ARAB BANKING CORPORATION (B.S.C.)

BASEL II - PILLAR III DISCLOSURES
30 JUNE 2008

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1.Introduction

The new CBB requirements, which acts 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 own regulatory funds.
- **Pillar II** addresses the 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 Central Bank of Bahrain (CBB) issued directives on the Pillar III disclosures under the Basel II framework applicable to licensed banks in Bahrain for the six-month period from 1 January 2008 to 30 June 2008. These directives set out the enhanced disclosure requirements required 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] 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 presented in accordance with International Financial Reporting Standards (IFRS).

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 Central Bank of Bahrain.

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

The principal subsidiaries as at 30 June 2008, all of which have 31 December as their year end, are as follows:

	Country of incorporation	**Shareholding % of Arab Banking Corporation (B.S.C.)**
ABC International Bank plc	United Kingdom	100
ABC Islamic Bank (E.C.)	Bahrain	100
Arab Banking Corporation (ABC) – Jordan	Jordan	87
Banco ABC Brasil S.A.	Brazil	56
ABC Algeria	Algeria	70
Arab Banking Corporation - Egypt [S.A.E.]	Egypt	98
ABC Tunisie	Tunisia	100
Arab Financial Services *	Bahrain	55

** Arab Financial Services became a subsidiary in May 2008, when the holding was increased from 46% to 55%.*

3.Capital structure

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

The issued and paid up share capital of the Bank was US$ 2,000 million at 30 June 2008, comprising of 2,000 million shares of US$ 1 each.

The subordinated term debt, amounting to US$ 500 million 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. This subordinated term debt has been approved by the CBB for inclusion in Tier 2 capital base.

The Group's capital base of US$ 3,546 million comprises Tier 1 capital of US$ 2,941 million and Tier 2 capital of US$ 605 million as detailed below:

Breakdown of Capital Base

US$ million	**Tier 1**	**Tier 2**	**Total**
Share capital	2,000	-	2,000
Share premium	110	-	110
Statutory reserve	308	-	308
General reserve	150	-	150
Retained earnings brought forward	619	-	619
Interim retained losses	(658)	-	(658)
Minority interest in consolidated subsidiaries	379	-	379
Foreign currency translation adjustment	45	-	45
Unrealized net gains from fair value of equity securities	-	2	2
Collective impairment provisions	-	115	115
Subordinated term debt	-	500	500
Tier 1 and Tier 2 capital before deductions	**2,953**	**617**	**3,570**
Significant minority investments in banking, securities and other financial entities	(9)	(9)	(18)
Other deductions – Unamortized IT costs	(3)	(3)	(6)
Tier 1 and Tier 2 capital base	**2,941**	**605**	**3,546**

Risk weighted assets (RWA)	
Credit risk	19,908
Market risk	2,129
Operational risk	1,030
	23,067
Tier 1 ratio	**12.8%**
Capital adequacy ratio	**15.4%**

4.Capital adequacy ratios (CAR)

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

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

In order to augment the Group's capital resources, at an Extraordinary General Meeting of the shareholders held on 29 April 2008, shareholders of the Bank approved an increase in the authorised, issued and paid up capital of the Bank.

The authorised share capital of the Bank was increased from US$ 1.5 billion to US$ 2.5 billion and the issued share capital from US$ 1 billion to US$ 2 billion through a priority rights offering of 1 billion shares (nominal value US$ 1 per share) to existing shareholders. These shares were issued at a premium of US$ 0.11 per share and the allotment was completed on 18 June 2008.

The Group's total capital adequacy ratio as at 30 June 2008 was 15.4% compared with the minimum regulatory requirement of 12%. The Tier 1 ratio was 12.8% for the Group. The Group ensures adherence to the CBB's requirements by monitoring its capital adequacy against higher internal limits.

Each banking subsidiary of the Group is directly regulated by its local banking supervisor which sets and monitors local capital adequacy requirements. The Group ensures that each subsidiary maintains sufficient capital levels for legal and regulatory compliance purposes.

The Tier 1 and total capital adequacy ratio of the significant banking subsidiaries (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.)	12.8%	14.7%
ABC International Bank Plc*	15.3%	14.1%
Banco ABC Brasil S.A.	19.3%	19.2%

* CAR 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 requirement 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 mentioned 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:

a. Claims on sovereigns

These pertain to exposures to governments and their central banks. Claims on Bahrain and 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.

b. Claims on public sector entities (PSEs)

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

c. 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%.

d. 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 may be assigned a risk weighting of 20% where such claims on the banks are of an original maturity of three months or less and the claims 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 of an original maturity of three months or less 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.

5.1 Credit risk (continued)

d. 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 investee entity, in which case they are deducted from the Group's capital.

e. Claims on corporate portfolio

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

f. 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), if it meets the criteria mentioned in the CBB's rule book.

g. Past due exposures

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:

(a) 150% risk weight when specific provisions are less than 20% of the outstanding amount of the loan.

(b) 100% risk weight when specific provisions are greater than 20% of the outstanding amount of the loan.

h. 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, are risk weighted at 75%. However, where foreclosure or repossession for a claim can be justified, the risk weight is 35%.

i. Equity portfolios

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

j. Other exposures

These are risk weighted at 100%.

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	88	88	-	-	-	-	-
Claims on sovereigns	5,246	4,365	881	111	20	1,043	125
Claims on public sector entities *	6,625	6,274	351	71	302	2,682	322
Claims on multilateral development banks	86	86	-	-	-	-	-
Claims on banks	13,149	11,342	1,807	2,270	1,080	5,622	675
Claims on corporate portfolio	11,383	9,146	2,237	625	17	10,055	1,206
Regulatory retail exposures	305	304	1	-	-	229	27
Past due exposures	9	9	-	-	-	9	1
Residential retail portfolio	12	12	-	12	-	4	1
Equity portfolios	71	71	-	-	-	90	11
Other exposures	174	174	-	-	-	174	21
	37,148	**31,871**	**5,277**	**3,089**	**1,419**	**19,908**	**2,389**

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

Since the period end position is representative of the risk positions of the Group, average gross exposures are not disclosed separately.

Refer to note 6.7 for details of unfunded exposures.

5.2 Market risk

The Group's capital charge in respect of market risk in accordance with the standardised methodology is as follows:

US$ million	RWA	Period end Capital Charge	Capital charge – Minimum*	Capital charge – Maximum*
Interest rate risk				
- Specific interest rate risk	15	1.2	1.1	1.2
- General interest rate risk	150	12.0	9.8	13.8
Equity position risk	924	73.9	72.5	108.6
Foreign exchange risk	1,036	82.9	61.7	82.9
Options risk	4	0.3	0.3	0.6
Total market risk	**2,129**	**170.3**		

Equity positions and foreign exchange positions constitute a major component of the market risk capital charge. In view of the continuing uncertainties in the international financial markets; the Group took measures in early March 2008 to exit its investments in hedge funds that formed part of the equities position shown above. An adverse 200 basis point shift in inherent rates would equate to an economic value impact of (-) US$ 1.5 million on the trading book.

* The information in these columns shows the minimum and maximum capital charge of each of the market risk categories on a day during the six-month period ended 30 June 2008.

5.3 Operational risk

In accordance with the Standardised methodology, the total capital charge in respect of operational risk was US$ 124 million. This capital charge was computed by categorizing the Group's activities into eight business lines (as defined by the Basel II framework) and multiplying the business line's three - year average gross income by a pre-defined beta factor.

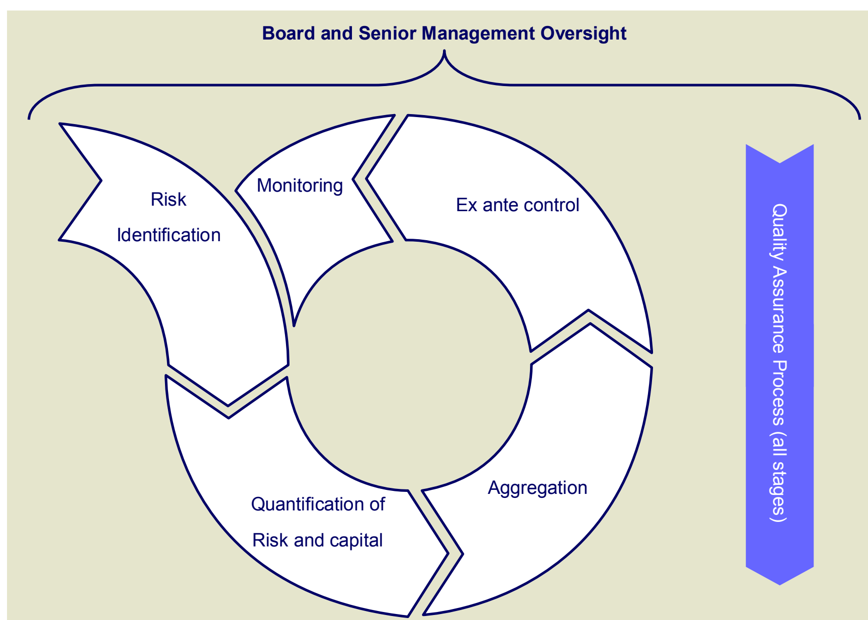
6.Risk management

6.1 Introduction

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

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

Figure 1:



6.2 Risk management structure

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

6.2 Risk management structure (continued)

Figure 2: Risk Management Structure

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 to coordinate with other Board Committees for monitoring compliance with the requirements of the regulatory authorities in the various countries in which the Group operates.

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

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

6.2 Risk management structure (continued)

ALCO is mainly responsible for defining long-term strategic plans and short-term tactical initiatives for directing asset and liability allocation prudently for the achievement of the Group's strategic goals. ALCO monitors the Group's liquidity and market risks and the Group's risk profile in the context of economic developments and market fluctuations, to ensure that the Group's ongoing activities are compatible with the risk/reward guidelines approved by the BRC. The above management structure, supported by teams of risk and credit analysts, as well as the IT systems, provide a coherent infrastructure to carry credit and risk functions in a seamless manner.

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

Credit risk concentrations and thresholds

The first level of protection against undue credit risk is through country, industry and 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. Where unsecured facilities sought are considered to be beyond prudential limits, Group policies require collateral to mitigate the credit risk in the form of cash, securities, and legal charges over the customer's assets or third-party guarantees. The Group also employs Risk Adjusted Return on Capital (RAROC) as a measure to evaluate the risk/reward relationship at the transaction approval stage. RAROC analysis is also conducted on a portfolio basis, aggregated for each business segment, business unit and for the whole group.

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

As at 30 June 2008, the Bank's exposures in excess of 15% of the obligor limits to individual counterparties are shown below:

US$ million	On balance sheet exposure	Off balance sheet exposure	Total exposure
Counterparty A	2,154	-	2,154
Counterparty B	1,809	-	1,809
Counterparty C	1,899	199	2,098
Counterparty D	3	1,464	1,467

6.2 Risk management structure (continued)

Excessive risk concentration

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

In order to avoid excessive concentrations of risk, Group policies and procedures include specific guidelines to focus on country and counterparty limits and 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 an assessment of the credit risk of the counterparty. The types of collateral mainly include cash and guarantees from banks.

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

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

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

6.3 Geographical distribution of exposures

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	9,192	-	-	958	956
Western Europe	5,921	14	11	72	72
Other Europe	91	-	-	-	-
Arab World	15,510	132	130	-	-
Other Africa	4	-	-	-	-
Asia	1,408	1	-	-	-
Australia/New Zealand	193	-	-	-	-
Latin America	4,502	9	6	-	-
Other	327	-	-	-	-
	37,148	**156**	**147**	**1,030**	**1,028**

The Group has collective impairment provisions amounting to US$ 115 million against exposures primarily in the Arab World and North America.

6.4 Industrial sector analysis of the exposures

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	Impaired securities	Specific Provision loans	Specific Provision Securities
Manufacturing	4,248	3,004	1,244	35	-	32	-
Mining and quarrying	23	12	11	1	-	-	-
Agriculture, fishing and forestry	8	8	-	2	-	2	-
Construction	1,016	719	297	2	-	1	-
Financial	15,857	13,836	2,021	23	1,030	23	1,028
Trade	585	494	91	49	-	49	-
Personal / Consumer finance	597	583	14	8	-	5	-
Commercial real estate financing	243	213	30	-	-	-	-
Residential mortgage	12	12	-	-	-	-	-
Government	9,566	8,675	891	25	-	25	-
Technology, media & telecommunications	809	635	174	-	-	-	-
Transport	807	715	92	1	-	1	-
Other sectors	3,377	2,965	412	10	-	9	-
	37,148	**31,871**	**5,277**	**156**	**1,030**	**147**	**1,028**

6.5 Exposure by external credit rating

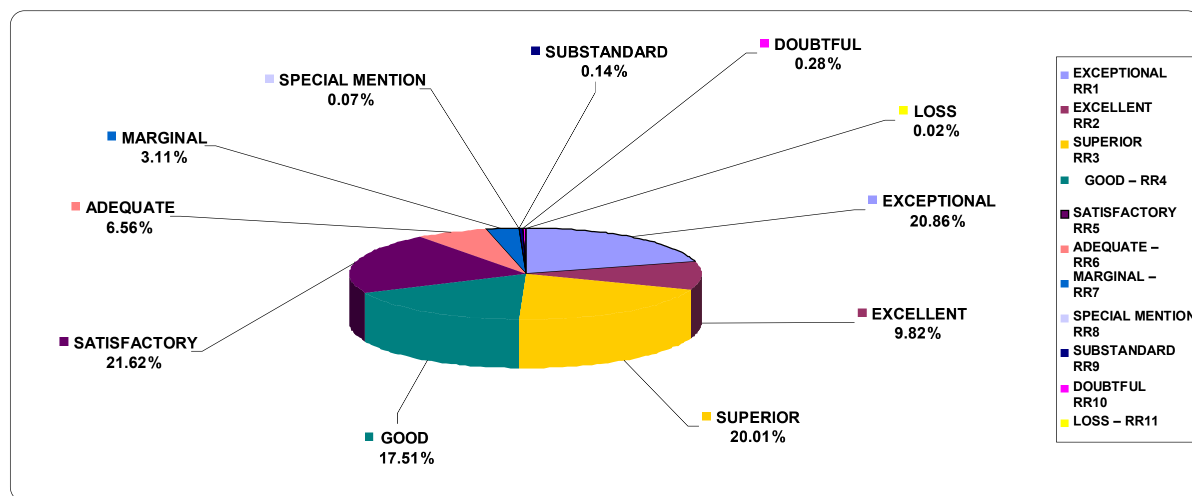
The Group uses external ratings from Standard & Poors', Moody's, Fitch ratings and Capital Intelligence (accredited External Credit Assessment Institutions (ECAI's). The breakdown of the Group's exposure into rated and unrated categories is as follows:

US$ million	**Net credit exposure (after credit risk mitigation)**	**Rated exposure**	**Unrated exposure**
Cash	88	-	88
Claims on sovereigns	5,135	4,189	946
Claims on public sector entities*	6,554	4,630	1,924
Claims on multilateral development banks	86	76	10
Claims on banks	10,879	8,667	2,212
Claims on corporate portfolio	10,758	1,393	9,365
Regulatory retail exposure	305	-	305
Past due exposures	9	-	9
Residential retail portfolio	-	-	-
Equity portfolios	71	-	71
Other exposures	174	-	174
	34,059	18,955	15,104

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

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 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 Group's credit policy, are assessed and updated regularly. Each risk rating class is mapped to grades equivalent to Standard & Poors', Moody's, Fitch ratings and Capital Intelligence rating agencies.



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

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$ 6,154 million, which are based on expected maturities 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	88	-	-	-	88	-	-	-	-	-	-	88
Claims on sovereigns*	522	737	61	316	1,636	1,103	1,292	292	42	-	2,729	4,365
Claims on public sector entities**	116	374	102	602	1,194	2,173	1,533	1,148	226	-	5,080	6,274
Claims on multilateral development banks	40	46	-	-	86	-	-	-	-	-	-	86
Claims on banks	2,687	1,196	2,225	811	6,919	3,146	1,165	5	107	-	4,423	11,342
Claims on corporate portfolio	1,061	1,707	886	585	4,239	3,136	1,111	531	28	101	4,907	9,146
Regulatory retail exposures	-	95	2	3	100	149	54	1	-	-	204	304
Past due exposures	-	-	-	-	-	-	-	-	9	-	9	9
Residential retail portfolio	-	-	-	-	-	-	-	4	8	-	12	12
Equity portfolios	-	-	-	-	-	-	-	-	-	71	71	71
Other exposures	-	-	-	-	-	-	-	-	-	174	174	174
	4,514	**4,155**	**3,276**	**2,317**	**14,262**	**9,707**	**5,155**	**1,981**	**420**	**346**	**17,609**	**31,871**

* 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 GSEs.

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	57	68	29	103	257	622	2	-	-	-	624	881
Claims on public sector entities	83	9	19	20	131	187	15	18	-	-	220	351
Claims on banks	167	215	227	353	962	825	20	-	-	-	845	1,807
Claims on corporate portfolio	137	554	295	293	1,279	834	81	25	18	-	958	2,237
Regulatory retail exposures	-	1	-	-	1	-	-	-	-	-	-	1
	444	**847**	**570**	**769**	**2,630**	**2,468**	**118**	**43**	**18**	**-**	**2,647**	**5,277**

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

(b) **Derivative:** Derivative are contracts, the value 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.

6.7 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 provides the calculation base to which a CCF is applied for calculating the exposure. CCF ranges between 20% and 50% for commitments with original maturity of upto one year and over one year respectively & 0% CCF is applicable for commitments which can be unconditionally cancelled at any time.

The table below summarizes the notional principal amounts and the relative exposure before applying credit risk mitigation:

US$ million	**Notional Principal**	**Credit exposure***
Short-term self-liquidating trade and transaction-related contingent items	6,517	3,162
Direct credit substitutes, guarantees and acceptances	1,414	754
Forward asset purchase commitments	15	15
Undrawn loans and other commitments	2,071	1,059
	10,017	**4,990**
RWA		**3,760**

* Credit exposure is after applying CCF.

At 30 June 2008, the Group held cash collaterals in relation to credit-related contingent items amounting to US$ 481 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.

6.7 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 is no significant concentration of credit risk in respect of contracts with positive fair value with any individual counterparty as at 30 June 2008.

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 current exposure (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 2008 were as follows:

	Derivatives		
US$ million	**Interest rate contracts**	**Foreign exchange contracts**	**Total**
Notional – Trading book	6,451	8,042	14,493
Notional – Banking book	3,284	605	3,889
	9,735	**8,647**	**18,382**
Credit RWA (replacement cost plus potential future exposure)	184	103	287
Market RWA	153	1,036	1,189

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 recognised in the consolidated statement of income.

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

Impairment is determined as follows:

(a) for assets carried at 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; and

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

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

Impairment losses on financial assets

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

Impairment against specific groups of financial assets

In addition to specific provisions against individually significant loans and advances and investments, the Group also makes a provision to cover impairment against specific group of financial assets where there is a measurable decrease in estimated future cash flows. This provision is based on any deterioration in the internal grade of the financial assets since it was granted. The amount of provision is based on historical loss pattern for loans within each grading and is adjusted to reflect current economic changes.

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

6.9 Market risk

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

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

The Group classifies market risk into the following:

- **Trading Market Risk**

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

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

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

- **Asset and Liability Risk**

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

- **Liquidity Risk**

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

As there is no specific measure that reflects all aspects of market risk, Group analyses risk using various risk measures, reporting results to Senior Management. It should be noted that some of these methodologies are made available to selected branches and subsidiaries.

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

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

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

6.9 Market risk (continued)

a. Currency risk

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

b. Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect future profitability or the fair values of financial instruments. The Group is exposed to interest rate risk as a result of mismatches of interest rate re-pricing of assets and liabilities. The most prominent market risk factor for the Bank is interest rates. This risk is minimized as the Group’s rate sensitive assets and liabilities are mostly floating rate, where the duration risk is lower. In general, the Group uses matched currency funding and translates fixed rate instruments to floating rate to better manage the duration in the asset book.

Interest Rate Risk in the Banking Book (IRRBB)

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

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

As at 30 June 2008, an immediate shift up by 25 basis points in interest rates, would potentially impact the Group’s economic value by (-) US$ 27 million.

6.10 Equity position risk

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

6.11 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 Planned by each unit. Subsequently, the actual quarterly performance is compared with that budgeted including the historical volatility in earnings, and detailed financial budget, which supports both the decision making and the planning process.

6.12 Liquidity risk

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. The Minimum Liquidity Guideline (MLG) is used to manage and monitor daily liquidity. The MLG represents the minimum number of days the Group can survive the combined outflow of all deposits and contractual drawdowns, under market value driven encashability scenarios.

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

6.13 Operational risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes 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. To achieve this goal the Group has developed an operational risk framework, which includes identification, measurement, management, and monitoring and risk control/mitigation elements. A variety of underlying processes are being deployed across the Group including risk and control self-assessments, Key Risk Indicators (KRI), event management, new product review and approval processes and business contingency plans.

The Group intends to make operational risk transparent throughout the enterprise, to which end processes are being developed to provide for regular reporting of relevant operational risk management information to business management, senior management, the ORCO, the BRC and the Board of Directors.

6.13 Operational risk (continued)

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

6.14 Legal risk

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

6.15 Capital Management

Internal Capital Adequacy Assessment Process (ICAAP)

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

The key principles driving capital management at the bank include:

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

The Group seeks to achieve the following goals by implementing an effective capital management framework:

- Goals for effective internal capital adequacy
- Meet the regulatory capital adequacy ratios and have a prudent buffer
- Maintain a strong credit rating
- Generate sufficient capital to support overall business strategy
- Integrate capital allocation decisions with strategic and financial planning process.

In addition, the Group prepares itself for compliance with the Foundation Internal Ratings Based (FIRB) requirements it has developed an ICAAP framework. The purpose of the ICAAP framework is to document the Group's structured process for the ongoing assessment of the Group's overall capital adequacy in relation to the Group's risk profile and a strategy for capital management as set out in Principle 1 of Basel II Pillar II.

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

- In January 2008, the CBB issued ICAAP guidelines for capital management. Within this framework the risk strategy as approved by the Board is incorporated, underscoring Board and senior management responsibility and oversight. The risk strategy document outlines the Group's risk appetite, capital adequacy goals and risk targets.

- The Group has an integrated approach to risk strategy and business strategy which analyses current and future capital requirements in relation to strategic objectives as part of the annual business planning process. The Business Plan is used in estimating the economic capital projections. In addition, throughout the year, as part of the process, actual usage is monitored against the projections.

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

- 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 (as set out in the table under Annex 3 of the Basel II Accord – Illustrative IRB Risk Weights) for Unexpected Loss (UL). 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.

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.

6.15 Capital Management (continued)

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

The output of the ICAAP gives senior management and the Board an improved view of the risks the Group faces and the impact of these risks.

The Group is in the process of implementing an advanced Economic Capital Management System. This tool will allow, at all levels of granularity, estimation of Economic Capital, RAROC, Sharpe Ratios, Risk Contributions, and effects of components accounts and counterparties for the effects of diversification benefits and concentration risks. This system will also allow an advanced capability for estimating economic capital under stress scenarios.

Supervisory Review and Evaluation Process (SERP)

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

7.Other disclosures

7.1 Related party transactions

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

a. Exposures to related parties

US$ million	
Claims on shareholders	-
Claims on directors & senior management	4
Claims on staff	22

b. Liabilities to related parties

US$ million	
Connected deposits	1,940

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	25	17	8
3 months to 1 year	7	6	1
1 to 3 years	25	25	-
Over 3 years	99	99	-
	156	**147**	**9**

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

Securities

US$ million	Principal	Provisions	Net book value
Less than 3 months	134	134	-
3 months to 1 year	873	873	-
1 to 3 years	23	21	2
Over 3 years	-	-	-
	1,030	**1,028**	**2**

Impaired securities arose primarily owing to exposures in Structured Investment Vehicles (SIVs) and Collateralised Debt Obligations (CDOs). Even though 70% or $434mn of the CDOs are still performing, i.e. current with interest payments, in view of the continued deterioration in market values and uncertainties as to ultimate recoveries as at 30 June 2008, the Group decided to increase the provision on CDOs also to 100%.

7.3 Restructured facilities

There were no facilities which were restructured during the six month period ended 30 June 2008.

7.4 Assets sold under recourse agreements

The Group has not entered into any recourse agreement during the six month period ended 30 June 2008.

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	149	318	8	113
Amounts written off	(10)	(28)	-	-
Write backs / cancellation due to improvement	(6)	-	-	-
Additional provisions made	9	736	-	1
Exchange adjustment and other movements	5	2	1	1
Balance at reporting date	**147**	**1,028**	**9**	**115**

* In addition to the above, specific provision on loans include US$ 56 million towards country exposures.

7.6 Industry sector analysis of the specific impairment provisions charges

US$ million	**Charges for Specific impairment provisions**
Manufacturing	4
Agriculture, fishing and forestry	1
Financial	734
Trade	(1)
Personal / Consumer finance	1
Other sectors	1
	740

7.7 Equity positions in the banking book

US$ million	
Quoted Equities	33
Unquoted Equities	40
	73
Realised gains (losses) during the period	1
Unrealised gains (losses) during the period	4