



بنك المؤسسة العربية المصرفية الإسلامية (ش.م.ب.م.)  
**ABC Islamic Bank (E.C.)**

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## BASEL II - PILLAR III DISCLOSURES 30 June 2009

## Table of contents

<b>1. Introduction .....</b>	<b>3</b>
<b>2. Group structure.....</b>	<b>4</b>
<b>3. Shari'a compliance.....</b>	<b>5</b>
<b>4. Capital structure .....</b>	<b>5</b>
<b>5. Capital adequacy ratios [CAR] .....</b>	<b>6</b>
<b>6. Profile of risk-weighted assets and capital charge.....</b>	<b>6</b>
<b>6.1 Credit risk.....</b>	<b>6</b>
<b>6.2 Market risk .....</b>	<b>9</b>
<b>6.3 Operational risk.....</b>	<b>9</b>
<b>7. Risk management .....</b>	<b>10</b>
<b>7.1 Introduction.....</b>	<b>10</b>
<b>7.2 Risk management structure.....</b>	<b>10</b>
<b>7.3 Geographical distribution of exposures .....</b>	<b>14</b>
<b>7.4 Industrial sector analysis of the exposures.....</b>	<b>15</b>
<b>7.5 Exposure by external credit rating .....</b>	<b>16</b>
<b>7.6 Maturity analysis of funded exposures .....</b>	<b>17</b>
<b>7.7 Maturity analysis of unfunded exposures .....</b>	<b>17</b>
<b>7.8 Impairment of assets .....</b>	<b>18</b>
<b>7.9 Market risk.....</b>	<b>19</b>
<b>7.10 Equity position risk.....</b>	<b>21</b>
<b>7.11 Business risk .....</b>	<b>21</b>
<b>7.12 Liquidity risk.....</b>	<b>21</b>
<b>7.13 Operational risk.....</b>	<b>22</b>
<b>7.14 Legal risk .....</b>	<b>22</b>
<b>8. Capital management .....</b>	<b>22</b>
<b>9. Other disclosures.....</b>	<b>25</b>
<b>9.1 Related party transactions .....</b>	<b>25</b>
<b>9.2 Ageing analysis of non-performing / impaired Islamic financing and securities ..</b>	<b>25</b>
<b>9.3 Restructured facilities .....</b>	<b>26</b>
<b>9.4 Assets sold under recourse agreements.....</b>	<b>26</b>
<b>9.5 Movement in specific and collective impairment provisions .....</b>	<b>26</b>
<b>9.6 Industry sector analysis of the specific impairment provisions charges.....</b>	<b>26</b>
<b>9.7 Equity positions in the banking book.....</b>	<b>27</b>
<b>9.8 Quantitative indicators of financial performance, position and liquidity risk .....</b>	<b>27</b>

## **1. Introduction**

This document gathers together all the elements of the disclosures required under Pillar III, which are not covered in the interim condensed consolidated financial statements, and is organized as follows:

Firstly, it gives an overview of the approach taken by ABC Islamic Bank (E.C.) [the Bank] to Pillar I and provides the profile of the risk-weighted assets according to the “standard portfolio” as defined by the Central Bank of Bahrain [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 the related monitoring processes and credit mitigation initiatives are set out.

Finally, this document provides all other disclosures required under the Public Disclosure Requirements Module of the CBB.

The disclosures in this section are in addition to the interim condensed consolidated financial statements and are presented in accordance with the Financial Accounting Standards issued by the Accounting and Auditing Organisation for Islamic Financial Institutions [AAOIFI] and the relevant provisions of the CBB and Financial Institutions Law. For matters which are not covered by AAOIFI standards, the Group uses the International Financial Reporting Standards [IFRS] and other sections of the interim condensed consolidated financial statements. However, the credit risk exposures considered in this section differ from the credit risk exposures reported in the consolidated financial statements due to the application of different methodologies between Basel II and IFRS 7, primarily on account of the following:

- 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 on-balance sheet exposure. In the consolidated financial statements, the nominal values of credit-related contingent items are treated as off-balance sheet.
- Under this section, the credit exposures are classified as per the Standard Portfolio approach mentioned in the CBB’s Basel II capital adequacy framework covering the standardised approach for credit risk. Besides in case of guaranteed exposures, the exposure would be reported based on the guarantor. However, in the consolidated financial statements, the assets are presented based on asset class (i.e. Islamic financing, securities, etc).
- Eligible collaterals are considered to arrive at the net exposure under the Basel II framework whereas collaterals are not netted in the consolidated financial statements.
- The available-for-sale investments portfolio is considered at cost in the Basel II framework whereas it is considered at fair value in the consolidated financial statements.
- Under 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 consolidated financial statements.

## 2. Group structure

ABC Islamic Bank (E.C.) [the Bank] is an exempt joint stock company incorporated in the Kingdom of Bahrain on 10 December 1985 and registered with the Ministry of Industry and Commerce under commercial registration number 16864. The Bank and its subsidiary [the Group] operate under a wholesale banking licence issued by the Central Bank of Bahrain [the CBB] and are engaged in financial trading in accordance with the teachings of Islam [Shari’a].

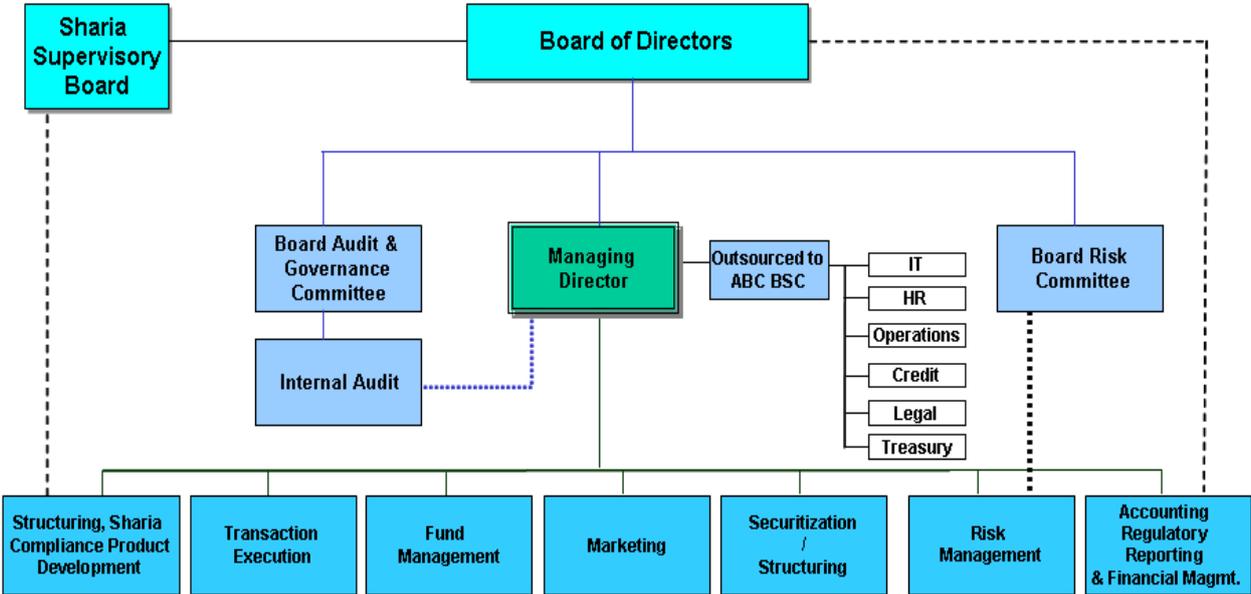
Arab Banking Corporation B.S.C. [ABC], which operates under a wholesale banking licence issued by the CBB, holds 100% of the share capital of the Bank.

The interim condensed consolidated financial statements and capital adequacy regulatory reports of the Group have been prepared and consolidated on a consistent basis.

The ownership in the subsidiary as at 30 June 2009 is as follows:

Name	Nature of business	Country of incorporation	Amount and % of holding
ABC Clearing Company	Islamic Investment Company	Cayman Islands	US\$ 2,000 and 100% management shares

Whilst the Board of Directors supervise the overall activities of the Bank, the Board Audit and Governance Committee and the Board Risk Committee are tasked with overseeing the respective areas. The following chart shows the organisational structure of the Bank, including the reporting lines to the various Board committees.



The Bank has in place comprehensive policies regarding the remuneration and benefits provided to members of the Board of Directors and its Committees, senior management and staff. With regard to Directors, compensation comprises fixed annual remuneration and attendance allowances, while for senior management and staff, compensation comprises a number of fixed elements, covering salary, allowances and benefits, in addition to variable, performance-related elements.

### 3. Shari'a compliance

The Shari'a Compliance Officer of the Bank conducts regular Shari'a compliance reviews to ensure that documentation, procedures and execution of transactions are in accordance with the Shari'a Standards issued by the AAOIFI and the Shari'a rules and principles as determined by the Shari'a Supervisory Board of the Bank [the SSB]. The results of such reviews are reported to the SSB. Cases of non-Shari'a compliance are thoroughly investigated to establish causes of their occurrence and to ensure introduction of adequate controls to avoid their recurrence in the future.

Non-Shari'a compliant earnings during the six-month period ended 30 June 2009 mainly represent introduction fees. These have been disposed off to charitable causes.

The SSB of the Group consists of three Shari'a scholars (Chairman and two members). The SSB meets periodically (3-4 times a year) or whenever there is a need to hold a meeting. The members receive a fixed sum of money as attendance fee for every meeting they attend, in addition to a fixed amount paid annually to each member as remuneration, irrespective of the number of meetings held during the year or the financial results of the Group. The Bank also pays for hotel accommodation and travel expenses of the non Bahrain-based members to facilitate their attendance of the SSB meetings.

### 4. Capital structure

The Group's capital base comprises of (a) Tier 1 capital which includes share capital, reserves and retained earnings, and (b) Tier 2 capital which consists of the current period's profit.

The issued and paid-up share capital of the Bank was US\$ 132.5 million at 30 June 2009, comprising of 132.5 million shares of US\$ 1 each.

The Group's capital base of US\$ 213.6 million comprises Tier 1 capital of US\$ 207.0 million and Tier 2 capital of US\$ 6.6 million as detailed below:

#### Breakdown of capital base

<i>US\$ million</i>	<b>Tier 1</b>	<b>Tier 2</b>	<b>Total</b>
Issued and fully paid ordinary shares	133	-	133
Legal / statutory reserves	12	-	12
Retained profit brought forward	62	-	62
Current interim profits (reviewed by external auditors)	-	7	7
<b>Capital base</b>	<b>207</b>	<b>7</b>	<b>214</b>

#### Risk weighted assets [RWA]

Credit risk	1,087
Market risk	-
Operational risk	43
	<b>1,130</b>
<b>Tier 1 ratio</b>	<b>18.3%</b>
<b>Capital adequacy ratio</b>	<b>18.9%</b>

## **5. Capital adequacy ratios [CAR]**

The purpose of capital management at the Group is to ensure the efficient utilisation of capital in relation to business requirements and growth, risk profile and shareholders' returns and expectations. The Group manages its capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of its activities. In order to maintain or adjust the capital structure, the Group may issue capital / Tier 2 securities and / or adjust the amount of dividend payment to shareholders. No changes have been made in the objectives, policies and processes of the Group from the previous years.

The Group's total capital adequacy ratio as at 30 June 2009 was 18.9% compared with the minimum regulatory requirement of 12%. The Tier 1 ratio was 18.3% for the Group. The Group ensures adherence to the CBB's requirements by monitoring its capital adequacy against higher internal limits.

## **6. Profile of risk-weighted assets and capital charge**

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

### **6.1 Credit risk**

#### **i) 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 the aforementioned, 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 PSEs, 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 the aforementioned are risk-weighted based on their credit ratings.

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

### 6.1 Credit risk (continued)

#### i) Definition of exposure classes per Standard Portfolio (continued)

##### c. Claims on multilateral development banks [MDBs]

All MDBs are risk-weighted in accordance with their credit rating, except for banks part of 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 favourable 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.

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

##### e. Claims on corporates

Claims on corporates are risk-weighted based on credit ratings. Risk weights for unrated corporate claims are assigned at 100%.

##### f. Past due exposures

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

- 150% risk weight when specific provisions are less than 20% of the outstanding amount of the facility.
- 100% risk weight when specific provisions are greater than 20% of the outstanding amount of the facility.

##### g. Equity portfolios

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

30 June 2009

**6. Profile of risk-weighted assets and capital charge (continued)****6.1 Credit risk (continued)****ii) Definition of exposure classes per Standard Portfolio (continued)****h. Project finance exposures**

Exposures on project finance are risk-weighted according to the Regulatory Slotting Criteria, in which the risk weighting ranges between 70% and 250%.

**i. Other exposures**

These are risk-weighted at 100%.

**iii) Credit exposure and risk-weighted assets**

*US\$ thousands*

	<b>Gross credit exposure</b>	<b>Funded exposure</b>	<b>Unfunded exposure</b>	<b>Risk-weighted assets for funded exposures</b>	<b>Risk-weighted assets for unfunded exposures</b>	<b>Total risk weighted assets</b>	<b>Capital charge (12%)</b>
Sovereigns	85,502	78,002	7,500	-	7,500	7,500	900
Claims on PSEs	89,819	89,819	-	-	-	-	-
Claims on banks	205,100	202,783	2,317	94,474	637	95,111	11,413
Claims on corporates	763,280	738,056	25,224	738,056	25,224	763,280	91,594
Past due exposures	128,647	128,647	-	68,393	-	68,393	8,207
Equity portfolio	6,175	6,175	-	6,175	-	6,175	741
Project finance	200,664	190,963	9,701	137,518	8,218	145,736	17,488
Other exposures	675	675	-	675	-	675	81
<b>Total</b>	<b>1,479,862</b>	<b>1,435,120</b>	<b>44,742</b>	<b>1,045,291</b>	<b>41,579</b>	<b>1,086,870</b>	<b>130,424</b>

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

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

### 6.1 Credit risk (continued)

#### ii) Credit exposure and risk-weighted assets

Breakdown of capital requirements for credit risk per type of Islamic financing contract is as follows:

<i>US\$ thousands</i>							
<b>Type of financing</b>	<b>Gross credit exposure</b>	<b>Funded exposure</b>	<b>Unfunded exposure</b>	<b>Risk-weighted assets for funded exposures</b>	<b>Risk-weighted assets for unfunded exposures</b>	<b>Total risk weighted assets</b>	<b>Capital charge (12%)</b>
Murabaha	592,943	572,399	20,544	377,622	20,544	398,166	47,780
Ijara	480,760	462,446	18,314	332,782	16,474	349,256	41,911
Ijara receivable	1,129	1,129	-	680	-	680	82
Sukuk	387,982	387,982	-	323,919	-	323,919	38,870
Mudaraba	911	911	-	182	-	182	22
Musharaka	6,441	2,874	3,567	3,161	3,924	7,085	850
LCs	2,317	-	2,317	-	637	637	76
Others	7,379	7,379	-	6,945	-	6,945	833
<b>Total</b>	<b>1,479,862</b>	<b>1,435,120</b>	<b>44,742</b>	<b>1,045,291</b>	<b>41,579</b>	<b>1,086,870</b>	<b>130,424</b>

### 6.2 Market risk

The Bank, with assistance from ABC, minimizes its market risk through:

- (i) match-funding its assets to reduce its profit rate risk;
- (ii) not taking commodity price risk by squaring position on transaction by transaction basis;
- (iii) funding exposures in the same currency and, hence, avoiding any foreign exchange currency risk; and
- (iv) maintaining no sukuk trading position.

Accordingly, the Bank maintains no capital charge for market risk.

### 6.3 Operational risk

In accordance with the Standardised methodology, the total capital charge in respect of operational risk was US\$ 42.8 million. This capital charge was computed by categorising the Group's activities into two business lines (out of the eight business lines defined by the Basel II framework) and multiplying the business line's three-year average gross income by a pre-defined beta factor.

#### Indicators of operational risk exposures:

Gross income <i>US\$ thousands</i>	11,541
Amount of non-Shari'a compliant income <i>US\$ thousands</i>	2
Number of Shari'a violations	Nil

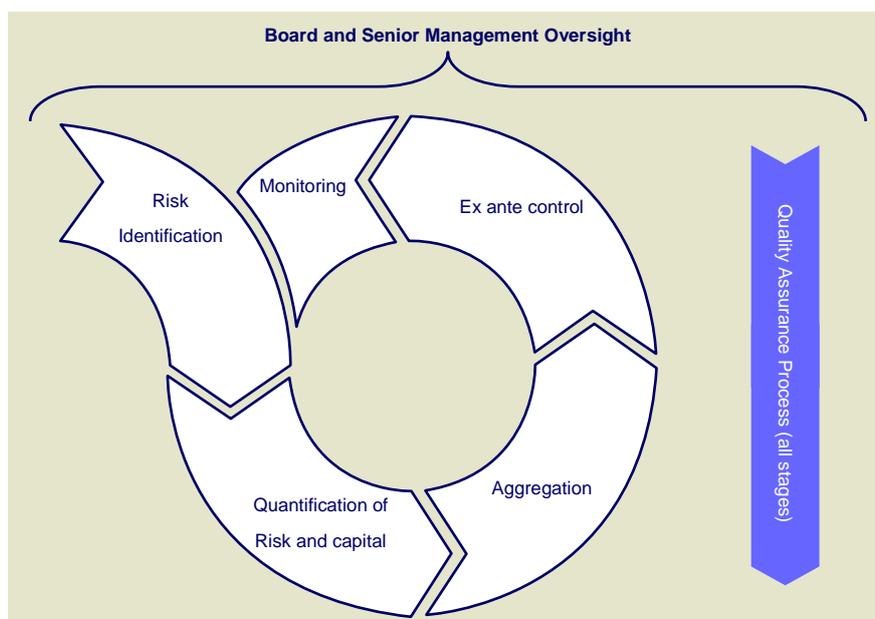
## 7. Risk management

### 7.1 Introduction

Risk is inherent in the ABC Group's activities and is managed through a process of ongoing identification, measurement and monitoring, subject to risk limits and other controls. The ABC 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, ABC has invested heavily into developing a comprehensive and robust risk management infrastructure. This includes risk identification processes under credit, market and operational risk spectrums, risk measurement models and rating systems, as well as a strong business process to monitor and control these risks. Figure 1 outlines the various congruous stages of the risk process.

*Figure 1:*



### 7.2 Risk management structure

ABC's Executive Management is responsible for implementing the 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 of the Head Office, as follows:

## 7. Risk management (continued)

### 7.2 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 for co-ordinating with other Board Committees for monitoring compliance with the requirements of the regulatory authorities in the various countries in which ABC operates.

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

In addition to being part of the above structure, through the outsourcing of the support functions including the credit approval, the Bank has the following risk management structure:

## 7. Risk management (continued)

### 7.2 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 ABC's strategic goals. ALCO monitors ABC's liquidity and market risks and the risk profile in the context of economic developments and market fluctuations, to ensure that ABC'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.

ABC's 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 ABC and the various subsidiaries of ABC, including the Bank. 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 ABC's internal credit rating system. Where unsecured facilities sought are considered to be beyond prudential limits, ABC 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. ABC 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.

## 7. Risk management (continued)

### 7.2 Risk management structure (continued)

#### Credit risk concentrations and thresholds (continued)

Single name concentrations are monitored on an individual basis. ABC'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. This restriction applies only at the consolidated level of the ABC Group and, hence, the Bank has several exposures that exceed 15% of its capital base. However, none of these exposures exceed 15% of ABC's capital base.

As at 30 June 2009, the Group's three largest exposures in excess of 15% of the capital base are shown below:

<i>US\$ thousands</i>	<b>On-balance sheet exposure</b>	<b>Off-balance sheet exposure</b>	<b>Total exposure</b>
Counterparty A	180,778	11,905	<b>192,683</b>
Counterparty B	140,387	-	<b>140,387</b>
Counterparty C	75,392	-	<b>75,392</b>

#### 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, the ABC 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 held by the Group 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.

Exposures by type of Islamic financing contract that are covered by guarantees or by eligible collaterals are as follows:

<i>US\$ thousands</i>	<b>Funded exposures</b>	<b>Unfunded exposures</b>
Murabaha (Guaranteed)	183,772	-
LCs (Cash collateral)	-	1,632

30 June 2009

## 7. Risk management (continued)

### 7.3 Geographical distribution of exposures

The Bank's nature of business, being an Islamic Bank, results in concentration of exposures in the Muslim world. Moreover, the Bank's approved concentration of activities, which is also in line with its role within the ABC Group, has large concentration in the GCC countries, as illustrated in the table below:

*US\$ thousands*

Country / region	Gross exposure	Percentage of exposure
Bahrain	179,827	12.15%
Saudi Arabia	468,330	31.65%
Kuwait	266,846	18.03%
Qatar	143,815	9.72%
UAE	374,410	25.30%
Oman	20,032	1.35%
Other MENA countries	2,636	0.18%
Other Asia	7,500	0.51%
Europe (including Turkey)	16,466	1.11%
<b>Total</b>	<b>1,479,862</b>	<b>100.00%</b>

The geographical distribution of gross credit exposures by major type of credit exposures can be analysed as follows:

*US\$ thousands*

Type of financing / region	Bahrain	Saudi Arabia	Kuwait	Qatar	UAE	Oman	Other MENA countries	Other Asia	Europe (including Turkey)	Total
Sovereigns	30,660	-	-	-	47,342	-	-	7,500	-	85,502
Claims on PSEs	89,819	-	-	-	-	-	-	-	-	89,819
Claims on banks	48,429	-	81,869	-	56,019	-	2,317	-	16,466	205,100
Claims on corporates	-	296,838	89,597	105,477	271,049	-	319	-	-	763,280
Past due exposures	4,069	56,978	67,600	-	-	-	-	-	-	128,647
Equity portfolio	6,175	-	-	-	-	-	-	-	-	6,175
Project finance	-	114,514	27,780	38,338	-	20,032	-	-	-	200,664
Other exposures	675	-	-	-	-	-	-	-	-	675
<b>Total</b>	<b>179,827</b>	<b>468,330</b>	<b>266,846</b>	<b>143,815</b>	<b>374,410</b>	<b>20,032</b>	<b>2,636</b>	<b>7,500</b>	<b>16,466</b>	<b>1,479,862</b>

30 June 2009

## 7. Risk management (continued)

### 7.4 Industrial sector analysis of the exposures

The industrial sector analysis of exposures is as follows:

<i>US\$ thousands</i>	<b>Gross exposure</b>	<b>Funded exposure</b>	<b>Unfunded exposure</b>
Financial institutions	311,770	309,453	2,317
Real estate	378,703	372,750	5,953
Metals	109,243	105,335	3,908
Utilities	110,654	110,654	-
Energy	294,590	276,842	17,748
Communication	50,219	50,219	-
Trading	43,832	40,265	3,567
Government	63,180	55,680	7,500
Transportation	21,006	21,006	-
Other industries	96,665	92,916	3,749
<b>Total</b>	<b>1,479,862</b>	<b>1,435,120</b>	<b>44,742</b>

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

<i>US\$ thousands</i>	<b>Financial institutions</b>					<b>Communication</b>			<b>Transportation</b>	<b>Other industries</b>	<b>Total</b>
<b>Type of financing / industry</b>	<b>Real estate</b>	<b>Metals</b>	<b>Utilities</b>	<b>Energy</b>	<b>Trading</b>	<b>Government</b>	<b>Transportation</b>	<b>Other industries</b>	<b>Total</b>		
Sovereigns	-	-	47,342	-	-	38,160	-	-	<b>85,502</b>		
Claims on PSEs	-	47,698	-	17,101	-	25,020	-	-	<b>89,819</b>		
Claims on banks	205,100	-	-	-	-	-	-	-	<b>205,100</b>		
Claims on corporates	28,151	360,547	320	63,312	135,060	50,219	8,000	21,006	96,665	<b>763,280</b>	
Past due exposures	71,669	-	27,587	-	-	29,391	-	-	-	<b>128,647</b>	
Equity portfolio	6,175	-	-	-	-	-	-	-	-	<b>6,175</b>	
Project finance	-	18,156	33,638	-	142,429	-	6,441	-	-	<b>200,664</b>	
Other exposures	675	-	-	-	-	-	-	-	-	<b>675</b>	
<b>Total</b>	<b>311,770</b>	<b>378,703</b>	<b>109,243</b>	<b>110,654</b>	<b>294,590</b>	<b>50,219</b>	<b>43,832</b>	<b>63,180</b>	<b>21,006</b>	<b>96,665</b>	<b>1,479,862</b>

30 June 2009

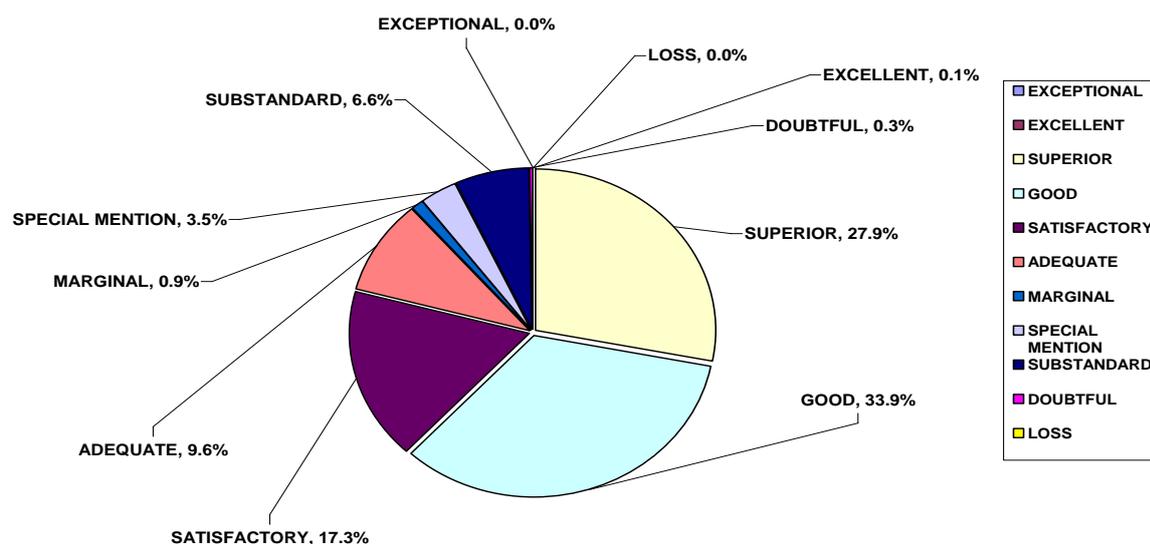
## 7. Risk management (continued)

### 7.5 Exposure by external credit rating

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

<i>US\$ thousands</i>	<b>Gross credit exposure</b>	<b>Rated exposure</b>	<b>Unrated exposure</b>
Sovereigns	85,502	30,660	54,842
Claims on PSEs	89,819	-	89,819
Claims on banks	205,100	202,783	2,317
Claims on corporates	763,280	25,058	738,222
Past due exposures	128,647	-	128,647
Equity portfolio	6,175	6,175	-
Project finance	200,664	-	200,664
Other exposures	675	-	675
<b>Total</b>	<b>1,479,862</b>	<b>264,676</b>	<b>1,215,186</b>

It is the Group's policy to maintain accurate and consistent risk ratings across the credit portfolio through its 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, are derived in accordance with ABC's credit policy, and are assessed and updated regularly. Each risk rating class is mapped to grades equivalent to Standard & Poor's, Moody's, Fitch Ratings and Capital Intelligence.



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

## 7. Risk management (continued)

### 7.6 Maturity analysis of funded exposures

Residual contractual maturity analysis of the Group's major types of funded credit exposures, amounting to US\$ 1,435,120 thousand, is as follows:

<i>US\$ thousands</i>	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	Total - over 12 months	Undated	Total
Sovereigns	-	1,717	1,458	2,917	6,092	53,940	17,917	-	71,857	53	78,002
Claims on PSEs	-	-	11,445	24,401	35,846	46,724	7,249	-	53,973	-	89,819
Claims on banks	13,426	31,138	33,317	10,294	88,175	114,608	-	-	114,608	-	202,783
Claims on corporates	23,354	2,813	76,912	53,785	156,864	459,367	93,151	28,674	581,192	-	738,056
Past due exposures	-	-	-	-	-	-	128,647	-	128,647	-	128,647
Equity portfolio	-	-	-	-	-	-	-	6,175	6,175	-	6,175
Project finance	3,776	605	1,729	3,162	9,272	43,497	77,799	60,395	181,691	-	190,963
Other exposures	-	-	-	-	-	-	-	-	-	675	675
<b>Total</b>	<b>40,556</b>	<b>36,273</b>	<b>124,861</b>	<b>94,559</b>	<b>296,249</b>	<b>718,136</b>	<b>324,763</b>	<b>95,244</b>	<b>1,138,143</b>	<b>728</b>	<b>1,435,120</b>

### 7.7 Maturity analysis of unfunded exposures

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

<i>US\$ thousands</i>	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	Total Over 12 months	Total
Sovereigns	-	-	-	-	-	7,500	-	-	7,500	7,500
Claims on banks	-	-	2,317	-	2,317	-	-	-	-	2,317
Claims on corporates	3,750	-	-	-	3,750	2,174	13,072	6,228	21,474	25,224
Project finance	-	-	-	-	-	3,567	-	6,134	9,701	9,701
<b>Total</b>	<b>3,750</b>	<b>-</b>	<b>2,317</b>	<b>-</b>	<b>6,067</b>	<b>13,241</b>	<b>13,072</b>	<b>12,362</b>	<b>38,675</b>	<b>44,742</b>

Unfunded exposures include credit-related financial instruments, comprising of letters of credit, guarantees and commitments.

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 facilities and other commitments represent commitments that have not been drawn down or utilised 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 up to one year and over one year respectively and 0% CCF is applicable for commitments which can be unconditionally cancelled at any time.

## 7. Risk management (continued)

### 7.7 Maturity analysis of unfunded exposures (continued)

The table below summarises the notional principal amounts and the relative exposures before applying credit risk mitigation:

<i>US\$ thousands</i>	Notional principal	Credit exposure*
Short-term self-liquidating trade and transaction-related contingent items	7,102	637
Direct credit substitutes, guarantees and acceptances	897	-
Undrawn facilities and other commitments	84,850	40,942
<b>RWA for contingent items</b>		<b>41,579</b>

\* Credit exposure is after applying CCF.

At 30 June 2009, the Group held cash collaterals in relation to credit-related contingent items amounting to US\$ 1,632 thousand.

### Penalties imposed on customers

During the period, no penalties were imposed on customers.

### 7.8 Impairment of assets

#### Impairment and un-collectability of financial assets

An assessment is made at each quarter end 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 counterparty or a group of counterparties is experiencing significant financial difficulty, default or delinquency in profit 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 profit 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.

## 7. Risk management (continued)

### 7.8 Impairment of assets (continued)

#### 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 facilities 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 asset since it was granted. The amount of provision is based on the historical loss pattern for facilities 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.

### 7.9 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 profit rates, equity prices, credit spreads, foreign exchange rates and commodity prices.

ABC 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 ABC's 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:

- **Non-trading market risk in securities**  
Non-trading market risk arises from market factors impacting securities that are held for long-term investment.
- **Asset and liability risk**  
Non-trading asset and liability risk exposures arise where the re-pricing characteristics of the Group's assets do not match with those of liabilities.

## 7. Risk management (continued)

### 7.9 Market risk (continued)

#### ▪ Liquidity Risk

Liquidity risk is the risk that maturing and encashable assets may not cover cash flow obligations (liabilities). In this respect, the Bank is supported by ABC, through the provision of a line of credit to cover any shortfall in liquidity. Accordingly, the Bank's liquidity needs are taken into consideration in ABC's liquidity management.

As there is no specific measure that reflects all aspects of market risk, ABC analyses risk using various risk measures, reporting results to senior management.

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

- Value-at-Risk [VaR]
- Basis Point Value [BPV]
- Stress Testing
- Non-Technical Risk Measures

On an annual basis, ABC's BRC reviews and approves VaR trading limits, BPV trading and investment Limits, Options Stress Testing Trading Limits, and Non-Technical Trading and Investment Limits.

It should be noted that the Bank applies BPV on the sukuk portfolio and the non-technical risk measures in its liquidity management at the Bank level. For the non-technical measures, notional limits are set for investment products, which are approved by the Board Risk Committee.

#### **a. Currency risk**

The Group is exposed to foreign exchange rate risk through its structural positions. In general, the Group uses matched currency funding to eliminate such a risk.

#### **b. Profit rate risk**

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

#### **c. Commodity risk (price risk)**

The Bank would be exposed to commodity risk if it holds commodity for its Murabaha transactions. However, in order to minimise or eliminate this risk, the Bank limits its holding of commodity to the day of the transaction and it settles its position for each specific transaction, hence eliminating overnight price risk in the commodities traded.

## **7. Risk management (continued)**

### **7.9 Market risk (continued)**

#### **d. Profit Rate Risk in the Banking Book [PRRBB]**

The Bank uses the BPV approach to control PRRBB. BPV measures changes in economic value resulting from changes in profit rates. In the BPV methodology, the modified duration approach and, for some products, the effective duration approach is used to measure the PRRBB. Modified duration is a good measure of linear risk for profit rate sensitive products.

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

As at 30 June 2009, an immediate shift by 25 basis points in profit rates would potentially impact the Group's economic value by US\$ 5,743 thousand.

### **7.10 Equity position risk**

Equity position risk arises from the possibility that changes in the price of equities or equity indices will affect future profitability or the fair values of financial instruments. As of the reporting date, the Bank had an equity position amounting to US\$ 6,175 thousand.

### **7.11 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 Plan. Subsequently, the actual quarterly performance is compared with budget, including the historical volatility in earnings, and the detailed financial budget, which supports both the decision making and the planning process.

### **7.12 Liquidity risk**

The Group's principal sources of liquidity are deposits placed with the ABC Clearing Company or funds raised through commodity Murabahas. However, for any shortfall in liquidity, the Bank relies on the Parent Bank; hence, the Bank's liquidity needs are taken into consideration in ABC's liquidity management process. ABC maintains liquid assets at prudential levels to ensure that cash can quickly be made available to honour all its obligations, even under adverse conditions. ABC 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 ABC can survive the combined outflow of all deposits and contractual draw-downs under market value driven encashability scenarios.

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

## **7. Risk management (continued)**

### **7.13 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, ABC has developed an operational risk framework, which includes identification, measurement, management, monitoring and risk control / mitigation elements. A variety of underlying processes are being deployed across ABC including risk and control self-assessments, Key Risk Indicators [KRI], event management, new product review, approval processes and business contingency plans.

ABC 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 Operational Risk Committee of ABC, the BRC of ABC and the Board of Directors.

ABC's 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.

### **7.14 Legal risk**

Inadequate documentation, legal and regulatory incapacity, 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, as well as ABC.

## **8. 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:

## 8. Capital management (continued)



The key principles driving capital management at the Group include:

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

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

- Effective internal capital adequacy;
- Meet the regulatory capital adequacy ratios and have a prudent buffer;
- Generate sufficient capital to support overall business strategy; and
- Integrate capital allocation decisions with strategic and financial planning process.

In addition, to prepare itself for compliance with the Foundation Internal Ratings-Based [FIRB] requirements, the Group 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.

## **8. Capital management (continued)**

- 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, profit 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 FIRB Risk Weights (as set out in the table under Annexure 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 and Business Unit, and aggregated at the Group level.
- b. **Market Risk:** Computed for the banking book 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.

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.

ABC has implemented an advanced Economic Capital Management System, which is now being implemented at the Bank. This tool will allow, at all levels of granularity, estimation of Economic Capital, RAROC, Sharpe Ratios, Risk Contributions, and effects of component 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.

## 8. Capital management (continued)

### Supervisory Review and Evaluation Process [SERP]

The CBB is the lead regulator for the Group and sets and monitors capital requirements on both a consolidated and an unconsolidated basis. 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 the 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 maximise intrinsic value for all stakeholders.

## 9. Other disclosures

### 9.1 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 at arm's length basis.

#### a. Exposures to related parties

##### *US\$ thousands*

Claims on shareholders	140,387
Claims on Directors and senior management	468
Claims on staff	300

#### b. Liabilities to related parties

##### *US\$ thousands*

Connected deposits	1,008,902
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### 9.2 Ageing analysis of non-performing / impaired Islamic financing and securities

In accordance with the guidelines issued by the CBB, credit facilities are placed on non-accrual status and profit suspended when either principal or profit is overdue by 90 days, whereupon profit 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.

An ageing analysis of all non-performing Islamic financing facilities on non-accrual basis, together with their related provisions, is as follows:

30 June 2009

**9. Other disclosures (continued)****9.2 Ageing analysis of non-performing / impaired Islamic financing and securities (continued)****Islamic financing**

An ageing analysis of all non-performing Islamic financing facilities on non-accrual basis, together with their related provisions, is as follows:

<i>US\$ thousands</i>	<b>Principal*</b>	<b>Provisions</b>	<b>Net book value</b>
Less than 3 months	29,391	-	29,391
3 months to 1 year	95,187	-	95,187
1 to 3 years	-	-	-
Over 3 years	4,069	-	4,069
<b>Total</b>	<b>128,647</b>	<b>-</b>	<b>128,647</b>

\* Carrying values of US\$ 127,102 thousand have been guaranteed by ABC.

**Securities**

The Bank has specific impairment provisions of US\$ 5 million in its available-for-sale securities portfolio. This impairment is in the GCC.

**9.3 Restructured facilities**

There were no facilities which were restructured during the six-month period ended 30 June 2009.

**9.4 Assets sold under recourse agreements**

The Group has not entered into any recourse agreement during the six-month period ended 30 June 2009.

**9.5 Movement in specific and collective impairment provisions**

<i>US\$ thousands</i>	<b>Specific Provisions</b>			<b>Collective Impairment provision</b>
	<b>Islamic financing</b>	<b>Securities</b>	<b>Other assets and off balance sheet items</b>	
At beginning of the period	-	3,000	-	-
Additional provisions made	-	2,000	-	-
Balance at reporting date	-	<b>5,000</b>	-	-

**9.6 Industry sector analysis of the specific impairment provisions charges**

Impairment of US\$ 3,000 thousand is in the financial institution sector and US\$ 2,000 thousand in the construction and real estate sector.

**9. Other disclosures (continued)****9.7 Equity positions in the banking book**

As at the period end, the equity position of the Group amounted to US\$ 6,175 thousand, all of which is quoted.

**9.8 Quantitative indicators of financial performance, position and liquidity risk**

	2005	2006	2007	2008	June *
					2009
Cost / income ratio %	51.9	46.3	10.1	14.7	25.5
Return on average equity %	8.5	9.0	34.7	13.1	9.3
Return on average assets %	0.8	0.7	4.7	1.8	0.9
Liquidity assets ratio %	38.4	40.1	26.2	24.6	24.6
Short term assets to short term liabilities %	65.9	54.2	63.5	34.7	24.3
Risk asset ratio – Tier 1 %	19.9	16.4	15.1	15.4	18.3
Risk asset ratio – Total %	21.4	16.6	15.7	17.6	18.9

\* Annualised