المؤسسة العربية المصرفية (ش.م.ب)
ARAB BANKING CORPORATION [B.S.C.]

# BASEL II – RISK & PILLAR III DISCLOSURES

30 June 2012

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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 2012 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-statement of financial position.

# 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 2012, 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 | 99 |
| 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 2012, 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 debt under its US$ 2,5 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. The bank had repurchased a portion of the debt in the previous years.

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$ 5,008 million comprises Tier 1 capital of US$ 4,047 million and Tier 2 capital of US$ 961 million as detailed below:

**Breakdown of Capital Base**

| ***US$ million*** | **Tier 1** | **Tier 2** | **Total** |
|---|---|---|---|
| Share capital | 3,110 | - | 3,110 |
| Statutory reserve | 355 | - | 355 |
| General reserve | 150 | - | 150 |
| Retained earnings brought forward | 156 | - | 156 |
| Profit for the period | - | 105 | 105 |
| Minority interest in consolidated subsidiaries | 417 | - | 417 |
| Foreign currency translation adjustment | (127) | - | (127) |
| Unrealized losses from fair value of equity securities | - | - | - |
| Unrealized gains from fair value of equity securities | | 2 | 2 |
| Collective impairment provisions | - | 194 | 194 |
| Subordinated term debt | - | 674 | 674 |
| **Tier 1 and Tier 2 capital before deductions** | **4,061** | **975** | **5,036** |
| Significant minority investments in banking, securities and other financial entities | (11) | (11) | (22) |
| Other deductions – Unamortized IT costs | (3) | (3) | (6) |
| **Tier 1 and Tier 2 capital base** | **4,047** | **961** | **5,008** |

| **Risk weighted assets (RWA)** | |
|---|---|
| Credit risk | **18,893** |
| Market risk | **1,406** |
| Operational risk | **1,450** |
| **Total Risk Weighted assets** | **21,749** |
| **Tier 1 ratio** | **18.6%** |
| **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 / 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 to the capital structure, the objectives, policies and processes from the previous year.

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 2012 was 23.0% compared with the minimum regulatory requirement of 12%. The Tier 1 ratio was 18.6% 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.) | ***26.0%*** | ***26.5%*** |
| ABC International Bank Plc* | ***13.8%*** | ***15.7%*** |
| Banco ABC Brasil S.A.* | ***10.2%*** | ***14.2%*** |

* 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 except for self-liquidating letters of credit issued or confirmed by such unrated banks.

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 portfolio

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 | 1 | 1 | - | - | - | - | - |
| Claims on sovereigns* | 3,022 | 2,667 | 355 | - | 17 | 528 | 63 |
| Claims on public sector entities ** | 2,230 | 2,094 | 136 | 55 | 126 | 1,645 | 198 |
| Claims on multilateral development banks | 140 | 140 | - | - | - | - | - |
| Claims on banks | 10,063 | 8,410 | 1,653 | 536 | 477 | 4,936 | 592 |
| Claims on corporate portfolio | 11,625 | 9,562 | 2,063 | 324 | 49 | 10,825 | 1,299 |
| Regulatory retail portfolio | 447 | 442 | 5 | - | - | 335 | 40 |
| Past due loans | 86 | 86 | - | 14 | - | 106 | 13 |
| Residential retail portfolio | 8 | 8 | - | 8 | - | 3 | 1 |
| Equity portfolios | 50 | 50 | - | - | - | 69 | 8 |
| Other exposures | 445 | 436 | 9 | - | - | 445 | 53 |
| | **28,117** | **23,896** | **4,221** | **937** | **669** | **18,892** | **2,267** |

* 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 2012 were US$ 28,504 million and US$ 19,333 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 | 423 | 51 | 44 | 55 |
| - Specific interest rate risk | 26 | 3 | 3 | 7 |
| - General interest rate risk | 397 | 48 | 41 | 48 |
| Equity position risk | 6 | 1 | - | 1 |
| Foreign exchange risk | 977 | 117 | 98 | 119 |
| Options risk | - | - | - | - |
| **Total market risk** | **1,406** | **169** | **142** | **175** |

* 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 2012.

## 5.3 Operational risk

In accordance with the Standardised Approach, as at 30 June 2012, the total capital charge in respect of operational risk was US$ 174 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.

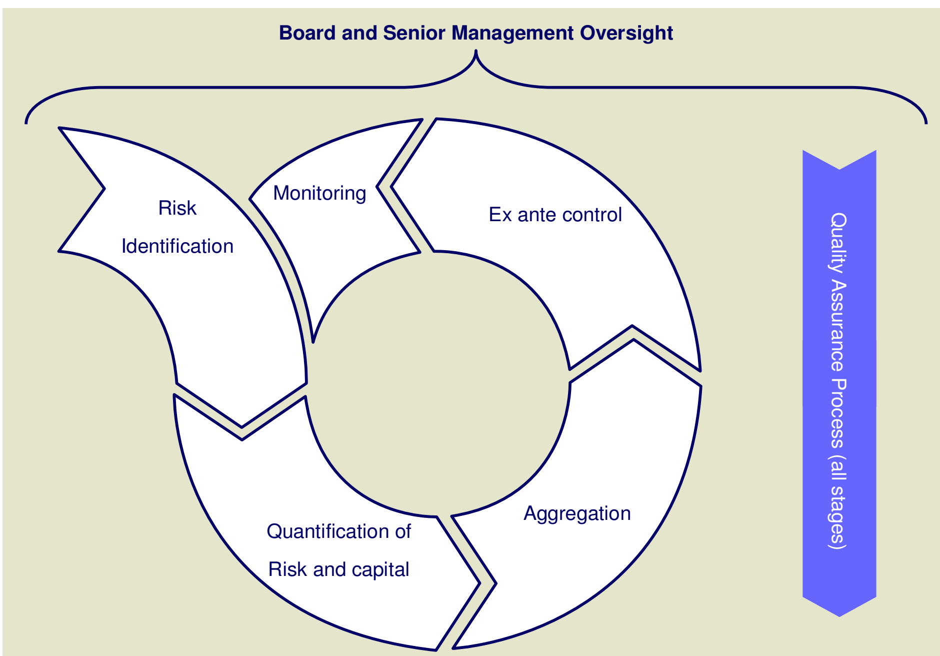
# 6. Risk management

## 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, market, liquidity, interest rate, operational, 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 credit, market and operational risk identification processes; 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:**




The Board Risk Committee (BRC) sets the Group’s Risk Strategy/Appetite and Policy Guidelines. Executive management is responsible for their implementation

# 6. Risk management (continued)

## 6.2 Risk management structure

**Figure 2:**


Within the broader governance infrastructure, the Board Committees carry the main responsibility for best practice management and risk oversight. At this level, the BRC oversees the definition of risk/reward guidelines, risk appetite, risk tolerance standards and risk process standards. The BRC also takes responsibility 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 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 **Group Asset and Liability Committee (ALCO)** is responsible for defining long-term strategic plans and policy, as well as short-term tactical initiatives for prudently directing asset and liability allocation. ALCO monitors the Group's liquidity and market risks, and the Group's risk profile, in the context of economic developments and market fluctuations.

The Group **Operational Risk Management Committee (ORCO)** is responsible for defining long-term strategic plans and short-term tactical initiatives for the identification, prudent management, control and measurement of the Group's exposure to operational and other non-financial risks. ORCO frames policy and oversees the operational risk function.

The **Credit & Risk Group (CRG)** is responsible 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. Additionally, it identifies market and operational risks arising from the Group's activities, recommending to the relevant central committees appropriate policies and procedures for managing exposure.

The Group's subsidiaries are responsible for managing their own risks, which they do through local equivalents of the head office committees described above.

Under the single obligor regulations of the CBB and other host regulators, the CRG and its local equivalents have to obtain approval for any planned exposures above specific thresholds to single counterparties, or groups of connected counterparties.

# 6. Risk management (continued)

## 6.2 Risk management structure (continued)

### 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 regulatory requirements as well as individual units' product and sectoral needs.

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. The BRC and the HOCC sets these limits and allocates them between the Group and its banking subsidiaries. A tiered hierarchy of delegated approval authorities, based on the risk rating of the customer under the Group's internal credit rating system, controls credit exposure to individual customers or customer groups.

Credit limits are prudent, and the Group uses standard mitigation and credit control technologies.

The Group employs a Risk-Adjusted Return on Capital (RAROC) measure to evaluate risk/reward at the transaction approval stage. This is aggregated for each business segment and business unit, and for the Group as a whole. It is upgraded when appropriate. Business unit account officers are responsible for day-to-day management of existing credit exposures, and for periodic review of the client and associated risks, within the framework developed and maintained by the CRG. Group Audit, meanwhile, carries out separate risk asset reviews of business units, to 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 that have significantly deteriorated are segregated and supervised more actively by the CRG's Remedial Loans Unit (RLU). 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. (Collective impairment provision) is also maintained to cover unidentified possible future losses.

# 6. Risk management (continued)

## 6.2 Risk management structure (continued)

As at 30 June 2012, 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 | | 1,046 | 1,046 |

### 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 | 3,160 | - | - | 325 | 323 |
| Western Europe | 4,513 | 20 | 15 | - | - |
| Other Europe | 48 | - | - | - | - |
| Arab World | 10,928 | 352 | 292 | 49 | 40 |
| Other Africa | 31 | - | - | - | - |
| Asia | 2,034 | - | - | 36 | 6 |
| Australia/New Zealand | 4 | - | - | - | - |
| Latin America | 7,399 | 62 | 41 | - | - |
| | **28,117** | **434** | **348** | **410** | **369** |

In addition to the above specific provisions the Group has collective Impairment provision amounting to US$ 194 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 | - | - | - | 1 | - | - | - | - | **1** |
| Claims on sovereigns* | 916 | 304 | - | 1,251 | - | 91 | - | 460 | **3,022** |
| Claims on public sector entities ** | 356 | 94 | - | 1,513 | - | 117 | - | 150 | **2,230** |
| Claims on multilateral development banks | - | 32 | - | 108 | - | - | - | - | **140** |
| Claims on banks | 1,123 | 3,021 | 45 | 3,236 | 4 | 1,357 | 4 | 1,273 | **10,063** |
| Claims on corporate portfolio | 704 | 956 | 3 | 4,006 | 27 | 457 | - | 5,472 | **11,625** |
| Regulatory retail exposures | - | 6 | - | 432 | - | - | - | 9 | **447** |
| Past due loans | - | 2 | - | 59 | - | - | - | 25 | **86** |
| Residential retail portfolio | - | 6 | - | 2 | - | - | - | - | **8** |
| Equity portfolios | 18 | - | - | 20 | - | 12 | - | - | **50** |
| Other exposures | 43 | 92 | - | 300 | - | - | - | 10 | **445** |
| | **3,160** | **4,513** | **48** | **10,928** | **31** | **2,034** | **4** | **7,399** | **28,117** |

* 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 | 4,551 | 3,859 | 692 | 82 | 59 | - | - |
| Mining and quarrying | 142 | 127 | 15 | 14 | 5 | - | - |
| Agriculture, fishing and forestry | 20 | 18 | 2 | 5 | 4 | - | - |
| Construction | 950 | 653 | 297 | 1 | 1 | - | - |
| Financial | 12,392 | 10,468 | 1,924 | 167 | 140 | 354 | 345 |
| Trade | 662 | 601 | 61 | 82 | 68 | - | - |
| Personal / Consumer finance | 635 | 602 | 33 | 22 | 15 | - | - |
| Commercial real estate financing | - | - | - | - | - | - | - |
| Residential mortgage | 8 | 7 | 1 | - | - | - | - |
| Government | 3,359 | 3,042 | 317 | 32 | 32 | 24 | 6 |
| Technology, media & telecommunications | 740 | 616 | 124 | 1 | 1 | 1 | 1 |
| Transport | 540 | 481 | 59 | - | - | - | - |
| Other sectors | 4,118 | 3,422 | 696 | 28 | 23 | 31 | 17 |
| | **28,117** | **23,896** | **4,221** | **434** | **348** | **410** | **369** |

# 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 | - | - | - | - | - | - | - | - | - | - | - | - | 1 | **1** |
| Claims on sovereigns* | 1 | - | - | - | 80 | - | - | - | - | 2,941 | - | - | - | **3,022** |
| Claims on public sector entities ** | 809 | - | - | - | 806 | 27 | - | - | - | 397 | - | 26 | 165 | **2,230** |
| Claims on multilateral development banks | - | - | - | - | 140 | - | - | - | - | - | - | - | - | **140** |
| Claims on banks | - | - | - | - | 10,063 | - | - | - | - | - | - | - | - | **10,063** |
| Claims on corporate portfolio | 3,685 | 141 | 20 | 946 | 1,235 | 618 | 183 | - | - | - | 735 | 514 | 3,548 | **11,625** |
| Regulatory retail exposures | 4 | - | - | 1 | - | 1 | 421 | - | - | - | 4 | - | 16 | **447** |
| Past due loans | 18 | 1 | - | 3 | - | 16 | 22 | - | - | 21 | - | - | 5 | **86** |
| Residential retail portfolio | - | - | - | - | - | - | - | - | 8 | - | - | - | - | **8** |
| Equity portfolios | 1 | - | - | - | 47 | - | - | - | - | - | 1 | - | 1 | **50** |
| Other exposures | 33 | - | - | - | 21 | - | 9 | - | - | - | - | - | 382 | **445** |
| | **4,551** | **142** | **20** | **950** | **12,392** | **662** | **635** | **-** | **8** | **3,359** | **740** | **540** | **4,118** | **28,117** |

* 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 and Fitch Ratings. (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 | 1 | - | 1 |
| Claims on sovereigns* | 3,022 | 2,493 | 529 |
| Claims on public sector entities** | 2,175 | 616 | 1,559 |
| Claims on multilateral development banks | 140 | 140 | - |
| Claims on banks | 9,528 | 7,432 | 2,096 |
| Claims on corporate portfolio | 11,301 | 1,019 | 10,282 |
| Regulatory retail exposure | 447 | 2 | 445 |
| Past due loans | 71 | 5 | 66 |
| Residential retail portfolio | - | - | - |
| Equity portfolios | 50 | - | 50 |
| Other exposures | 445 | - | 445 |
| | 27,180 | 11,707 | 15,473 |

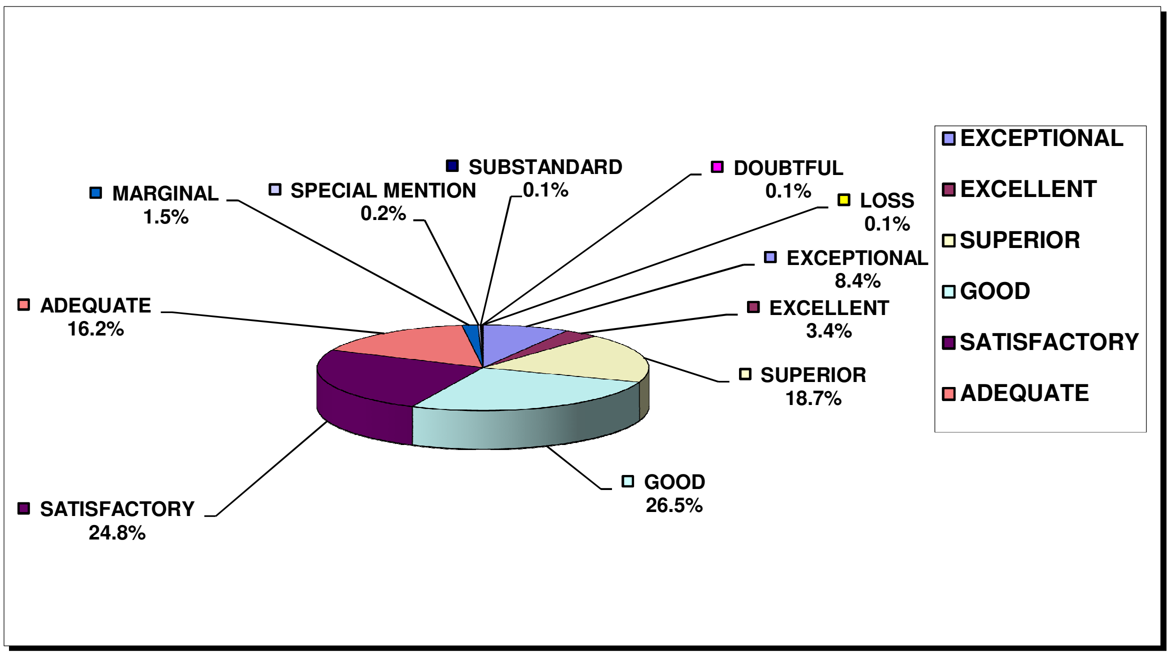
* Includes Ginnie Mae & and Small Business Administration pools.

** 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)

The Group has a policy of maintaining accurate and consistent risk methodologies. It uses a variety of financial analytics, combined with market information, to support risk ratings that form 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. They are assessed and updated regularly. Each risk rating class is mapped to grades equivalent to Standard & Poor's, Moody's and Fitch rating agencies



# 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$ 885 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 | 1 | - | - | - | **1** | - | - | - | - | - | **-** | **1** |
| Claims on sovereigns* | 1,011 | 612 | 195 | 168 | **1,986** | 646 | 31 | 4 | - | - | **681** | **2,667** |
| Claims on public sector entities** | 384 | 500 | 43 | 17 | **944** | 261 | 520 | 212 | 124 | 33 | **1,150** | **2,094** |
| Claims on multilateral development banks | - | 140 | - | - | **140** | - | - | - | - | - | **-** | **140** |
| Claims on banks | 2,688 | 1,331 | 966 | 1,007 | **5,992** | 2,409 | - | 1 | - | 8 | **2,418** | **8,410** |
| Claims on corporate portfolio | 883 | 1,475 | 1,111 | 1,290 | **4,759** | 3,268 | 902 | 232 | 14 | 387 | **4,803** | **9,562** |
| Regulatory retail exposures | 7 | 43 | 13 | 26 | **89** | 88 | 209 | 50 | 6 | - | **353** | **442** |
| Past due loans | 4 | 5 | 16 | 7 | **32** | 27 | 26 | - | 1 | - | **54** | **86** |
| Residential retail portfolio | - | - | - | - | **-** | - | 2 | 5 | 1 | - | **8** | **8** |
| Equity portfolios | - | - | - | - | **-** | - | - | - | - | 50 | **50** | **50** |
| Other exposures | - | - | - | - | - | - | - | - | - | 436 | **436** | **436** |
| | **4,978** | **4,106** | **2,344** | **2,515** | **13,943** | **6,699** | **1,690** | **504** | **146** | **914** | **9,953** | **23,896** |

* 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 | 19 | 45 | 4 | 116 | **184** | 152 | - | - | 19 | - | **171** | **355** |
| Claims on public sector entities | 27 | 20 | 20 | 15 | **82** | 16 | 38 | - | - | - | **54** | **136** |
| Claims on banks | 219 | 385 | 223 | 418 | **1,245** | 313 | 90 | - | 5 | - | **408** | **1,653** |
| Claims on corporate portfolio | 170 | 376 | 261 | 712 | **1,519** | 487 | 56 | - | 1 | - | **544** | **2,063** |
| Regulatory retail exposures | - | 2 | 1 | - | **3** | 2 | - | - | - | - | **2** | **5** |
| Other Exposure | | 2 | 1 | 4 | **7** | 2 | | | | | **2** | **9** |
| | **435** | **830** | **510** | **1,265** | **3,040** | **972** | **184** | **-** | **25** | **-** | **1,181** | **4,221** |

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 | 4,877 | 1,951 |
| Direct credit substitutes, guarantees and acceptances | 3,543 | 1,523 |
| Undrawn loans and other commitments | 1,057 | 418 |
| | **9,477** | **3,892** |
| **RWA** | | **2,906** |

* Credit exposure is after applying CCF.

At 30 June 2012, the Group held eligible guarantees as collateral in relation to credit-related contingent items amounting to US$ 507 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 2012.

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 2012 were as follows:

| | **Derivatives** | | |
|---|---|---|---|
| ***US$ million*** | **Interest rate contracts** | **Foreign exchange contracts** | **Total** |
| Notional – Trading book | 4,833 | 5,917 | 10,750 |
| Notional – Banking book | 816 | 320 | 1,136 |
| | **5,649** | **6,237** | **11,886** |
| Credit RWA (replacement cost plus potential future exposure) | 175 | 45 | 220 |
| Market RWA | 397 | 977 | 1,374 |

# 6. Risk management (continued)

## 6.8 Impairment of assets

An assessment is made at each balance sheet date to determine whether a specific financial asset, or group of financial assets, may be impaired. If such evidence exists, an impairment loss is recognised in the consolidated statement of income.

**Evidence of impairment may include:**

- Significant financial difficulty, default or delinquency in interest or principal payments
- The probability that it will enter bankruptcy or other financial reorganisation
- 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 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. These 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, 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 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 to rigorous credit risk scenario testing and averaging the existing Expected Loss (EL) with a severely stressed scenario EL. Additionally, 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 | 18 | 2 |
| Financial | 2 | - |
| Trade | 1 | - |
| Personal / Consumer finance | 3 | 1 |
| Other Services | 1 | 1 |
| Commercial real estate financing | 3 | - |
| Construction | - | 3 |
| Agriculture, fishing & forestry | - | 1 |
| | **28** | **8** |

# 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 measured, monitored and controlled by the RMD, with strategic oversight exercised by ALCO. The RMD's Market Risk Management (MRM) unit is responsible for the development and implementation of market risk policy, the risk measurement and monitoring framework, and the review of all trading and investment products / limits before submission to ALCO.

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 those of its liabilities.

The Group adopts a number of methods to monitor and manage market risks across its trading and non-trading portfolios. These include:

- Value-at-Risk (VaR) (i.e. 1-day 99th percentile VaR using the 'historical simulation' methodology)
- Sensitivity analysis( i.e. basis-point value (BPV) for interest rates and 'Greeks' for options)
- Stress testing / scenario analysis
- Non-technical risk measures (e.g. nominal position values, stop loss vs. P&L, and concentration risk).

As a reflection of the Group's risk appetite, limits are established against the aforementioned market risk measures. The BRC approves these limits annually and the MRM reports on them daily. The MRM reports risk positions against these limits, and any breaches, to the Senior Management and ALCO.

**Currency rate risk**
The Group's trading book has exposures to foreign exchange risk arising from cash and derivatives trading. Additionally, structural balance sheet positions relating to net investment in foreign subsidiaries expose the Group to foreign exchange risk. These positions are reviewed regularly by the ALCO, keeping in view ABC's strategic objectives, and Group Treasury manages them on a day-to-day basis.

# 6. Risk management (continued)

## 6.9 Market risk (continued)

**Interest rate risk**

The Group trading, investment and banking activities expose it to interest rate risk. The exposure to interest rate risk in the banking book (IRRBB) arises due to mismatches in the re-setting of interest rates of assets and liabilities. The fact that the Group's rate-sensitive assets and liabilities are mostly floating rate, helps to mitigate this risk. In order to manage the overall interest rate risk, the Group generally uses matched currency funding and translates fixed-rate instruments to floating rate.

As at 30 June 2012, a 200 basis points parallel shift in interest rates would potentially impact the Group's economic value by $47 million.

**Equity price 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 positions and investment portfolio, primarily in its core international and GCC markets The Group classifies market risk as follows:

## 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 | 12 |
| Unquoted equities | 38 |
| | **50** |
| Realised gain during the period | 5 |
| Unrealised gain as at 30 June 2012* | 4 |

*At 30 June 2012, unrealised gain on equity investments amounted to US$ 4 million. 45% of the unrealised gain or US$ 2 million was included in Tier 2 capital.

# 6. Risk management (continued)

## 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 prudent 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 and inter-bank borrowings.

The Minimum Liquidity Guideline (MLG) is used to manage and monitor liquidity on a daily basis. The MLG represents the minimum number of days the Group can survive the combined outflow of all deposits and contractual draw downs, under normal market conditions.

A maturity gap report, which reviews mismatches, is used to monitor medium- and long-term liquidity.

## 6.13 Operational risk

**Operational Risk**

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems — or from external events. Operational risk in ABC Group includes legal risk. Reputational impact is taken into consideration when assessing the impact of actual, and potential, operational risk events.

The Group applies the 'Standardised Approach' for calculating its Pillar 1 operational risk capital. As at 30 June 2012, the total capital charge in respect of operational risk was USD 174 million.

The Group applies modern, proven methodologies for the qualitative management of its operational and other non-financial risks, adapting them to the Group's size, nature, complexity and risk profile.

The Group-wide framework has to be implemented by all entities that Arab Banking Corp (B.S.C.) controls directly or indirectly.

The operational risk management framework is being introduced across the Group, following the Operational Risk Committee's rolling two-year 'master plan'. Local operational risk committees implement corresponding plans at the subsidiary levels.
The Group currently employs the following tools for the management of operational risks:

- Internal loss data
- Risk and control self-assessments
- Group-wide control standards / control standard self-assessments
- Control environment scans
- Key indicators.

### Operational risk tolerance

The Group uses quantitative and qualitative elements to classify actual and potential operational risks as 'very high', 'high', 'medium', 'low' or 'very low'. A separate escalation procedure requires, among other things, that the Group Chief Credit & Risk Officer be immediately informed of all risk events classified 'very high' or 'high' that have either happened or are likely to happen.

# 6. Risk management (continued)

## 6.13 Operational risk (continued)

**Business Continuity**

The Group has robust business continuity plans – both in order to meet local and international regulatory obligations, and in order to protect the Group's business functions, assets and employees. 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. To address local disaster events, the Group has established business continuity centres at the geographic location of each business unit. To address a regional disaster scenario affecting Bahrain, the Group has established a licensed branch in the UK, which maintains full operational status and is capable of carrying out the majority of the Group's operational activities. As regards activities relating to marketable securities, brokerage and client-related businesses, the Group has selected its subsidiary in Jordan as a business continuity centre, and obtained the required approval from the Central Bank of Jordan.

The two centres have been stress tested and at a minimum two tests are conducted each year, using live data to ensure that their guidelines and procedures are effective. Continuous updates of these plans are performed annually, 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.

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.

# 6. Risk management (continued)

## 6.15 Capital management (continued)

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 per the guidelines provided in Basel II.

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) 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 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

# 6. Risk management (continued)

## 6.15 Capital management (continued)

- 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

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

# 6. Risk management (continued)

## 6.15 Capital management (continued)

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.

***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 * | 528 |
| Claims on directors & senior management | 2 |
| Claims on staff | 24 |

* Unfunded exposures

b. Liabilities to related parties

| ***US$ million*** | |
|---|---|
| Connected deposits | 3,653 |

The Interest expense in respect of connected deposits is US$ 7 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 | 34 | 26 | 8 |
| 3 months to 1 year | 17 | 9 | 8 |
| 1 to 3 years | 58 | 40 | 18 |
| Over 3 years | 325 | 273 | 52 |
| | **434** | **348** | **86** |

# 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 | - | - | - |
| 3 months to 1 year | - | - | - |
| 1 to 3 years | 51 | 37 | 14 |
| Over 3 years | 359 | 332 | 27 |
| | **410** | **369** | **41** |

## 7.3 Restructured facilities

Facilities restructured during the period ended 30 June 2012 amounted to US$ 62 million. The carrying amount of restructured facilities amounted to US$ 244 million as at 30 June 2012. 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$ 760 million. The carrying value of securities sold under repurchase agreements at the period end amounted to US$ 871 million.

Amounts paid for assets purchased under resale agreements at the period end amounted to US$ 592 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$ 599 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 year | 392 | 379 | 3 | 195 |
| Amounts written off | (8) | (7) | - | - |
| Write backs / cancellation due to improvement | (3) | (10) | - | (3) |
| Additional provisions made | 39 | 1 | 2 | 3 |
| Exchange adjustment and other movements | (6) | 6 | - | (1) |
| Balance at reporting date | **414** | **369** | **5** | **194** |

* In addition to the above, specific provision on loans include US$ 61 million towards country exposures.