ARAB BANKING CORPORATION (B.S.C.)

BASEL II – RISK & PILLAR III DISCLOSURES

30 June 2011

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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 for the period ended 30 June 2011 prepared in accordance with International Accounting Standard 34 'Interim Financial 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 the Bank and its subsidiaries have been prepared and consolidated on a consistent basis.

The principal subsidiaries as at 30 June 2011, 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	58
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 2011, comprising of 3,110 million shares of US$ 1 each.

During the year ended 31 December 2007, the Bank raised US$ 500 million of Subordinated debts under its US$ 2,500,000,000 billion Euro Medium Term Deposit Note Programme. This debt 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. During the year ended 31 December 2009, the Bank repurchased a portion of its subordinated liabilities with a nominal value of US$ 88 million. During the six-month period ended 30 June 2011, the Bank also repurchased a portion of its subordinated liabilities with a nominal value of US$ 39 million (30 June 2010: US$ nil). The resultant net gain on the repurchase amounting to US$ 9 million (30 June 2010: US$ nil) is included in "Other operating income".

During the year ended 31 December 2010, a subsidiary of the Bank raised subordinated debt of a nominal amount of US$ 300 million. These are issued for ten years without an investor put option.

The inclusion of the subordinated term debt in Tier 2 capital base and the subsequent buy-back has been approved by the CBB.

3. Capital structure (continued)

The Group's capital base of US$ 4,953 million comprises Tier 1 capital of US$ 4,036 million and Tier 2 capital of US$ 917 million as detailed below:

Breakdown of Capital Base

US$ million	**Tier 1**	**Tier 2**	**Total**
Share capital	3,110	-	3,110
Statutory reserve	335	-	335
General reserve	150	-	150
Retained earnings brought forward	(28)	-	(28)
Profit for the year	-	116	116
Minority interest in consolidated subsidiaries	465	-	465
Foreign currency translation adjustment	17	-	17
Unrealized net gains from fair value of equity securities	-	2	2
Collective impairment provisions	-	171	171
Subordinated term debt	-	641	641
Tier 1 and Tier 2 capital before deductions			
Significant minority investments in banking, securities and other financial entities	(11)	(11)	(22)
Other deductions – Unamortised IT costs	(2)	(2)	(4)
Tier 1 and Tier 2 capital base	**4,036**	**917**	**4,953**

Risk weighted assets (RWA)	
Credit risk	**18,500**
Market risk	**1,735**
Operational risk	**1,313**
Tier 1 ratio	**18.7%**
Capital adequacy ratio	**23.0%**

4. Capital adequacy ratios (CAR)

The objective of capital management at the Group is to ensure the efficient utilisation 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 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 authorized, 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 were completed. The rights issue was fully underwritten by the Central Bank of Libya. The underwriting fee of US$ 110 million was 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 2011 was 23.0% compared with the minimum regulatory requirement of 12%. The Tier 1 ratio was 18.7% 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. ABC ensures that each subsidiary maintains sufficient capital levels for legal and regulatory compliance purposes. There have been no instances of deficiencies in capital levels of the banking subsidiaries under the local capital adequacy requirements.

4. Capital adequacy ratios (CAR) (continued)

The Tier 1 and total capital adequacy ratio 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 regulatory capital)	Tier 1 ratio	CAR (total)
ABC Islamic Bank (E.C.)	***23.7%***	***24.2%***
ABC International Bank Plc*	***14.6%***	***17.4%***
Banco ABC Brasil S.A.*	***11.6%***	***15.4%***

* 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	62	62	-	-	-	1	-
Claims on sovereigns*	5,011	4,478	533	-	18	824	99
Claims on public sector entities **	3,796	3,684	112	65	87	1,952	234
Claims on multilateral development banks	155	155	-	-	-	-	-
Claims on banks	10,991	9,032	1,959	469	405	4,985	598
Claims on corporate portfolio	11,632	9,460	2,172	1,274	45	9,762	1,171
Regulatory retail exposures	282	279	3	-	-	211	25
Past due loans	313	313	-	5	-	433	52
Residential retail portfolio	142	142	-	18	-	130	16
Equity portfolios	60	60	-	-	-	83	10
Other exposures	118	118	-	-	-	118	14
	32,562	**27,783**	**4,779**	**1,831**	**555**	**18,499**	**2,219**

* Includes Ginnie Mae & 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 six-month period in 2011 were US$ 32,704 million and US$ 18,715 million respectively.

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	500	40	31	60
- Specific interest rate risk	12	1	1	2
- General interest rate risk	488	39	30	58
Equity position risk	19	2	2	4
Foreign exchange risk	1,211	97	133	145
Options risk	6	-	-	1
Total market risk	**1,736**	**139**	**166**	**210**

* The information in these columns shows the minimum and maximum capital charge of each of the market risk categories during the period ended 30 June 2011

5.3 Operational risk

In accordance with the Standardised Approach, as at 30 June 2011, the total capital charge in respect of operational risk was US$ 158 million. This capital charge was computed by splitting 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.

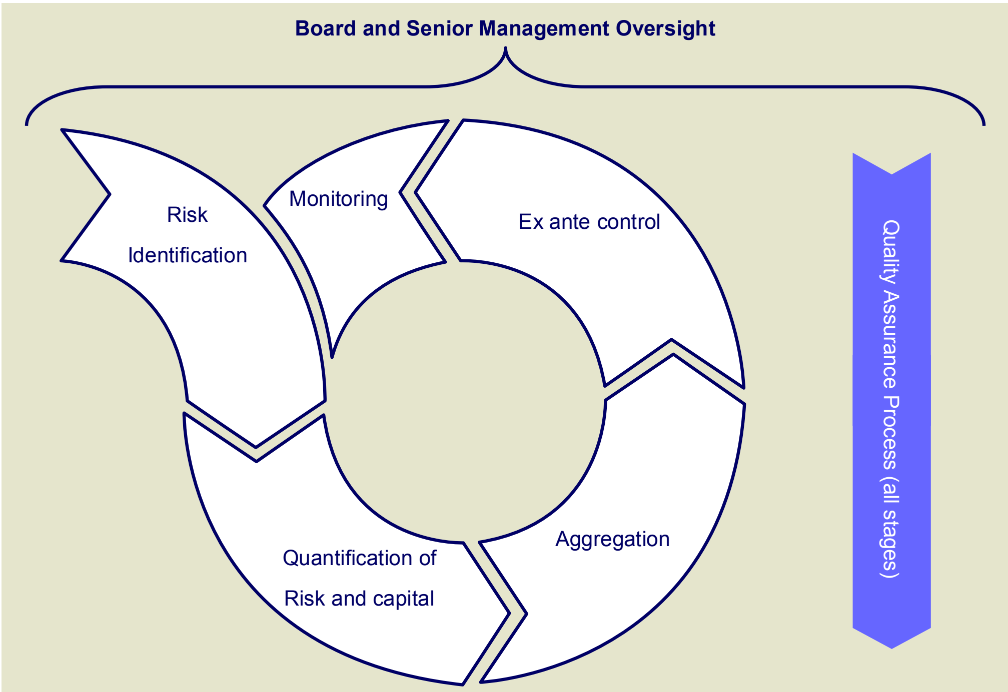
6.Risk management

6.1 Introduction

Risk is inherent in the Group's activities and is managed through a process of on-going 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 risks as well as other forms of risk inherent in its financial operations.

Over the last few years the Group has invested heavily in 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; and 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 minimise them. This is done through the BRC, senior management committees, as shown below, and the Credit & Risk Group in Head Office.

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 Risk Management Committee (RMC) reviews risk methodologies 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 wholesale and retail lending portfolios, setting country and other high-level Group limits, dealing with impaired assets, provisioning and general credit policy matters.

The **Asset and Liability Committee (ALCO)** is chiefly responsible for defining long-term strategic plans and short-term tactical initiatives for prudently directing asset and liability allocation 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. In this way, it ensures that the Group's ongoing activities are compatible with the risk/reward guidelines as 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 the prudent management, control and measurement of the Group's exposure to operational risks. It oversees the independent Operational Risk Management function and also provides advice and guidance on the operational risk framework, risk assessments, measurement and mitigation, and related monitoring. ORCO periodically reviews reports, key risk indicators, action plans, capital numbers, framework issues, etc.

The **Credit & Risk Group (CRG)** has overall responsibility for centralized 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, and thus provides a coherent infrastructure for the management of the Group's credit and risk functions.

Each subsidiary of the Group is responsible for managing its own risks and has its own Subsidiary Board Risk Committee (to which Head Office nominates members and sends representatives to participate as observers/invitees), Credit Committee, and (in the case of major subsidiaries) ALCO, or equivalent.

CREDIT RISK

The Group's portfolio and credit exposures are managed in accordance with the Group Credit Policy, which applies Group-wide qualitative and quantitative guidelines, with particular emphasis on avoiding undue concentrations or aggregations of risk. The Group's banking subsidiaries are governed by specific credit policies that are aligned with the Group Credit Policy, but may be adapted to suit local practices and regulatory requirements as well as individual units' product and sectoral needs.

The credit risk section of the CRG's Risk Management Department (RMD) coordinates all technology development related to credit risk management and provides senior management with consolidated information on Group exposures to counterparties, countries, industries, etc.

The first level of protection against undue credit risk is through the Group's counterparty, country, industry and other risk threshold limits, together with customer and customer group credit 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.

6. Risk management (continued)

6.2 Risk management structure (continued)

Where unsecured facilities are considered to be beyond prudential limits, Group policies require collateral to mitigate the credit risk in the form of cash, securities, and 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.

The Group employs a Risk Adjusted Return on Capital (RAROC) measure to evaluate the risk/reward relationship at the transaction approval stage. This is aggregated for each business segment, business unit and for the Group as a whole, and is constantly being upgraded in line with market needs.

Business unit account officers are responsible for day-to-day management of existing credit exposures. In the case of customers with limits exceeding the relevant business unit’s authority, they must regularly review customers’ financial and economic conditions, under the oversight of the CRG’s Head Office Credit Department. Every quarter, senior management and the BRC review the exposure profile of the Group using a variety of risk parameters. Group Audit meanwhile carries out separate Risk Asset Reviews of business units to assess and provide an independent opinion on the quality of their credit exposures and adherence to credit policies and procedures. These measures, collectively, constitute the main lines of defence against undue risk for the Group.

Credit exposures found to rank below a satisfactory risk rating are segregated and more actively supervised as impaired assets, under the guidance or supervision of the CRG’s Remedial Loans Unit (RLU). Impaired assets are reviewed regularly by the respective business units, with progress reports submitted at least quarterly to the RLU, which in turn reports to senior management and regulators. Subject to minimum loan loss provision levels mandated under the Group Credit Policy, specific provisions in respect of impaired assets are based on estimated potential losses, through a quarterly portfolio review and adequacy of provisioning exercise, which complies with IAS 39 reporting. An unencumbered portfolio provision (Collective Impairment Provision) is also maintained to cover unidentified possible future losses.

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. These focus on country and counterparty limits and the importance of maintaining a diversified portfolio. Identified concentrations of credit risk are controlled and managed accordingly.

6. Risk management (continued)

6.2 Risk management structure (continued)

Single name concentrations are monitored on an individual basis. 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 their regulatory capital base.

As at 30 June 2011, the Group's exposures in excess of 15% of the obligor limits to individual counterparties were as shown below:

US$ million	**On balance sheet exposure**	**Off balance sheet exposure**	**Total exposure**
Counterparty A	-	1,084	1,084
Counterparty B	1,024	-	1,024
Counterparty C	966	-	966

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 and where required, requests additional collateral in accordance with the underlying agreement and monitors the market value of collateral obtained on an ongoing basis. The Group also makes use of master netting agreements with counterparties.

6. Risk management (continued)

6.2 Risk management structure (continued)

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 authorized by the appropriate level of seniority within the Group. The effectiveness of hedges is monitored monthly by the Group.

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	6,560	-	-	326	323
Western Europe	5,342	27	20	11	6
Other Europe	55	-	-	-	-
Arab World	10,819	587	282	51	39
Other Africa	53	-	-	-	-
Asia	1,831	-	-	37	6
Australia/New Zealand	118	-	-	-	-
Latin America	7,784	16	15	-	-
	32,562	**630**	**317**	**425**	**374**

In addition to the above specific provisions the Group has collective Impairment provision amounting to US$ 171 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	-	-	-	62	-	-	-	-	**62**
Claims on sovereigns*	2,394	62	-	1,909	-	105	-	541	**5,011**
Claims on public sector entities **	2,037	96	-	1,528	-	102	-	33	**3,796**
Claims on multilateral development banks	-	35	-	120	-	-	-	-	**155**
Claims on banks	1,248	4,278	18	2,730	33	1,187	115	1,382	**10,991**
Claims on corporate portfolio	837	759	37	3,746	20	424	3	5,806	**11,632**
Regulatory retail exposures	-	4	-	273	-	-	-	5	**282**
Past due loans	-	4	-	303	-	-	-	6	**313**
Residential retail portfolio	1	65	-	65	-	-	-	11	**142**
Equity portfolios	20	-	-	27	-	13	-	-	**60**
Other exposures	23	39	-	56	-	-	-	-	**118**
	6,560	**5,342**	**55**	**10,819**	**53**	**1,831**	**118**	**7,784**	**32,562**

* 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	4,930	4,112	818	68	55	-	-
Mining and quarrying	90	75	15	-	-	-	-
Agriculture, fishing and forestry	56	52	4	2	2	-	-
Construction	1,059	745	314	2	1	-	-
Financial	13,380	11,206	2,174	168	132	368	350
Trade	714	579	135	82	67	-	-
Personal / Consumer finance	591	567	24	19	13	-	-
Commercial real estate financing	142	142	-	11	2	-	-
Residential mortgage	-	-	-	-	-	-	-
Government	6,967	6,469	498	32	32	24	6
Technology, media & telecommunications	631	471	160	232	2	1	1
Transport	596	529	67	1	1	-	-
Other sectors	3,406	2,836	570	13	10	32	17
	32,562	**27,783**	**4,779**	**630**	**317**	**425**	**374**

6. 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	**Manufactu -ring**	**Mining and quarrying**	**Agriculture, fishing and forestry**	**Construc- tion**	**Financial**	**Trade**	**Personal / consumer finance**	**Commercial real estate financing**	**Residential mortgage**	**Govern- ment**	**Technology, media & telecommunic -ations**	**Transport**	**Other sectors**	**Total**
Cash	-	-	-	-	-	-	-	-	-	-	-	-	62	**62**
Claims on sovereigns*	51	-	-	-	72	-	-	-	-	4,888	-	-	-	**5,011**
Claims on public sector entities **	825	-	-	-	663	38	-	-	-	2,059	-	36	175	**3,796**
Claims on multilateral development banks	-	-	-	-	155	-	-	-	-	-	-	-	-	**155**
Claims on banks	-	-	-	-	10,989	-	-	-	-	-	-	-	2	**10,991**
Claims on corporate portfolio	4,037	90	56	1,050	1,426	662	309	142	-	-	400	558	2,902	**11,632**
Regulatory retail exposures	-	-	-	-	-	-	272	-	-	-	-	-	10	**282**
Past due loans	16	-	-	9	10	14	10	-	-	20	230	1	3	**313**
Residential retail portfolio	-	-	-	-	-	-	-	-	-	-	-	-	142	**142**
Equity portfolios	1	-	-	-	53	-	-	-	-	-	1	1	4	**60**
Other exposures	-	-	-	-	12	-	-	-	-	-	-	-	106	**118**
	4,930	**90**	**56**	**1,059**	**13,380**	**714**	**591**	**142**	**-**	**6,967**	**631**	**596**	**3,406**	**32,562**

* 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	62	-	62
Claims on sovereigns*	5,011	4,676	335
Claims on public sector entities**	3,731	2,251	1,480
Claims on multilateral development banks	155	155	-
Claims on banks	10,522	8,790	1,732
Claims on corporate portfolio	10,358	1,163	9,195
Regulatory retail exposure	282	-	282
Past due loans	308	5	303
Residential retail portfolio	124	-	124
Equity portfolios	60	-	60
Other exposures	118	-	118
	30,731	17,040	13,691

* Includes Ginnie Mae & and Small Business Administration pools.

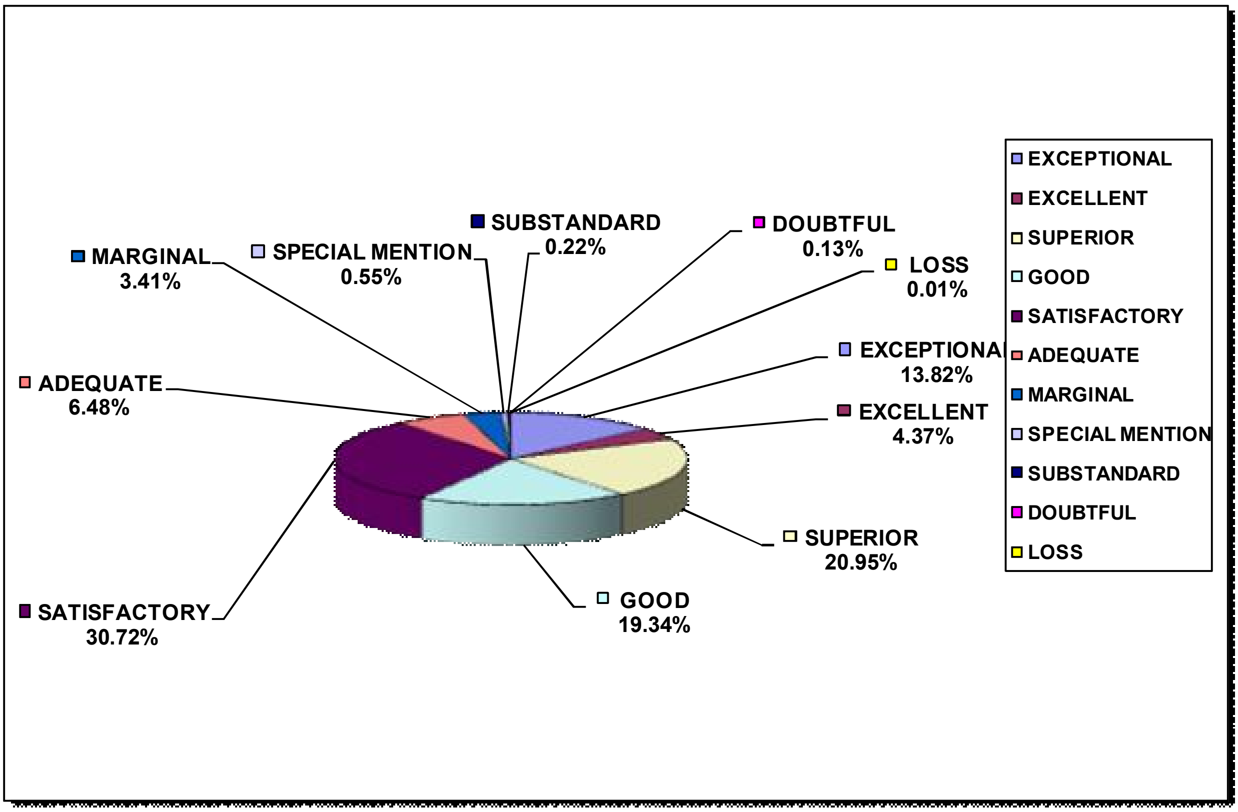
** Includes exposures to CMOs of Freddie Mac and Fannie Mae, both of which are deemed to be GSE.

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.

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. Ratings may be notched up or down based upon contingents or credit support as appropriate.



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$ 3,030 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	62	-	-	-	62	-	-	-	-	-	-	62
Claims on sovereigns*	2,337	621	323	157	3,438	732	35	-	-	273	1,040	4,478
Claims on public sector entities**	2,479	95	45	36	2,655	165	629	220	-	15	1,029	3,684
Claims on multilateral development banks	120	35	-	-	155	-	-	-	-	-	-	155
Claims on banks	3,741	963	934	993	6,631	2,174	107	4	-	116	2,401	9,032
Claims on corporate portfolio	677	1,178	1,238	881	3,974	3,738	1,240	262	7	239	5,486	9,460
Regulatory retail exposures	-	50	4	11	65	81	127	6	-	-	214	279
Past due loans	26	43	4	1	74	237	1	-	1	-	239	313
Residential retail portfolio	-	-	-	-	-	-	2	7	9	124	142	142
Equity portfolios	-	-	-	-	-	-	-	-	-	60	60	60
Other exposures	-	-	-	-	-	-	-	-	-	118	118	118
	9,341	**2,985**	**2,548**	**2,079**	**16,953**	**7,128**	**2,140**	**506**	**110**	**945**	**10,829**	**27,783**

* 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	9	49	-	17	75	437	-	-	21	-	458	533
Claims on public sector entities	-	6	6	47	59	35	18	-	-	-	53	112
Claims on banks	495	346	355	317	1,513	431	14	-	1	-	446	1,959
Claims on corporate portfolio	297	350	306	562	1,515	601	38	9	9	-	657	2,172
Regulatory retail exposures	-	2	-	1	3	-	-	-	-	-	-	3
	801	**753**	**667**	**944**	**3,165**	**1,504**	**70**	**9**	**31**	**-**	**1,614**	**4,779**

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	5,179	2,425
Direct credit substitutes, guarantees and acceptances	3,409	1,492
Undrawn loans and other commitments	1,212	667
	9,800	**4,584**
RWA		**3,601**

* Credit exposure is after applying CCF.

At 30 June 2011, the Group held eligible guarantees as collateral in relation to credit-related contingent items amounting to US$ 484 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 favourable 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 2011.

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 2011 were as follows:

	Derivatives		
US$ million	**Interest rate contracts**	**Foreign exchange contracts**	**Total**
Notional – Trading book	3,219	5,516	8,735
Notional – Banking book	709	678	1,387
	3,928	**6,194**	**10,122**
Credit RWA (replacement cost plus potential future exposure)	118	77	195
Market RWA	488	1,217	1,705

6. Risk management (continued)

6.8 Impairment of assets

Impairment and uncollectability of financial assets

An assessment is made at each balance sheet date 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.

In respect of a borrower or a group of borrowers, evidence of impairment may include indications of:

- significant financial difficulty, default or delinquency in interest or principal payments
- the probability that it will enter bankruptcy or other financial reorganisation
- based on observable data, a measurable decrease in estimated future cash flows, such as changes in arrears or economic conditions, which correlate with defaults

Impairment is determined as follows:

(a) for assets carried at amortised 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 significant and prolonged decline in cost and fair value
(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, wherein a decline in value of investment that is neither significant nor prolonged is taken to equity. These are written down, with future increases in their fair value being recognised directly in equity.

On a quarterly basis, the Group assesses whether any provision for impairment should be recorded in the consolidated statement of income. In particular, management exercises considerable judgement when estimating the amount and timing of future cash flows in order to determine the level of provision required. Such estimates are necessarily based on assumptions about several factors, involving varying degrees of judgement and uncertainty. 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 and 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 subjecting 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.

6. Risk management (continued)

6.8 Impairment of assets (continued)

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.

Industry sector analysis of the specific and collective impairment provisions charges and write-offs

US$ million	Provision (recovery)	Write-offs
Manufacturing	13	3
Financial	(1)	128
Trade	1	1
Personal / Consumer finance	1	-
Other Services	(15)	3
Commercial real estate financing	-	-
Construction	-	-
	(1)	**135**

Remedial Loans Unit

Non-performing loans as a percentage of gross loans increased from 3.49% in December 2010 to 5.08% in June 2011, continuing to reflect the adverse global market conditions. The provisions coverage ratio (total provisions as percentage of non-performing loans) fell from 127.6% in December 2010 to 95.1% in June 2011. However, non-performing loans as a percentage of equity in June 2011 increased to 17.5%, compared with 13% in December 2010 mainly due to the addition of a new NPL of US$ 230 million which was classified as non-performing in June 2011. However, the Group remains confident this new large NPL will be resolved and will return to a performing status before FYE 2011, because the collateral margin coverage is strong (130%) and a third party exit route from an AA- rated GCC state-owned entity, will ultimately provide full repayment.

The RLU policy is continuously revised given the dynamic economic environment and is enhanced on an ongoing basis to cover any new issues related to the management of impaired assets, especially those that arise from differences related to local versus global provisioning policies. Policy changes are applied consistently across the Group.

The Head Office based Recovery & Support Unit has now been merged into the Remedial Loans Unit for more effective management of impaired assets across the whole Group, while maintaining the support and assistance to retail subsidiaries in remedial loan management.

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 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, with strategic oversight exercised by ALCO. The RMD's Market Risk Management (MRM) Unit is responsible for developing and implementing market risk policy, as well as 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 as follows:

- **Trading Market Risk** arises from movements in market risk factors that affect short-term trading.

- **Non-Trading Market Risk in Securities** arises from market factors affecting securities held for long-term investment.

- **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.

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. It should be noted that some of these methodologies are made available to selected branches and subsidiaries.

The primary market risk measures 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 applying appropriate limits and stop-loss parameters, determined by each subsidiary's local ALCO and approved by its Board of Directors. In accordance with ABC's strategic plans, ALCO regularly reviews the Group's structural balance sheet positions, which relate to its net investment in its foreign subsidiaries. Group Treasury manages these positions on an ongoing basis, 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 due to mismatches of interest rate re-pricing of assets and liabilities. Interest rates are the Group's primary market risk factor. The fact that the Group's rate-sensitive assets and liabilities are mostly floating rate, where duration risk is lower than for fixed rate, minimises this risk. In general, the Group use matched currency funding and translates fixed-rate instruments to floating rate to better manage the duration in the asset book. When managing the interest rate risk resulting from the Group's trading and banking activities, the effect of interest rate movements is assessed using sensitivity analyses and other modeling techniques. There are established limits on individual Business Units' aggregate maximum exposures to interest rate risk, as there are on an overall basis for the core banking units. MRM monitors Board-approved trading limits, bringing any exceptions to the attention of ALCO.

Interest Rate Risk in the Banking Book (IRRBB)

The Group uses the Basis Point Value (BPV) approach to control the IRRBB. BPV measures changes in economic value resulting from changes in interest rates. The BPV methodology uses the modified duration and, for some products, the effective duration approaches 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. With products that have embedded options, the effective duration is typically a better representation of interest sensitivity than modified duration.

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 rate-sensitive component and is excluded from these computations. As at 30 June 2011, an immediate shift up by 25 basis points in interest rates would potentially impact the Group's economic value by (-) US$ 20 million.

As a normal part of its treasury trading activities, the Group may also be exposed to equity, debt security, commodity and volatility risk. MRM monitors these risks against Board-approved limits.

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 the future profitability or the fair values of financial instruments. The Group is exposed to equity risk in its trading position and investment portfolio, primarily in its core international and GCC markets.

Equity positions in the banking book

Quoted equities	14
Unquoted equities	46
	60
Realised gains during the period	2
Unrealised gain as at 30 June 2011*	6

*At 30 June 2011, unrealised gains on equity investments amounted to US$ 6 million. 45% of the unrealised gains or US$ 2 million was included in Tier 2 capital.

6.12 Liquidity risk

Liquidity risk is the risk that maturing and encashable assets may not cover cash flow obligations (liabilities). The Group maintains liquid assets at prudential levels to ensure that cash can quickly be made available to honour 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. ABC 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. In this way, it ensures 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 draw downs, under market value driven encashability scenarios. Maturity mismatch is also managed within internal policy limits.

6. Risk management (continued)

6.12 Liquidity risk (continued)

Key Initiatives

Several steps were taken - over the course of the year to improve management of market risk. The CRG is currently reviewing the quantitative risk management measurements it employs and seeking to streamline its financial instrument valuation processes

6.13 Operational risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes or systems or from external events. Operational risk is inherent in all business activities and can never be eliminated entirely. However, shareholder value can be preserved and enhanced by managing, mitigating and, in some cases, insuring against operational risk.

A framework has been implemented across the Group to manage operational risk which includes identification, measurement, management, monitoring and risk control/mitigation elements. A variety of underlying processes and controls support this framework. These include risk and control self-assessments, key risk indicators, event management, new product review and approval processes, and business contingency plans.

Operational risks are identified and assessed through the Risk & Control Self-Assessment (RCSA) process. Once risks are identified, their potential impact is assessed through a combination of likelihood and impact before (inherent risk) and after (residual risk), considering 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, 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. There is also a process to capture operational loss events.

In order to make operational risk transparent throughout the Group, processes for 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 follows the Standardised Approach for calculating operational risk capital. As such, a detailed mapping of the Group's business lines and gross income to the Basel II Business Line Framework has been implemented.

Group policy dictates that the functions of booking, recording and monitoring of transactions are performed by staff that are independent of individuals initiating 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 process and control programmes, to manage its operational risk within the guidelines established by Group policy, and to develop internal procedures that comply with Group policies. To ensure that management of all the operational risks the Group may be exposed to is adequate, support functions are also involved in the identification, measurement, management, monitoring and control/mitigation of operational risk as appropriate.

6. Risk management (continued)

6.13 Operational risk (continued)

Key Initiatives

The CRG took several steps to upgrade management of operational risk.

Systems, processes and controls were upgraded. Improvements to systems included enhanced key indicator dashboards, and improved data management and reporting. Processes covering control validation and issue escalation were strengthened. From a controls perspective, Operational Risk Management is working more closely with Group Audit to ensure their risk management methodologies are aligned, to eliminate potential overlap and to strengthen overall risk management.

The Group has taken steps to strengthen the link between senior management remuneration and effective risk management by linking a proportion of remuneration to achievement of robust risk management objectives.

Business continuity

As part of the Group's aim to meet local and international regulatory obligations, as well as to protect the Group's business functions, assets and employees, it has robust business continuity plans. These plans provide each ABC subsidiary with the necessary guidelines and procedures in case of an emergency. The plans were designed employing best-practice methodology BS25999, as used by most UK and other European financial institutions.

The business continuity plans cover local and regional risk scenarios which might impact any business unit. To address local disaster events, the Group has established business continuity centres within the geographic location of each of the business units. To address a regional disaster scenario affecting the Kingdom of Bahrain, the Bank has established a licensed branch in the UK, which maintains full operational status and is capable of carrying out the majority of the Bank's activities. As regards activities relating to marketable securities, brokerage and client-related businesses, the alternative site selected is the Bank's subsidiary in Jordan, approval for which has been obtained from the Central Bank of Jordan. These two licenses would enable ABC Head Office to carry out all of its functions from these two countries. These plans are being stress tested to ensure that the guidelines and procedures are fully effective. Continuous updates of these plans are performed on an annual basis, to ensure that they are kept up to date with changes in each ABC unit.

6.14 Legal risk

Examples of legal risk include inadequate documentation, legal and regulatory incapacity, insufficient authority of a counterparty and contract invalidity/unenforceability. Legal Counsel and Corporate Secretary bear responsibility for identification and management of this risk. They consult with internal and external legal counsels. All major Group subsidiaries have their own in-house legal departments, acting under the guidance of the Legal Counsel, 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 aims to maintain an optimum level of capital to enable it to pursue strategies that build long-term shareholder value, while always meeting minimum regulatory ratio requirements. The diagram below illustrates this concept:

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

- Return on capital is maximised to generate a sustainable return above the cost of capital

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

6. Risk management (continued)

6.15 Capital management (continued)

The 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. These encompass reviewing, monitoring and controlling capital usage and allocation. These processes include the following:

- Preparation of a risk strategy document outlining the Group's risk appetite, capital adequacy goals and risk targets. The document complies with the CBB's guidelines for capital management, issued in January 2008, and incorporates the risk strategy as approved by the Board of Directors, underscoring Board and senior management responsibility and oversight.

- Comprehensive assessment of economic capital, i.e. credit, market and operational risks, as well as processes relating to other risks such as liquidity, interest rate risk in the banking book, strategic and reputational risks.

- 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.

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 timeframe, under normal market conditions and 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

- 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.

6. Risk management (continued)

6.15 Capital management (continued)

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

Other risks such as liquidity, strategic and reputational risks are currently captured providing a capital buffer.

The results of the ICAAP 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 14 stress cases. Examples include:

- Investment grade / sub-investment grade stressed
- Investment grade / sub-investment grade probability of default (PD) stressed
- Sub-investment stressed both for ratings and PD
- Total portfolio PD stressed
- Total portfolio ratings stressed
- Total portfolio ratings and PD stressed

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

- Global recession. This scenario stresses the PDs and loss given defaults (LGDs) by time period and distinguishes between on and off balance sheet exposures
- Escalated regional political tension. PDs and LGDs for entities in the region are stressed individually
- Middle East recession
- As for global recession above, but for Arab world exposures only
- European recession
- As for global recession above, but for European exposures only

6. Risk management (continued)

6.15 Capital management (continued)

The Group has also designed three broad families of planned stress test scenarios (STS) for market risk:

- 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
  - Non-parallel shocks applied sequentially to the term structures of interest rates
- Hypothetical STS: This family of STS is designed to quantify the expected impact of unlikely but not improbable relevant events, which have not been observed before in financial markets but might materialise at short notice. Examples of the Hypothetical STS include:
  - Revaluation or devaluation scenarios for currencies in which the Group has material, significant open FX positions
  - Instantaneous shock scenarios designed to gauge the tilt / curvature / convexity impact of bar-bell, and asymmetric movements in the levels of reference market interest rates
- Historical STS: These STS replicate the observed behaviour of reference market data across interest rate, currency and equity classes of risk during particular historical periods of elevated market turbulence. Examples include the following:
  - The US and European bond markets crisis, 1994
  - The Asian crisis, 1997
  - The Long-Term Capital Management and Russian crisis, 1998
  - The Lehman Brothers default, 2008

In order to gauge the risk attached to 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 FX rates and implied volatilities – CRG has created a particular sub-set of hypothetical STS, the so-called "Doomsday" STS. These are applied daily in the Group's main trading and position-keeping systems. They produce scenario-based revaluations, which are then compared to appropriate limits set by senior management.

6. Risk management (continued)

6.15 Capital management (continued)

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 assessment of all banks and, instead of applying a standard minimum capital adequacy requirement, the supervisor may allow a lower capital adequacy ratio in excess of 8% for a bank with sound risk management capabilities.

The CBB initiated this assessment process in 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 maximising 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 arm's length rationale.

a. Exposures to related parties

US$ million	
Claims on shareholders *	517
Claims on directors & senior management	3
Claims on staff	21

* Unfunded exposures

b. Liabilities to related parties

US$ million	
Connected deposits	3,758

The Interest expense in respect of connected deposits is US$ 4 million.

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	233	-	233
3 months to 1 year	42	26	16
1 to 3 years	265	207	58
Over 3 years	90	84	6
	630	**317**	**313**

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	11	6	5
3 months to 1 year	-	-	-
1 to 3 years	390	347	43
Over 3 years	24	21	3
	425	**374**	**51**

7.3 Restructured facilities

Facilities restructured during the period ended 30 June 2011 amounted to US$ 2 million. The carrying amount of restructured facilities amounted to US$ 104 million as at 30 June 2011. The impact of restructured credit facilities on provisions and present and future earnings is insignificant.

7.4 Assets sold under recourse agreements

Proceeds from assets sold under repurchase agreements for the period ended amounted to US$ 4,311 million. The carrying value of securities sold under repurchase agreements at the period end amounted to US$ 4,891 million.

Amounts paid for assets purchased under resale agreements at the period end amounted to US$ 384 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$ 385 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	399	515	4	169
Amounts written off	(7)	(128)	-	-
Write backs / cancellation due to improvement	(12)	(29)	-	-
Additional provisions made	32	6	-	2
Exchange adjustment and other movements	16	10	-	-
Balance at reporting date	**428**	**374**	**4**	**171**

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