the transactions. Each business line – for these purposes including Operations, Information Technology, Human Resources, Legal & Compliance and Financial Control - is further responsible for employing the aforementioned framework processes and control programmes to manage its operational risk within the guidelines established by the Group's policy, and to develop internal procedures that comply with these policies. To ensure that all operational risks to which the Group is exposed are adequately managed, support functions are also involved in the identification, measurement, management, monitoring and control/mitigation of operational risk, as appropriate.

6.14 Legal risk

Inadequate documentation, legal and regulatory incapacity or insufficient authority of a counterparty and contract invalidity or unenforceability are all examples of legal risk. Identification and management of this risk are the responsibilities of the Head Office Legal & Compliance Department [LCD] and are carried out through consultation with internal and external legal counsels, together with close monitoring of the litigation cases involving the Group. All major Group subsidiaries have their own in-house legal departments, acting under the guidance of the LCD, which aims to facilitate the business of the Group by providing proactive, business oriented and creative advice.

6. Risk management (continued)

6.15 Capital management

Internal Capital Adequacy Assessment Process (ICAAP)

The Group's capital management aims to maintain an optimum level of capital to enable it to pursue strategies that build long-term shareholder value, whilst always meeting minimum regulatory ratio requirements.

Among the key principles driving capital management at the Group are:

- Adequate capital is maintained as a buffer for unexpected losses to protect stakeholders, i.e. shareholders and depositors; and
- Maximize return on capital and generate sustainable return above the cost of capital.

The Group has developed an ICAAP framework, the purpose of which is to document the Group's process for the ongoing assessment of the its overall capital adequacy in relation to the its risk profile and present a strategy for capital management as set out in Principle 1 of Basel II Pillar II.

This framework outlines the Group's risk strategy, capital objectives, methodology used to measure internal capital, the related assumptions underpinning the methodologies and a set of processes for capital management, such as reviewing, monitoring and controlling capital usage and allocation including:

- In January 2008, the CBB issued ICAAP guidelines for capital management. Within this framework the risk strategy as approved by the Board of Directors is incorporated, underscoring Board and senior management responsibility and oversight. The risk strategy document outlines the Group's risk appetite, capital adequacy goals and risk targets;
- Comprehensive assessment of economic capital, i.e. credit, market and operational risks, and processes relating to other risks such as liquidity, interest rate risk in the banking book, strategic and reputational risks; and
- The processes in place for monitoring, reporting and internal audit review.

The methodologies for internally estimating capital for the Group's key risks are as follows:

a. Credit Risk: Assessed on the basis of Foundation IRB Risk Weights (FIRB). This supports the internal estimation of Economic Capital per Business Segment, Business Unit and aggregated at the Group level.

The Group uses a 23-point rating scale to grade corporate and financial institution obligors, of which 20 are performing grades. The Group's vendor and internally developed rating tools use financial and non-financial factors besides peer and sector comparisons in arriving at counterparty obligor ratings and may be notched up or down based upon contingents or credit support as appropriate. The banks rating scale is broadly mapped to the equivalent ratings of Standard & Poor's, Moody's, Fitch and Capital Intelligence rating agencies for comparability purposes.

6. Risk management (continued)

6.15 Capital management (continued)

b. **Market Risk:** Computed for both the Trading and the Banking books using the Internal Model approach.

VaR measures the worst expected loss over a given horizon under normal market conditions at a given confidence interval. It provides an aggregate view of the portfolio's risk that accounts for leverage, correlations, and current positions. The Group uses the historical simulation approach to measure VaR. The key model assumptions for the trading portfolio are:

- 2 year historical simulation;
- 1 day VaR; and
- 99% (one tail) or 98% (two tail) confidence interval.

The historical simulation method provides a full valuation going back in time, such as over the last 500 days, by applying current weights to a time series of historical returns.

The Group uses the stress testing methodology to review its exposures against historical and Group specific extreme scenarios.

c. **Operational Risk:** Applied on the Standardised Approach basis.

Other risks such as Liquidity, Strategic and Reputational risks are currently captured by providing a capital buffer.

The results of the ICAAP process are subject to stress testing to take account of the breakdown of the underlying assumptions. Specific stress tests for both credit and market risks have been developed to focus on the key risks the Group faces based on its risk exposure, portfolio and strategic objectives.

The Group currently conducts stress tests covering fourteen stress cases; examples include but are not limited to:

- Investment grade / sub-investment grade ratings stressed;
- Investment grade / sub-investment grade Probability of default (PD) stressed;
- Sub-investment stressed both for ratings & PD;
- Total portfolio PD stressed;
- Total portfolio ratings stressed; and
- Total portfolio ratings & PD stressed.

6. Risk management (continued)

6.15 Capital management (continued)

The Group is in the process of designing and implementing an advanced tool for estimating economic capital under stress scenarios as follows:

1. Global Recession

- This scenario stresses the PDs and Loss Given Default (LGD) by time period and distinguishes between on- and off-balance sheet exposures.

2. Escalated Regional Political Tension

- PDs and LGDs for entities in the region are stressed individually.

3. Middle East Recession

- As for Global Recession above but for Arab World exposures only.

4. European Recession

- As for Global Recession above but for Europe exposures only.

The Group has also designed three broad families of Stress testing scenarios (STS) for market risk:

1. **Sensitivity STS:** These STS are mostly applied as instantaneous, parallel and non-parallel shocks of fixed, predetermined quanta to the current levels of market reference interest rates. Examples of these Sensitivity STS include:

    - Parallel shocks for all market reference interest rates; and

    - Non-parallel shocks applied sequentially to the term structures of interest rates.

2. **Hypothetical STS:** This family of STS is designed to quantify the likely impact of unlikely but not improbable relevant events which have not been observed before in the financial markets but which might materialize at a short notice. Examples of the Hypothetical STS include:

    - Revaluation or devaluation scenarios for currencies in which the Group has significant open FX positions ; and

    - Instantaneous shock scenarios designed to gauge the tilt/curvature/convexity impact of bar-bell and asymmetric movements in the levels of market reference interest rates.

6. Risk management (continued)

6.15 Capital management (continued)

3. **Historical STS:** These STS replicate the observed behaviour of reference market data across IR, FX and equity classes of risk factors during particular historical periods of elevated market turbulence. Examples include the following:

    - The US and European Bond markets crisis of 1994;
    - The Asian Crisis of 1997;
    - The LTCM and Russian Crisis of 1998; and
    - The Lehman default of 2008.

    In addition to the above STS, and with a view to correctly gauging the risk of non-linear positions in the Group's Trading Book which might be sensitive to instantaneous, synchronous changes in the level of two or more classes of risk factors – such as interest rates and implied volatilities or of FX rates and implied volatilities - MRM has created a particular subset of hypothetical STS, the so-called "*Doomsday*" STS, which are applied daily in the Group's main trading and position-keeping systems..

Supervisory Review and Evaluation Process (SERP)

The CBB is the lead regulator for the Group and sets and monitors capital requirements on both a consolidated and an unconsolidated basis. Individual banking subsidiaries are regulated directly by their local banking supervisors, who set and monitor their capital adequacy requirements. The CBB requires each Bahrain-based bank or banking group to maintain a minimum ratio of total capital to risk-weighted assets of 12%, taking into account both on- and off-balance sheet transactions. However, under the SERP guidelines, the CBB would also make an individual risk profile assessment of all banks and, instead of applying a standard minimum capital adequacy requirement, the supervisor may allow a lower capital adequacy ratio (but in excess of 8%) for a bank with sound risk management capabilities. The CBB initiated this assessment process in the first quarter of 2008. The Group's capital management strategy is currently to maintain a buffer over the 12% minimum regulatory capital requirement to account for liquidity, concentration, reputation, strategic, country, and other risks while enhancing its risk management and risk control infrastructure. This would ultimately allow the Group to achieve a successful assessment and pursue possible lower capital requirements from the CBB. At the same time, senior management strongly believes in the economic value of capital and is committed to maximize intrinsic value for all stakeholders.

7 Other disclosures

7.1 Related party transactions

Related parties represent associated companies, major shareholders, directors and key management personnel of the Group and entities controlled, jointly controlled or significantly influenced by such parties. Pricing policies and terms of these transactions are approved by the Group's senior management and are based on the arms length rationale.

a. Exposures to related parties

US$ million	
Claims on shareholders	-
Claims on directors and senior management	2
Claims on staff	18

b. Liabilities to related parties

US$ million	
Connected deposits	1,657

7.2 Ageing analysis of all impaired loans and securities

In accordance with the guidelines issued by the CBB, credit facilities are placed on non-accrual status and interest suspended when either principal or interest is overdue by 90 days, whereupon interest credited to income is reversed. Following an assessment of impairment, specific provision is established if there is objective evidence that a credit facility is impaired, as detailed in section 6.8.

An ageing analysis of all impaired loans and securities on non-accrual basis, together with their related provisions is as follows:

Loans

US$ million	**Principal**	**Provisions**	**Net book value**
Less than 3 months	28	1	27
3 months to 1 year	20	17	3
1 to 3 years	278	181	97
Over 3 years	87	82	5
	413	**281**	**132**

7. Other disclosures (continued)

7.2 Ageing analysis of all impaired loans and securities (continued)

Securities

US$ million	Principal	Provisions	Net book value
Less than 3 months	19	2	17
3 months to 1 year	16	13	3
1 to 3 years	490	452	38
Over 3 years	24	21	3
	549	**488**	**61**

7.3 Restructured facilities

Facilities restructured during the period ended 30 June 2010 amounted to US$1 million. The carrying amount of restructured facilities amounted to US$ 58 million as at 30 June 2010.

7.4 Assets sold under recourse agreements

Proceeds from assets sold under repurchase agreements at the period end amounted to US$ 3,512 million. The carrying value of securities sold under repurchase agreements at the period end amounted to US$ 3,977 million.

Amounts paid for assets purchased under resale agreements at the period end amounted to US$ 358 million and relate to customer product and treasury activities. The market value of the securities purchased under resale agreements at the period end amounted to US$ 358 million.

7.5 Movement in specific and collective impairment provisions

	Specific Provisions			
US$ million	Loans*	Securities	Other assets and off balance sheet items	Collective Impairment provision
At beginning of the period	313	556	4	166
Amounts written off	(16)	(48)	-	-
Write backs / cancellation due to improvement	(5)	(14)	-	(1)
Additional provisions made	45	8	-	1
Exchange adjustment and other movements	(6)	(14)	2	1
Balance at reporting date	**331**	**488**	**6**	**167**

* In addition to the above, specific provision on loans include US$ 52 million towards country exposures.

7. Other disclosures (continued)

7.6 Industry sector analysis of the net specific and collective impairment provisions charged for the period ended 30 June 2010

US$ million	
Manufacturing	12
Financial	13
Trade	11
Personal / Consumer finance	2
Government	(4)
	34

7.7 Equity positions in the banking book

US$ million	
Quoted equities	25
Unquoted equities	41
	66
Realised gains during the period	1
Unrealised gains as at 30 June 2010	3