



# **RISK AND CAPITAL MANAGEMENT**

## **BASEL II - PILLAR III DISCLOSURES**



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## 1 Executive summary

Gulf Finance House BSC (“GFH/ the Bank”) was incorporated in 1999 in the Kingdom of Bahrain under Commercial Registration No. 44136. The Bank operates as an Islamic Wholesale Investment Bank under a license granted by the Central Bank of Bahrain (“CBB”). The Bank’s activities are regulated by the CBB and supervised by a Shari’a Supervisory Board whose role is defined in the Bank’s Memorandum and Articles of Association. The principal activities of the Bank include investment advisory services and investment transactions which comply with Islamic rules and principles.

The CBB Basel II guidelines became effective on 1 January 2008 as the common framework for the implementation of Basel II capital adequacy framework for Banks incorporated in the Kingdom of Bahrain.

These semi-annual disclosures have been prepared in accordance with the CBB requirements outlined in the Public Disclosure Module (“PD”), Section PD-3.1.6: *Additional Requirements for Semi Annual Disclosures*, CBB Rule Book, Volume II for Islamic Banks. These semi-annual quantitative disclosure requirements follow the requirements of Basel II - Pillar 3 and the Islamic Financial Services Board’s (IFSB) recommended disclosures for Islamic banks. These disclosures should be read in conjunction with the detailed Risk and Capital Management Disclosures made in Bank’s Annual Report for the year ended 31 December 2012 and the condensed consolidated interim financial information for the six months ended 30 June 2013.

This report contains a description of the Bank’s risk management and capital adequacy practices and processes, including detailed information on the capital adequacy process.

As at 30 June 2013 the Group’s CAR stood at a healthy 24.20%. The Bank is in constant discussion with its regulator in relation to its capital position & its plan to further improve its regulatory capital ratio.

### **Basel II Framework**

The Basel II framework introduced by CBB with effect from 2008, provides a more risk sensitive approach to assessment of risk and the calculation of regulatory capital i.e. the minimum capital that a bank is required to maintain. The framework intends to strengthen the risk management practices and processes within financial institutions. GFH has accordingly taken steps to comply with these requirements. The CBB’s capital management framework, consistent with the Basel II accord, is built on three pillars:

- **Pillar I** defines the regulatory minimum capital requirements by providing rules and regulations for measurement of credit risk, market risk and operational risk. The requirement of capital has to be covered by the bank’s own regulatory funds.



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- **Pillar II** addresses a bank's internal processes for assessing overall capital adequacy in relation to risks (ICAAP). Pillar II also introduces the Supervisory Review and Evaluation Process (SREP), which assesses the internal capital adequacy.
  
  - **Pillar III** complements the other two pillars and focuses on enhanced transparency in information disclosure, covering risk and capital management, including capital adequacy.



## 2 Group Structure

The condensed consolidated interim financial information comprise the financial information of the Bank and its subsidiaries (together referred to as the “Group”) as at and for the six months ended 30 June 2013.

The principal subsidiaries and associates as at 30 June 2013 and their treatment for consolidated capital adequacy purposes are as follows:

<b>Entity name</b>	<b>Domicile</b>	<b>Investment classification as per Prudential Consolidation and Deduction (“PCD”)</b>	<b>Regulatory treatment as per PCD</b>
<b>Subsidiaries</b>			
GFH Sukuk Limited	Cayman Islands	Financial entity	Fully consolidated
Legends Development Company LLC (“Legends”)	UAE	Significant commercial entity	Risk weighting of investment exposure
GFH Capital Limited (formerly known as G Capital Limited)	UAE	Financial entity	Fully consolidated
KHCB Asset Company	Cayman Islands	Financial entity	Fully consolidated
Harbour East 3 Real Estate S.P.C.	Bahrain	Commercial entities	Fully consolidated
Harbour North 1 Real Estate S.P.C.			
Harbour North 2a Real Estate S.P.C.			
Harbour North 2b Real Estate S.P.C.			
Harbour North 3 Real Estate S.P.C.			
Harbour Row 1 Real Estate S.P.C.			
Harbour Row 2 Real Estate S.P.C.			
Harbour Row 3 Real Estate S.P.C.			
Harbour Row 4 Real Estate S.P.C.			



Entity name	Domicile	Investment classification as per Prudential Consolidation and Deduction (“PCD”)	Regulatory treatment as per PCD
<b>Associates</b>			
Khaleeji Commercial Bank BSC (“KHCB”)	Bahrain	Significant financial entity	Pro-rata consolidated
Injazat Technology Fund BSC (c)	Bahrain	Commercial entity	Risk weighted
Al Barakah Takaful	Jordan	Insurance entity	Full deduction
Cemena Investment Company	Cayman Islands	Commercial entity	Risk weighted
LUFC Holdings Limited (subsidiary of GFH Capital Limited)	Cayman Islands	Commercial entity	Risk weighting of investment exposure

The investments in subsidiaries and associates are subject to large exposure and connected counterparty limits and guidelines set by the CBB. These guidelines are considered for transfer of funds or regulatory capital within the Group. The investment in subsidiaries should be deducted from the capital of the Bank. In the opinion of the Bank, these are pass-through entities and hence the underlying investments are risk weighted.

There are no restrictions for transfer of capital.

Refer to note 11 in the condensed consolidated interim financial information for the impact of discontinued business during the six months ended 30 June 2013.



### 3 Capital structure and capital adequacy ratio

The Bank's regulator CBB sets and monitors capital requirements for the Bank as a whole (i.e. at a consolidated level). In implementing current capital requirements CBB requires the Bank to maintain a prescribed ratio of 12% and 8% of total regulatory capital to total risk-weighted assets on consolidated and solo basis respectively. Banking operations are categorised as either trading book or banking book, and risk-weighted assets are determined according to specified requirements that seek to reflect the varying levels of risk attached to assets and off-balance sheet exposures. The CBB also requires banks incorporated in Bahrain to maintain a buffer of 0.5 per cent above the minimum capital adequacy ratio.

The Bank's policy is to maintain strong capital base so as to maintain investor, creditor and market confidence and to sustain the future development of the business.

The Bank is required to comply with the provisions of the revised Capital Adequacy Module of the CBB (which is based on the Basel II and IFSB framework) in respect of regulatory capital. The Bank has adopted the standardised approach to credit and market risk and basic indicator approach for operational risk management under the revised framework.

The Bank's regulatory capital position at 30 June 2013 was as follows:

*USD 000's*

	<b>Tier 1</b>	<b>Tier 2</b>	<b>Total</b>
Share capital	770,061	-	770,061
Treasury shares	(912)	-	(912)
Share premium	-	-	-
Statutory reserve	67,519	-	67,519
Other reserves	1,041	-	1,041
Accumulated losses brought forward	(383,191)	-	(383,191)
Current interim profits	-	4,182	4,182
Profit equalization reserves	-	6	6
Investment risk reserves	-	4	4
<b>Tier 1 and Tier 2 capital before general deductions</b>	<b>454,518</b>	<b>4,192</b>	<b>458,710</b>
Excess amount over materiality thresholds in case of investment in commercial entities	2,725	-	2,725
Investment in insurance entity greater than or equal to 20%	973	-	973
<b>Total eligible capital base</b>	<b>450,820</b>	<b>4,192</b>	<b>455,012</b>



USD 000's

<b>Risk weighted exposures</b>	<b>Risk weighted exposure</b>	<b>Capital requirement @ 12%</b>
Credit risk	1,678,436	201,412
Market risk	86,903	10,428
Operational risk	114,576	13,749
<b>Tier 1 and Tier 2 capital base</b>	<b>1,879,915</b>	<b>225,589</b>

<b>Tier 1 Capital Adequacy ratio</b>	<b>23.98%</b>
<b>Total Capital Adequacy ratio</b>	<b>24.20%</b>

The Bank's paid up capital consists only of ordinary shares which have proportionate voting rights.





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## 4 Credit risk

### 4.1 Capital requirements for credit risk

To assess its capital adequacy requirements for credit risk in accordance with the CBB requirements, the Bank adopts the standardized approach. According to the standardized approach, on and off balance sheet credit exposures are assigned to various defined categories based on the type of counterparty or underlying exposure. The main relevant categories are claims on banks, claims on investment firms, investment in equities, holdings in real estate, claims on corporate portfolio and other assets. Risk Weighted Assets (RWAs) are calculated based on prescribed risk weights by CBB relevant to the standard categories and counterparty's external credit ratings, where available.

#### *Rating of exposures and risk weighting*

As the Bank is not engaged in granting credit facilities in its normal course of business, it does not use a detailed internal credit “grading” model. The use of external rating agencies is limited to assigning of risk weights for placements with financial institutions. However, preferential risk weight of 20% is used which is applicable to short term claims on locally incorporated banks where the original maturity of these claims are three months or less and these claims are in Bahraini Dinar or US Dollar. The other exposures are primarily classified as ‘unrated exposure’ for the purposes of capital adequacy computations.

As per CBB guidelines, 100% of the RWA's financed by owners' equity (i.e. self financed) are included for the purpose of capital adequacy computations whereas only 30% of the RWA's financed by equity of investment account holders [EIAH] are required to be included.

The investment in associate for a significant financial entity has been prorata consolidated for regulatory capital adequacy purposes.

Following is the analysis for credit risk as computed for regulatory capital adequacy purposes:

USD 000's

Asset categories for credit risk	Gross credit exposures	Average risk weights	Total credit risk weighted exposure
<b>Self financed assets</b>			
Cash items	4,155	0%	-
Total claims on sovereigns	3,767	0%	-
Standard Risk Weights for Claims on Banks	31,101	21%	6,472
Preferential Risk Weight for Claims on Locally Incorporated Banks	1,105	20%	221
Short-term Claims on Banks	113	20%	23
Claims on Corporates including Takaful Companies and Category 3 Investment Firms	144,175	100%	144,175
Mortgage	35,906	75%	26,930
Past Due Facilities	124,604	143%	178,022
Investments in Securities and Sukuk	167,135	150%	250,419
Holding of Real Estate	490,728	198%	972,495
Others Assets	30,790	100%	30,790
<b>Total self financed assets (A)</b>	<b>1,033,579</b>	<b>156%</b>	<b>1,609,547</b>
<b>Total regulatory capital required (A x 12%)</b>			<b>193,145</b>
<b>Financed by EIAH</b>			
Cash items	-	0%	-
Total claims on sovereigns	26,431	0%	-
Standard Risk Weights for Claims on Banks	23,631	46%	10,762
Preferential Risk Weight for Claims on Locally Incorporated Banks	84,810	20%	16,962
Claims on Corporates including Takaful Companies and Category 3 Investment Firms	176,607	100%	176,607
Investments in Securities and Sukuk	18,831	134%	25,299
<b>Total financed by EIAH (B)</b>	<b>330,310</b>	<b>70%</b>	<b>229,630</b>
<b>Considered for credit risk (C) = (B x 30%)</b>			<b>68,889</b>
<b>Total regulatory capital required (C x 12%)</b>		<b>12%</b>	<b>8,267</b>
<b>TOTAL RISK WEIGHTED EXPOSURE</b>			<b>1,678,436</b>
<b>TOTAL REGULATORY CAPITAL REQUIRED</b>			<b>201,412</b>

## 4.2 Quantitative information on credit risk

### 4.2.1 Gross and average credit exposure

The following are gross credit risk exposures considered for Capital Adequacy Ratio calculations of the Bank classified as per disclosure in the condensed consolidated interim financial information:

*USD 000's*

Balance sheet items	Self Finance exposure	Financed by EIAH	Total Funded exposure	Unfunded exposure	Total gross credit exposure	Average gross credit exposure*
Bank balances	31,294	2,139	33,433	-	33,433	27,992
Placements with financial institutions	692	-	692	-	692	346
Equity -accounted investees	236,480	-	236,480	-	236,480	236,204
Investment securities	175,300	-	175,300	-	175,300	174,485
Investment property	259,404	-	259,404	-	259,404	259,404
Assets held for sale	22,246	-	22,246	-	22,246	52,206
Other assets	144,653	-	144,653	2,500	147,153	133,871
<b>Total credit exposure</b>	<b>870,069</b>	<b>2,139</b>	<b>872,208</b>	<b>2,500</b>	<b>874,708</b>	<b>884,508</b>

\* Average gross credit exposures have been calculated based on the average of balances outstanding on a quarterly basis for six months period ended 30 June 2013. Assets funded by EIAH are geographically classified in GCC countries, and are placed with Banks and financial institutions having maturity profile of up to 3 months.

#### 4.2.2 Credit exposure by geography

The classification of credit exposure by geography, based on the location of the counterparty, was as follows:

USD 000's

	<b>GCC countries</b>	<b>MENA</b>	<b>Asia</b>	<b>UK</b>	<b>Europe (excluding UK)</b>	<b>USA</b>	<b>Total</b>
<b>Assets</b>							
Bank balances	5,413	3	-	-	-	28,017	33,433
Placements with financial institutions	692	-	-	-	-	-	692
Equity -accounted investees	236,480	-	-	-	-	-	236,480
Investment securities	90,919	46,178	36,573	-	1,630	-	175,300
Investment property	259,404	-	-	-	-	-	259,404
Assets held for sale	-	-	-	22,246	-	-	22,246
Other assets	71,221	31,954	29,096	12,382	-	-	144,653
<b>Total</b>	<b>664,129</b>	<b>78,135</b>	<b>65,669</b>	<b>34,628</b>	<b>1,630</b>	<b>28,017</b>	<b>872,208</b>
<b>Off-Balance sheet</b>							
Commitments	2,500	-	-	-	-	-	2,500
Restricted investment accounts	2,360	-	-	-	-	-	2,360

#### 4.2.3 Credit exposure by industry

The classification of credit exposure by industry was as follows:

USD 000's

	Trading and manufacturing	Banks and financial institutions	Development Infrastructure	Technology	Others	Total
<b>Assets</b>						
Bank balances	-	33,411	-	-	22	33,433
Placements with financial institutions	-	692	-	-	-	692
Equity -accounted investees	72,245	164,235	-	-	-	236,480
Investment securities	-	8,037	160,767	3,722	2,774	175,300
Investment property	-	-	259,404	-	-	259,404
Assets held for sale	-	-	-	-	22,246	22,246
Other assets	416	6,316	111,646	-	26,275	144,653
	<b>72,661</b>	<b>212,691</b>	<b>531,817</b>	<b>3,722</b>	<b>51,317</b>	<b>872,208</b>
<b>Off-Balance sheet items</b>						
Commitments	-	-	2,500	-	-	2,500
Restricted investment accounts	-	-	2,360	-	-	2,360

#### 4.2.4 Exposure by maturity

The maturity profile of exposures based on maturity was as follows:

USD 000's

	Up to 3 months	3 to 6 months	6 months-1 year	1 to 3 years	Over 3 years	Total
<b>Assets</b>						
Bank balances	33,380	-	-	-	53	33,433
Placements with financial institutions	692	-	-	-	-	692
Equity -accounted investees	-	-	-	236,480	-	236,480
Investment property	-	-	-	-	259,404	259,404
Investment securities	-	-	-	175,300	-	175,300
Assets held for sale	-	-	22,246	-	-	22,246
Other assets	1,990	5,108	67,279	69,392	884	144,653
<b>Total assets</b>	<b>36,062</b>	<b>5,108</b>	<b>89,525</b>	<b>481,172</b>	<b>260,341</b>	<b>872,208</b>
<b>Off-Balance sheet items</b>						
Commitments	2,500	-	-	-	-	2,500
Restricted investment accounts	-	-	-	2,360	-	2,360

The table above shows the maturity profile of the Group's assets and unrecognized commitments on the basis of their contractual maturity, here available. For other items, (including past due receivables), the maturity profile is on the basis of their expected realization.



#### 4.2.5 Exposures in excess of regulatory limits

The following exposure (funded and unfunded) were in excess of 15% of the regulatory capital base as at 30 June 2013:

	<b>% of capital base</b>	<b>Exposure (US\$ 000's)</b>
<b>Non-financial institutions</b>		
Counterparty A	15.87%	72,245

The CBB has set single exposure limit of 15 % of the Bank's capital base on exposures to individual or a group of closely related counterparties and as per the prudential rules prior approval of the CBB is required for assuming such exposures, except in cases of certain categories of exposure which are exempted by CBB. In case of non-exempt exposures, a deduction from capital is required for the amount in excess of the single exposure limits.

#### 4.2.6 Impaired facilities and past due exposures

As the Bank is not engaged in granting credit facilities in its normal course of business, it does not use a detailed internal credit "grading" model. The current risk assessment process classifies credit exposures into two broad categories "Unimpaired" and "Impaired", reflecting risk of default and the availability of collateral or other credit risk mitigation. Currently, the Bank does not have any exposures that are collateralized. The Bank does not perform a collective assessment of impairment for its credit exposures as the credit characteristics of each exposure is considered to be different. Credit and investment exposures are subject to regular reviews by the Investment units and Risk Management Department. Quarterly updates on the investments / facilities are prepared by the investment unit reviewed by the management and sent to the Board for review.

All impaired and past due credit exposures at 30 June 2013 mainly relate to the real estate and development infrastructure sectors.



*Movement in impairment provisions during the period:*

US\$ 000's

	<b>Financing receivables</b>	<b>Financing to projects</b>	<b>Receivable from investment banking services</b>	<b>Other receivables</b>
<b>30 June 2013</b>				
At 1 January	70,150	81,382	153,630	74,311
Charge for the period	-	1,000	-	-
<b>At 30 June</b>	<b>70,150</b>	<b>82,382</b>	<b>153,630</b>	<b>74,311</b>

*Analysis of past due and impaired and past due but not impaired receivables:*

US\$ 000's

<b>As at 30 June 2013</b>	<b>Past due but not impaired amounts *</b>	<b>Gross impaired amounts</b>
Up to 3 months	-	-
Over 3 months to 1 year	-	11,688
1 to 3 years	50,838	383,505
Over 3 years	-	-
<b>Total</b>	<b>50,838</b>	<b>395,193</b>

\* The Bank believes that the past due exposures are not impaired on the basis of the assessment of the level of future expected cash flows from the counterparty and / or the stage of collection of amounts owed to the Bank.





*Geographical concentration of impaired and past due receivables:*

US\$ 000's

As at 30 June 2013	Gross exposure	Specific impairment allowance	Net exposure		
			Past due but not impaired	Neither past due nor impaired	Total
GCC Countries	192,637	161,891	258	30,488	30,746
Other MENA	97,996	66,827	21,482	9,688	31,170
Other Asia	109,099	80,000	29,098	-	29,098
Europe	71,755	71,755	-	-	-
UK	12,382	-	-	12,382	12,382
<b>Total</b>	<b>483,869</b>	<b>380,473</b>	<b>50,838</b>	<b>52,558</b>	<b>103,396</b>

*Industry/sector wise breakdown of impaired and past due receivables:*

US\$ 000's

As at 30 June 2013	Gross exposure	Specific impairment allowance	Net exposure		
			Past due but not impaired	Neither past due nor impaired	Total
Development Infrastructure	446,259	367,051	50,838	28,370	79,208
Banks and financial institution	13,389	13,389	-	-	-
Others	24,221	33	-	24,188	24,188
<b>Total</b>	<b>483,869</b>	<b>380,473</b>	<b>50,838</b>	<b>52,558</b>	<b>103,396</b>

**4.2.7 Credit risk mitigation**

The credit risk exposures faced by the Bank are primarily in respect of its own short term liquidity related to placements with other financial institutions, and in respect of investment related funding made to its project vehicles. The funding made to the project vehicles are based on the assessment of the underlying value of the assets and the expected streams of cash flows. Since these exposures arise in the ordinary course of the Bank's investment banking activities and are with the project vehicles promoted by the Bank, they are generally transacted without any collateral or other credit risk mitigants.



#### 4.2.8 Related party and intra-group transactions

Related counterparties are those entities which are connected to the Bank through significant shareholding or control or both. The Bank has entered into business transactions with such counterparties in the normal course of its business. For the purpose of identification of related parties the Bank follows the guidelines issued by Central Bank of Bahrain and definitions as per FAS issued by AAOIFI. Detailed break up of related parties transactions and exposures as at and for the six months period ended 30 June 2013 are as follows:

US\$ 000's

	Associates	Key management personnel	Significant shareholders / entities in which directors are interested	Assets under management including special purpose entities	Total
<b>30 June 2013</b>					
<b>Assets</b>					
Cash and bank balances	3,176	-	-	-	3,176
Equity accounted investees	236,480	-	-	-	236,480
Investment securities	4,695	-	27,599	109,078	141,372
Assets -held for sale	22,246	-	-	-	22,246
Other assets	12,382	-	1,808	80,256	94,446
<b>Liabilities</b>					
Investors' funds	(83)	-	-	14,379	14,295
Placements from financial and other institutions	27	-	-	-	27



US\$ 000's

	Associates	Key management personnel	Significant shareholders / entities in which directors are interested	Assets under management (including special purpose entities)	Total
<b>30 June 2013</b>					
<b>Income</b>					
Management and other fees	2,262	-	-	2,680	4,943
Income from placements with financial and other institutions	251	-	-	-	251
Share of profit from equity accounted investees	1,096	-	-	-	1,096
Income from investment securities	(145)	-	-	-	(145)
Other income	285	-	1,000	-	1,285
<b>Expenses</b>					
Staff cost	-	633	-	-	633
<b>Commitments</b>					
Commitment to extend finance	-	-	-	2,500	2,500

#### 4.2.9 Exposure to highly leveraged and other high risk counterparties

The Bank has no exposure to highly leveraged and other high risk counterparties as per definition provided in the CBB rule book PD 1.3.24.



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#### **4.2.10 Renegotiated facilities**

As at 30 June 2013, other assets which are neither past due nor impaired include certain short-term financing to projects amounting to US\$ 66,192 thousand which were renegotiated. In certain cases, on a need basis, the Bank supports its project vehicles by providing short-term liquidity facilities. These facilities are provided based on assessment of cash flow requirements of the projects and the projects ability to repay the financing amounts based on its operating cash flows. The assessment is independently reviewed by the management of the Bank. Although no specific collateral is provided, such exposures are usually adequately covered by the value of the underlying project asset cash flows. The terms of the renegotiation primarily include extension of the repayment period. The facilities are provided for as viewed necessary based on periodic impairment assessments.

#### **4.2.11 Equity investments held in banking book**

The Bank does not have a trading book and hence all of its equity investments are classified in the banking book and are subject to credit risk weighting under the capital adequacy framework. For regulatory capital computation purposes, the Bank's equity investments in the banking book include available-for-sale investments, significant and majority investments in commercial entities and associate investments in non-significant financial and nonfinancial entities (i.e. significant financial entities which qualify as associates are treated separately for regulatory purposes).

The RMD provides an independent review of all transactions. A fair evaluation and impairment assessment of investments takes place every quarter with inputs from the Investment department and RMD. Investment updates are periodically reviewed by the Board of Directors. Regular audits of business units and processes are undertaken by Internal Audit.

The Bank's equity investments are predominantly in its own projects, which include venture capital, private equity and development infrastructure investment products. The intent of such investments is a later stage exit along with the investors principally by means of sell outs at the project level or through initial public offerings. The Bank also has a strategic financial institutions investment portfolio which is aligned with the long term investment objectives of the Bank.



Information on equity investments(including associates)	US\$ 000's
Privately held	236,481
Quoted in an active market	165,774
Managed funds	8,629
Realised gain/ (loss) during the period	488

The following are the categories under which equity investments are included in the capital adequacy computations as per the requirements of the CBB rules:

US\$ 000's

	Gross exposure*	Risk weight	Risk weighted exposure	Capital charge @12%
Quoted equity investments	565	100%	565	68
Unquoted equity investments	157,940	150%	236,910	28,429
Investments in funds	8,629	150%	12,944	1,553
Real estate holdings	481,767	200%	963,534	115,624
<b>Total</b>	<b>648,901</b>		<b>1,213,953</b>	<b>145,674</b>

\*Includes amounts of risk weighted assets arising from pro rata consolidation of certain investments.



## 5 Market risk

To assess its capital adequacy requirements for market risk in accordance with the CBB capital adequacy module for Islamic Banks, the Bank adopts the standardised approach. Foreign exchange risk charge is computed based on 8% of overall net open foreign currency position of the Bank.

US\$ 000's

	30 June 2013	Maximum during the period	Minimum during the period
Foreign exchange risk - A	6,447	6,447	6,184
Risk weighted assets - B= (A*12.5)	80,588	-	-
Capital requirement – (B*12%)	9,670	-	-

	30 June 2013	Maximum during the period	Minimum during the period
Sukuk risk Equity of investment account holders - A	1,684	1,684	-
Risk weighted assets - B= (A*12.5)	21,053	-	-
Capital requirement – (B*12%)	2,526	-	-

The Sukuk risk is arising on pro- rata consolidation of an associate for capital adequacy purposes.

## 6 Operational risk

The Bank adopts the Basic Indicator Approach to evaluate operational risk charge in accordance with the approach agreed with the CBB. The bank's average gross income for the last two financial years is multiplied by a fixed coefficient alpha of 15% set by CBB and a multiple of 12.5x is used to arrive at the risk weighted assets that are subject to capital charge.

US\$ 000's

	Average gross income	Risk weighted assets	Capital charge at 12%
Operational risk	61,107	114,576	13,749



### *Litigations and claims*

The Group is a party to number of claims and litigations in connection with projects promoted by the Bank in the past and with certain transactions. Further, claims against the Bank also have been filed by former employees. Based on the advice of the Bank's external legal counsel, it is premature to quantify the amount or timing of liability, if any. The external legal counsels has also confirmed that the Bank has strong grounds to successfully defend itself against these claims and no material claims are expected to arise from those litigations. No further disclosures regarding contingent liabilities arising from any of such claims are being made by the Bank as the directors of the Bank believe that such disclosures may be prejudicial to the Bank's position.

### *Contingencies*

The Group has contingent claims arising from the decision to not proceed with a project. The Group is currently negotiating with the counter party for an amicable settlement. While liability is not admitted, if defense against the action is unsuccessful, the claim and associated costs could amount to approximately US\$ 36 million. The management do not expect any significant liability to arise on final closure.

## **7 Other types of risk**

### **7.1 Liquidity risk**

Liquidity risk is the risk that the Bank will encounter difficulty in meeting its financial obligations on account of a maturity mismatch between assets and liabilities. The Group's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Group's reputation. Whilst this is the policy, the Group's current position is under severe stress with contractual liabilities exceeding liquid assets. Focus has therefore been on extending the maturity of liabilities and raising capital in the form of debt or equity.

The following are the key liquidity ratios which reflect the liquidity position of the Bank.

<b>Liquidity ratios</b>	<b>30 June 2013</b>	<b>Maximum</b>	<b>Minimum</b>
Liquid assets : Total assets	3.91%	3.91%	2.71%
Liquid assets : Total deposits	27.34%	27.34%	17.33%
Short term assets : Short term liabilities*	131.00%	148.75%	131.00%
Illiquid assets : Total assets	96.09%	97.49%	96.09%

\* Based on maturity profile of assets and liabilities of one year or less.



The maturity profile of the Bank's financial liabilities is as follows based on contractual cash flows are as follows:

USD'000's

	Up to 3 months	3 to 6 months	6 months-1 year	1 to 3 years	Over 3 years	Carrying amount
Investors' funds	14,437	-	-	-	-	14,437
Placements from financial and other institutions	9,353	16,282	-	84,800	-	110,435
Financing liabilities	1,190	1,840	-	85,000	127,508	215,538
Other liabilities	19,528	-	35,000	16,450	-	70,978
<b>Total liabilities</b>	<b>44,508</b>	<b>18,122</b>	<b>35,000</b>	<b>186,250</b>	<b>127,508</b>	<b>411,388</b>
<b>Unrestricted investment accounts</b>	<b>2,139</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>2,139</b>

## 7.2 Management of profit rate risk in the banking book

Profit rate risk is the potential impact of the mismatch between the rate of return on assets and the expected rate of return of the sources of funding. Majority of the Bank's profit based asset and liabilities are short-term in nature, except for certain long term liabilities which have been utilised to fund the Bank's strategic investments in its associates.

US\$'000's

	Up to 3 months	3 to 6 months	6 months - 1 year	1 to 3 years	Over 3 years	Total
<b>30 June 2013</b>						
<b>Assets</b>						
Bank balances	3,176	-	-	-	-	3,176
<b>Total assets</b>	<b>3,176</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>3,176</b>
<b>Liabilities</b>						
Investors' funds	14,437	-	-	-	-	14,437
Placements from financial and other institutions	9,353	16,282	-	84,800	-	110,435
Financing liabilities	1,190	1,840	-	85,000	127,508	215,538
<b>Total liabilities</b>	<b>24,980</b>	<b>18,122</b>	<b>-</b>	<b>169,800</b>	<b>127,508</b>	<b>340,410</b>
<b>Equity of investment account holders</b>	<b>2,139</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>2,139</b>
<b>Profit rate sensitivity gap</b>	<b>(23,943)</b>	<b>(18,122)</b>	<b>-</b>	<b>(169,800)</b>	<b>(127,508)</b>	<b>(339,373)</b>





The management of profit rate risk against profit rate gap limits is supplemented by monitoring the sensitivity of the Bank's financial assets and liabilities to various standard and non-standard profit rate scenarios. Standard scenarios that are considered on a monthly basis include a 100 basis point (bp) parallel fall or rise in all yield curves. An analysis of the Group's sensitivity to an increase or decrease in market profit rates for a 200bps increase / (decrease) is as below: (assuming no asymmetrical movement in yield curves and a constant balance sheet position)

US\$ 000's

**200 bps parallel increase / (decrease)**

At 30 June 2013  
 Average for the period  
 Maximum for the period  
 Minimum for the period

2013
± 6,787
± 6,816
± 6,845
± 6,787

**7.3 Concentration risk**

This risk arises from exposure to a common set of factors that can produce losses large enough to threaten the Bank's health or ability to maintain its core business. Concentration risk can arise from exposure to specific classes of assets, sector, country, revenue streams, counterparty, a group of counterparties, etc. Concentration risk is mitigated by limits, diversification by assets, geography counterparty quality etc. As part of ICAAP, thresholds for exposure concentrations will be set up which will trigger additional capital requirements. The geographical and sector concentration of credit exposures has been disclosed in paragraphs 4.2.2 and 4.2.3.

**7.4 Counterparty credit risk**

Counterparty credit risk is the risk that a counterparty to a contract in the profit rate, foreign exchange, equity and credit markets defaults prior to maturity of the contract. In addition to the identified credit risk exposures the Bank's counterparty credit risk from markets as such is limited to the fair value of contracts of foreign exchange risk management instruments the overall exposure to which is usually not significant. For other credit market transactions (primarily inter-bank placements), the Bank has established a limit structure based on the credit quality (assessed based on external rating) of each counter party bank to avoid concentration of risks for counterparty, sector and geography. The Bank is constantly reviewing and monitoring the position to ensure proper adherence to the limits and defined policies of the Bank. As at 30 June 2013, the Bank did not have any open positions on foreign exchange contracts.



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### **7.5 Reputational risk (non-performance risk)**

Reputation risk is the risk that negative perception regarding the Bank's business practices or internal controls, whether true or not, will cause a decline in the Bank's investor base, lead to costly litigation that could have an adverse impact on liquidity or capital of the Bank. Being an Islamic Investment Bank, reputation is an important asset and among the issues that could affect the Bank's reputation is the inability to exit from investments, lower than expected returns on investments and poor communication to investors. A well developed and coherently implemented communication strategy helps the Bank to mitigate reputational risks. Additionally, the RMD has recently put together an Internal Capital Adequacy Assessment Process (ICAAP) Policy to effectively assess and measure all non Pillar 1 risks.

### **7.6 Displaced commercial risk**

Displaced Commercial Risk (DCR) refers to the market pressure to pay returns that exceeds the rate that has been earned on the assets financed by the liabilities, when the return on assets is under performing as compared with competitor's rates. The Bank's DCR primarily arises from the funds accepted in the form of Investment Account Holders (IAH) which is currently not very significant in terms of its size and in comparison to the overall activities of the Bank. The returns to investors on the funds are based on returns earned from short-term placements and hence the Bank is not exposed to a significant repricing risk or maturity mismatch risk in relation to these accounts. In relation to the DCR that may arise from its investment banking and restricted investment account products, the risk is considered limited as the Bank does not have any obligation to provide fixed or determinable returns to its investors. The Bank constantly monitors all potential risks that may arise from all such activities as part of its reputational risk management.

### **7.7 Other risks**

Other risks include strategic, fiduciary risks, regulation risks etc. which are inherent in all business activities and are not easily measurable or quantifiable. However, the Bank has proper policies and procedure to mitigate and monitor these risks. The Bank's Board is overall responsible for approving and reviewing the risk strategies and significant amendments to the risk policies. The Bank senior management is responsible for implementing the risk strategy approved by the Board to identify, measure, monitor and control the risks faced by the Bank. The Bank as a matter of policy regularly reviews and monitors financial and marketing strategies, business performance, new legal and regulatory developments and its potential impact on the Bank's business activities and practices.



## 8 Product disclosures

### 8.1 Equity of Investment Account Holders (EIAH)

The Bank does not have significant amount under EIAH and does not use EIAH as a main source of its funding. The Bank does not, as a focused product proposition, offer EIAH products to its clients. The current EIAH deposits have been accepted on a case-by-case basis considering the Bank's relationship with its customers. The EIAH holder authorises the Bank to invest the funds in any investments approved by the Bank's Sharia'a Board without any preconditions. All EIAH accounts are on profit sharing basis, but the Bank does not guarantee any particular level of return. In accordance with the principles of Sharia'a, the entire investment risk is on the investor. Any loss arising from the investment will be borne by the customer except in the case of the Bank's negligence. The Bank charges a Mudarib fee as its share of profit. Early withdrawal is at the discretion of the Bank and is subject to the customer giving reasonable notice for such withdrawal and agreeing to forfeit a share of the profit earned on such account.

Currently, the Bank comingles the EIAH funds with its funds for investments only into interbank placements and hence is not subject to any significant profit re-pricing or maturity mismatch risks. The Bank has an element of displaced commercial risk on EIAH which is mitigated by setting up and maintaining an appropriate level of Profit Equalisation Reserve (PER) and Investment Risk Reserve (IRR) to smoothen return to EIAH holders.

Profit Equalisation reserve (PER) is created by allocations from gross income of the Mudarabah before adjusting the Mudarib (Bank) share. Investment Risk Reserves (IRR) comprises amounts appropriated out of the income of investment account holders after deduction of the Mudarib share of income. Administrative expenses incurred for management of the funds are borne directly by the Bank and are not charged separately to investment accounts. All terms of the EIAH are agreed upfront with the customers and form part of the agreement with the customer. Till date, the Bank has not made any withdrawals on PER or IRR. Any movements on these accounts are therefore only on account of additional reserves added. The historical returns data on EIAH is as follows:

US\$ 000's

	30 June 2013	31 December 2012	31 December 2011
Total EIAH as at 30 June / 31 December	2,139	2,353	1,898
Average EIAH balance	3,807	4,025	3,720
Average rate of return earned (%)	0.30%	0.57%	0.78%
Total profits on EIAH assets earned	11	23	29
Distributed to investor	10	20	19
Allocated to IRR	-	4	3
Allocated to PER	-	6	5
Bank's share of profits	1	3	2
Average declared rate of return (%)	0.27%	0.50%	0.51%

*The information disclosed above pertains to EIAH managed by the Bank and does not include the historical return data of similar products of its subsidiaries which are no longer consolidated in 2008 due to sale of controlling interests.*



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## **8.2 Restricted investment accounts**

The Bank offers Restricted Investment Accounts (“RIAs”) to both financial institutions and high net worth individuals in the GCC. All RIA product offering documents (“Offering Document”) are drafted and issued with input from the Bank’s Investment Banking, Shari’a, Financial Control, Legal and Risk Management Departments to ensure that the Investors have sufficient information to make an informed decision after considering all relevant risk factors. The Bank has guidelines for the development, management and risk mitigation of its’ RIA investments and for establishment of sound management and internal control systems to ensure that the interests of the investment account holders are protected at all times. Wherever it is necessary for the Bank establishes Special Purpose Vehicles (SPVs) for management of the investment. The Bank has a Board approved SPV Governance framework in place to equip the Board in ensuring that the management of such SPVs are conducted in a professional and transparent manner.

The Bank is aware of its fiduciary responsibilities in management of the RIA investments and has clear policies on discharge of these responsibilities. The Bank considers the following in discharge of its fiduciary responsibilities:

- Ensuring that the investment structure, Offering Documents and the investment itself are fully compliant with Islamic Shari’a principles and the CBB regulations;
- Appropriately highlighting to the Investors, as part of the RIA Offering Document, of all the relevant and known risk factors and making it clear that the investment risk is to be borne by the Investor before accepting the investment funds;
- Completing all necessary legal and financial due diligence on investments undertaken on behalf of the Investors with the same level of rigor as the Bank requires for its’ own investments;
- Ensuring that the funds are invested strictly in accordance with the provisions outlined in the Offering Documents;
- Preparing and disseminating periodical investment updates to Investors on a regular basis during the tenor of the investment;
- Distributing the capital and profits to the Investor in accordance with the terms of the offering document; and
- In all matters related to the RIA, RIA SPV(s) and the investment, act with the same level of care, good faith and diligence as the Bank would apply in managing its own investments.

Within the Bank, the abovementioned responsibilities and functions are provided, managed and monitored by qualified and experienced professionals from the Investment Banking, Shari’a, Financial Control, Legal, Investment Administration and the Risk Management Departments.



The restricted investment accounts primarily represents the investments in the projects promoted by the Bank and managed on a portfolio basis on behalf of investors.

Company	Cumulative distributions %	Half yearly distribution for six months ended 30 June 2013	Annual Distributions				
			2012	2011	2010	2009	2008
Mena Real Estate Company KSCC	-%	-	-	-	-	-	-
Gulf Holding Company Gulf North Africa	2.80%	-	-	-	-	9.41%	-
Holding Company KSCC Gulf Real Estate Development Company	5.31%	-	-	-	-	10.12%	7.55%
Pan European Fund	4.29%	-	-	-	-	9.57%	6.76%
Al Basha'er Fund	1.47%	-	-	-	-	-	5.36%
Oman Development Company	-	-	-	NA	NA	NA	NA
	-	-	-	-	-	-	-

NA – Not applicable

*The information disclosed above pertains to RIA managed by the Bank and does not include the historical return data of similar products of its subsidiaries which are no longer consolidated in 2008 due to sale of controlling interests.*

*The annual distributions represents the percentage of return based on the distributions made during each year and the opening balances of the investments.*

*The cumulative distribution represents the cumulative return based on distributions made during the investment period and the average opening balances of the investments.*

## 9 Financial performance and position

Following are basic quantitative indicators of the financial performance:

	2013 (6 months)	2012 (12 months)	2011 (12 months)	2010 (12 months)	2009 (12 months)	2008 (12 months)
Return on average equity	0.91%	2.19%	0.16%	-127.15%	-104.40%	31.62%
Return on average assets	0.47%	1.17%	0.04%	-25.62%	-28.41%	10.19%
Cost-to-Income-Ratio*	70.72%	53.90%	79.20%	-	490.56%	35.91%

\* Cost has been considered excluding impairment allowances. Income is net of finance expense.