



Kuwait Finance House (Bahrain) B.S.C.(c)

Public Disclosure

31st December 2010

www.kfh.bh



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1. Group Structure

The public disclosures under this section have been prepared in accordance with the Central Bank of Bahrain (“CBB”) requirements outlined in its Public Disclosure Module (“PD”), Section PD-1: Annual Disclosure requirements, CBB Rule Book, Volume II for Islamic Banks. Rules concerning the disclosures under this section are applicable to Kuwait Finance House (Bahrain) B.S.C. (c) (“KFH Bahrain” or “the Bank”) being a locally incorporated Bank with an Islamic retail banking license and its subsidiaries, together known as (“the Group”). All amounts presented in the document are in Bahraini Dinar and rounded off to the nearest thousand.

The Board of Directors (the “Board”) at KFH Bahrain seeks to optimise the Group’s performance by enabling the business units to realise the Group’s business strategy and meet agreed business performance targets by operating within the agreed capital and risk parameters and the risk policy framework.

2. Capital Adequacy

The Group manages the capital base to cover risks inherent in the business. The adequacy of the Group’s capital is monitored using, among other measures, the rules and ratios established by the Basel Committee on Banking Supervision (“BIS rules/ratios”) and adopted by the CBB in supervising the Bank.

The primary objectives of the Group’s capital management are to ensure that the Group complies with externally imposed capital requirements and that the Group maintains healthy capital ratios in order to support its business and to maximise shareholders’ value.

Regulatory capital consists of Tier 1 capital (core capital) and Tier 2 capital (supplementary capital). Tier 1 comprises share capital, share premium, statutory reserve, general reserve, retained earnings, foreign currency translation reserve and non-controlling stakeholders less goodwill. Tier 2 capital includes subordinated murabaha payable, collective impairment and revaluation reserves. Certain adjustments are made to IFRS based results and reserves, as prescribed by the CBB in order to comply with Capital Adequacy (CA) Module issued by the CBB. From the regulatory perspective, the significant amount of the Group’s capital is in Tier 1.

The Group’s approach to assessing capital adequacy has been in line with its risk appetite in the light of its current and future activities. To assess its capital adequacy requirements in accordance with the CBB requirements, the Group adopts the Standardised Approach for the Credit and Market Risk, and the Basic Indicator Approach for the Operational Risk.

The Bank’s capital adequacy policy is to maintain a strong capital base to support the development and growth of the business. Current and future capital requirements are determined on the basis of expectations for each business group, expected growth in off-balance sheet facilities and future sources and uses of funds. In achieving an optimum balance between risk and return, the Bank has established an Internal Capital Adequacy Assessment Program (ICAAP) which quantifies the economic capital requirements for the key risks that the Bank is exposed to including credit risk, investment risk, liquidity risk, strategic risk, profit rate risk, reputation risk, operational risk, and concentration risk. The Bank also



conducts comprehensive stress tests for various portfolios and assesses the impact on the capital and profitability. In addition, the Bank's stress testing frameworks and models allow for forward looking scenarios, which is considered for business growth strategies. The ICAAP of the Bank is driven by the Board through the Capital Adequacy Strategy and the ICAAP Policy. In case a plausible stress scenario is identified which may severely affect the capital adequacy of the Bank, the senior management decides an appropriate corrective action to be taken under such a scenario.

For the purpose of computing CAR the Bank is only consolidating KFJ Jordan, a financial subsidiary. None of the Bank's investment in subsidiaries exceeds the materiality thresholds specified in Prudential Consolidation and Deduction Module hence not deducted from the available capital. All other subsidiaries (i.e. commercial subsidiaries) are risk weighted as per the requirement of CA Module.

All transfer of funds or regulatory capital within the Group is only carried out after proper approval process.



2.1 Quantitative disclosures

Table – 1. Capital Structure

CAPITAL STRUCTURE	
Capital Structure (PD-1.3.12, 1.3.13,1.3.14, 1.3.15) *	
Components of Capital	Amount BD ‘000
Core capital - Tier 1:	
Issued and fully paid ordinary shares	177,140
Employee stock incentive program funded by the Bank	(17,379)
Share premium	71,403
Statutory reserve	13,351
General reserve	29,648
Retained earnings	20,642
Other reserves	(4,707)
Total Tier 1 Capital	290,098
Deductions from Tier 1:	
Unrealised gross losses arising from fair valuing equity securities	6,135
Tier 1 Capital before PCD deductions	296,233
Supplementary capital - Tier 2:	
Subordinated murabaha payable	99,422
Asset revaluation reserve - Property, plant, and equipment (45% only)	6,595
Investment risk reserve	11,742
Tier 2 Capital before PCD deductions	117,759
Total Available Capital before PCD deductions (Tier 1 & 2)	413,992

Available Capital before PCD deductions	Tier I 296,233	Tier II 117,759
Deductions		
Investment in insurance entity greater than or equal to 20% of investee's capital base	1,209	1,209
Excess amount over maximum permitted large exposure limits	79,427	79,427
Aggregate Deductions	80,636	80,636
Total eligible capital	215,597	37,124

* For the purposes of guidance we have cross referenced every table with the relevant Para number of the CBB's Public Disclosures module.

Table – 2. Capital Requirement by Type of Islamic Financing Contracts.

CAPITAL ADEQUACY	
Regulatory Capital Requirements (PD-1.3.17) by Each Type of Islamic Financing Contracts	
Type of Islamic Financing Contracts	Capital Requirement
Murabaha contracts with Banks	385
Financing contracts with customers	
- Murabaha	114,601
- Ijarah	7,587
- Musharakah	3,562
Total	126,135

Table – 3. Capital Requirement for Market and Operational Risk

CAPITAL ADEQUACY		
Capital Requirements for Market Risk (PD-1.3.18) & Operational Risk (PD-1.3.19) & 1.3.30(a)		
Particulars	Risk Weighted Assts	Capital Requirement
Market Risk - Standardised Approach	45,774	5,722
Operational Risk - Basic indicator approach	96,907	12,113

Table – 4. Capital Ratios

CAPITAL ADEQUACY		
Capital Adequacy Ratios (PD-1.3.20)		
Particulars	Total Capital Ratio	Tier 1 Capital Ratio
	%	
Consolidated Ratios	22.03%	18.79%

3. Risk Management

3.1 Bank -wide Risk Management Objectives

The management of the Bank believes in the proactive management of risk in the full cycle of a financial transaction including its operating circumstances from the origination stage to its final disposal from the books of the Group. The risk management objective for each area of risk is to adopt the best practices available to adhere to the Basel II and the CBB requirements. The Group is able to identify, capture, monitor and manage different dimensions of risk with the aim of protecting asset values and income streams, and hence, optimising the Group's shareholder returns, while maintaining its risk exposure within defined parameters.

To effectively manage risk, Board approval is sought on a regular basis. The Bank has implemented sophisticated risk management systems such as Focus Asset and Liability Management (ALM), credit risk rating systems, stress test models, ICAAP model and various other analytical tools.

The Bank's risk appetite is defined within the parameters of its risk strategy. The Bank reviews and redefines its risk appetite according to the evolving business plans considering fluctuations in economic and market conditions and future forecasts. The Bank also assesses on a regular basis its tolerance for specific risk categories in term of limits structures for various risks and its strategy to manage these risks.

3.2 Strategies, Processes & Internal Controls

3.2.1 Bank's Risk Strategy

The Bank's risk strategy, backed by appropriate limit structures, is articulated through a Risk Charter, Capital Adequacy strategy, Credit risk strategy, Investment risk strategy, Market risk strategy, Profit rate risk strategy, Liquidity risk strategy, and Operational risk strategy and ICAAP policy. These strategies provide an enterprise-wide integrated risk management framework in the Bank. The Risk Charter identifies risk objectives, policies, strategies and risk governance both at the Board and the management level. The Capital Adequacy strategy and ICAAP policy is aimed at ensuring financial stability by allocating enough capital to cover unexpected losses. Limit structures serve as a key component in articulating risk strategy in quantifiable risk appetite. They are further supported by a comprehensive framework for various risk silos with its own strategies, policies and methodology documents. In addition, the Bank is in the process of implementing various risk systems to help quantify not just the regulatory capital but also the economic capital allocated to various portfolios.

The Group is exposed to various types of risk, such as market, credit, rate of return, liquidity and operational risks, all of which require comprehensive controls and ongoing oversight. The risk management framework encapsulates the spirit behind Basel II, which includes management oversight and control, risk culture and ownership, risk recognition and assessment, control activities, adequate information and communication channels, monitoring risk management activities and correcting deficiencies.



3.2.2 Credit Risk

The Bank manages its credit risk exposures by evaluating each new product/activity with respect to the credit risk introduced by it. The Bank uses comprehensive credit evaluation and assessment criteria and scorecard for every credit proposal and records the risks arising from each new exposure. The Bank has established a limit structure to avoid concentration of risks for counterparty, industrial sector and geographical area. The Bank also conducts stress testing for assessing the impact of adverse systematic and firm specific conditions on its credit portfolio. The Bank also maintains Credit Risk Policy and Collateral Management policy for credit risk mitigants.

3.2.3 Market Risk

The Bank measures and monitors the market risk in its portfolio using appropriate measurement techniques such as limits on its FX open positions, stop loss limits, notional limits and VaR limits. The Bank conducts stress testing to assess the impact of adverse market conditions on its market risk sensitive portfolio.

3.2.4 Operational Risk

The Bank has established a Risk Control and Self Assessment (RCSA) process necessary for identifying and measuring and controlling its operational risks. This exercise covers the Bank's business lines and associated critical activities, exposing the Bank to operational risks.

3.2.5 Equity Risk in the Banking Book

Equity price risk is the risk that the fair values of equities decrease as the result of changes in the levels of equity indices and the value of individual stocks. The equity price risk exposure arises from the Group's investment portfolio. The Bank manages and monitors market risk arising out of its investment in public equity using VaR and its private equity using industrial sector, geographical areas and investment type limits. The strategy used has been effective throughout the reporting period.

3.2.6 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 Bank manages the mismatch risk and re-pricing characteristics of the assets and liabilities by monitoring, managing and limiting its re-pricing gaps. It also manages the market value sensitivity of the portfolio to the profit rates.



3.2.7 Displaced Commercial Risk (DCR)

DCR refers to the market pressure to pay returns to Unrestricted Investment Account (URIA) holders that exceeds the rate that has been earned on the assets financed by the URIA, when the return on assets is under performing as compared with competitor's rates.

The Bank manages DCR through the Profit Sharing Investment Account (PSIA) policy approved by the Board according to which the Bank can forego its mudarib share to manage DCR. The Bank strives to offer competitive returns to its investors based the average returns generated by the underlying assets after performing analysis of its profitability and studies of other market indicators.

The quantitative disclosures regarding DCR are discussed in tables 28 and 39.

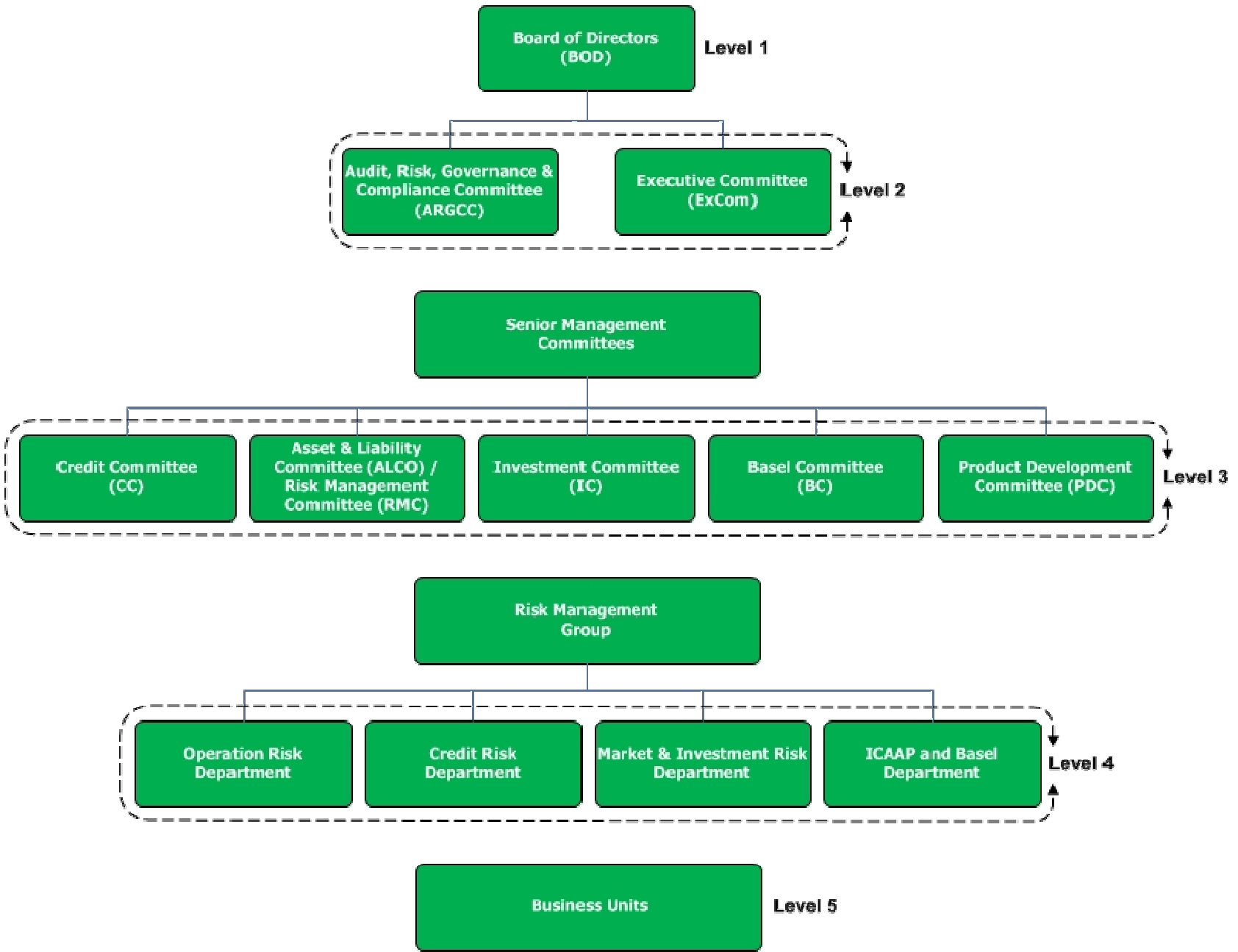
3.3 Structure and Organisation of Risk Management Function

The Risk Management structure at the Bank encompasses all levels of authorities, organisational structure, people and systems required for the effective functioning of risk management processes. The roles and responsibilities associated with each level of risk management structure and authorities consist of the following:

The Board retains ultimate responsibility and authority for all risk management matters, including:

- a. Establishing overall policies and procedures; and
- b. Delegating authority to the Executive Committee, Audit Risk Governance and Compliance (ARGC) Committee and further delegation to the management.





Internal Audit Function

3.4 Risk Measurement & Reporting Systems

The Bank measures the risk using the risk management systems and risk MIS reports. The Bank has put in place various limits based on its risk appetite. These limits have been approved by the Board. Any limit breaches are reported to the respective senior management committees and the Board by the Risk Management Department (RMD) based on the limit breach procedure approved by the Board. The limits are reviewed and revised at least on annual basis or when deemed necessary. The Bank has implemented sophisticated risk management systems such as Focus Asset and Liability Management (ALM), credit risk rating systems, stress test models, ICAAP model, VaR and various other analytical models in order to generate the MIS and monitor the limits.

3.5 Credit Risk

3.5.1 Introduction

Credit risk is the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. It arises principally from lending, trade finance and treasury activities. The Bank controls credit risk by monitoring credit exposures, and continually assessing the creditworthiness of counterparties. Financing contracts are mostly secured by collateral in form of mortgage of real estate properties or other tangible securities.

The Board sets the guidelines for managing the credit risk in terms of credit risk strategy, credit risk policy, credit criteria specifications, collateral management policy and credit risk limits including individual and concentration limits. Any change to these guidelines is approved by the Board.

The Bank manages and controls credit risk by setting limits on the amount of risk it is willing to accept in terms of counterparties, product types, geographical areas and industrial sectors. All credit proposals undergo a comprehensive risk assessment which examines the customer's financial condition, trading performance, nature of the business, quality of management, and market position, etc. Counterparty facility limits for corporate customers are established by the use of a credit risk classification system, which assigns each counterparty a risk rating in terms of obligor risk rating and the facility risk rating. The proposals are reviewed by the Credit Review and Administration Department which is separate from the risk taking business units. A comprehensive template is used to review the proposals by the credit review team. Credit approval decision is then made and terms and conditions are set.

The Bank has established a credit quality review process to provide early identification of possible changes in the creditworthiness of counterparties, including regular collateral revisions. Corporate contracts/facilities are reviewed on annual basis by Corporate Finance and the Credit Review and Credit Administration Department.

Exposure limits are based on the aggregate exposure to counterparty and any connected entities across the Bank. Risk ratings methodology is subject to regular revision by RMD.

3.5.2 Types of credit risk

The Bank's Financing contracts mainly comprise Ijarah/Ijarah Muntahia Bittamleek, Istisna, Murabaha, Murabaha (International Commodity), Murabaha Letter of Credit, Diminishing Musharakah and Qard Al Hassan.

Ijarah /Ijarah Muntahia Bittamleek (“IMB”)

The Bank enters into a contract under which the Bank purchases and leases out an asset required by the customer for a rental fee. The duration of the lease and rental fees are agreed in advance. Ownership of the asset remains with the Bank until last payment is received from the customer. The Bank provides Ijarah financing in the form of IMB.

Istisna financing

Istisna is a contract of acquisition of goods or property by specification or order, where the price is paid in advance, but the goods are manufactured and delivered at a later date. The price and necessary specifications of the goods or property must be fixed as at the time of the contract.

Murabaha

Murabaha is a contract between the Bank and its client for the sale of goods at a price which includes a profit margin agreed by both parties. As a financing technique, it involves the purchase of goods, usually a vehicle, by the Bank as requested by its client. The goods are then sold to the client at a profit. Repayment, usually in instalments, is specified in the contract.

Murabaha (International Commodity)/Tawarruq

A commodity Murabaha is a contract between the Bank and its client for the sale of goods at a price plus an agreed profit margin for the Bank. The product is called an International Commodity Murabaha/Tawarruq because the profits are made on the buying and selling of a Shari'a compliant commodity usually metal on international market such as copper, aluminium or lead.

Murabaha Letter of Credit

A documentary credit is an undertaking by the Bank to pay the seller of goods, subject to the conformity of contractual instructions. Pursuant to a Murabaha Letter of Credit, the Bank imports the goods in its own name. The customer then purchases the goods from the Bank under a Murabaha arrangement.

Diminishing Musharakah

This form of financing makes the client as a “partner” in term of ownership of the asset. This arrangement allows equity participation and sharing of profit and loss on a pro rata basis. During the period of financing, the non-Bank partner makes payments to increase its equity in the subject matter with the ultimate objective that it will eventually buy the entire Bank's equity and have the title in the asset transferred solely to him.

Qard Al Hassan

The Bank provides a benevolent finance. Under this arrangement the Bank provides financing without any profit there from and is usually short term in nature. The recipient will have to repay the principal only at the time of maturity. The funding is from the Shareholder's capital.

Wakala

Wakala is a contract between 'Muwakkil' and the 'Wakeel'. The Muwakkil places the funds with the Wakeel for a fixed time period. The Wakeel invests the Muwakkil's fund and pays a profit generated there-from as per the agreed rate of return.

Musawama

A musawama is a contract for the sale of assets at a price agreed by both parties. The Bank purchases the product and assumes ownership. The assets are then sold to the client with a mark-up and the ownership of the asset is transferred to the client. However, neither the cost of acquiring the asset nor the profit to be earned from it is disclosed to the client.

3.5.3 Past Due and Impaired Islamic Financing

The Bank defines non performing facilities as the facilities that are overdue for a period of 90 or more days. These exposures, studied on a case by case basis, are placed on a non-accrual status with income being recognised to the extent that it is actually received. It is the Bank's policy that when an exposure is overdue for a period of 90 or more days, the whole financing facility extended is considered as past due, not only the overdue instalments. Additionally, the bank invokes a cross default clause for corporate counterparties such that all facilities to those counterparties are then considered as non-performing.

As a policy, the Bank has placed on a non-accrual status any facility where there is reasonable doubt about the collectability of the receivable irrespective of whether the customer concerned is currently in arrears or not. The past due and impaired facilities are governed by the provisioning policy of the Bank.

3.5.4 External Credit Assessment Institutions

The Bank relies on external ratings for Sovereigns and Financial Institutions (FIs) for assessing the creditworthiness of the counterparties, as they are generally rated by an external rating agency. The Bank uses Standard & Poor's, Fitch, Capital Intelligence and Moody's to provide ratings for such counterparties. In case of unrated FIs, the Bank assesses the credit risk based on the internal FI rating model based on the following parameters:

Earnings, Liquidity, Asset quality, Capital adequacy, Size and Sensitivity to benchmark profit rates and other macroeconomic variables.

3.5.5 Definition of Geographical Area

The geographic distribution of the credit exposures is monitored on an ongoing basis by the Bank's RMD and reported to the Board on a quarterly basis. The Bank's classification of geographical area is according to its business needs and the distribution of its portfolios.



3.5.6 Concentration Risk

Concentration risk is the credit risk stemming from not having a well diversified credit portfolio, i.e. being overexposed to a single customer, industry sector or geographic region.

As per 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 related counterparties, exceeding 15% of the regulatory capital base. In order to avoid excessive concentrations of risk, the Bank's credit concentration policy and procedures include specific guidelines to focus on maintaining a diversified portfolio. Identified concentrations of credit risks are controlled and managed accordingly.

3.5.7 Credit Risk Mitigation

3.5.7.1 Introduction

Credit risk mitigation is defined as the utilisation of a number of techniques, such as collaterals and guarantees to mitigate the credit risks that the Group is exposed to.

The Bank's first priority when establishing relationship with the customer for financing is to determine the borrower's capacity to repay and not to rely principally on security or collateral.

Acceptable forms of collateral and their valuation parameters are defined within the collateral management policy. Valuations are done conservatively and are regularly reviewed to reflect any changes in market conditions. Security structures and legal covenants are also subject to regular review to ensure that they continue to fulfil their intended purpose and remain in line with local market practice.

The Group accepts only Shari'a compliant collaterals as credit risk mitigants. Further, a representative from the Shari'a Department sits on the credit committee which takes decisions on significant collaterals.

3.5.7.2 Policy guidelines for credit risk mitigation

The Bank has policy guidelines for the following credit risk mitigants:

- Collaterals
- Guarantees



1. Policy for collaterals

Collaterals are governed by the collateral management policy of the Bank. The business units review and recommend detailed guidelines relating to collateral in consultation with RMD. These guidelines cover the following:

- Permissible collateral types – based on size, age, value, location and manufacturer.
- Maximum financing to collateral value, for secured facilities based on each type of collateral.
- Collateral verification and appraisal processes including frequency of review.
- Approved panel of solicitors, property and other valuers.
- Collateral documentation requirements, custody (for securities) and Takaful requirements.
- Ongoing processes for margin maintenance, continuation of Takaful, etc.
- Collateral valuation process
- Applicable haircuts on various types of collaterals

The Bank has a detailed policy for the initial valuation and periodic revaluation of collaterals of various types. This includes the methodology for valuation, periodicity of the collateral valuation and the guidelines on the evaluators (external valuers/internal credit administration units who will carry the independent review). For corporate facilities covered by fixed assets (land, building, plant and machinery), collateral values are reassessed annually by the external evaluators selected by the bank and quarterly by the internal evaluator from the credit administration unit. Ad hoc valuation may also be requested if the management of the bank deems it necessary. Any collateral which are subject to market fluctuations on a more frequent basis are valued more frequently. For example, volatile securities (equity, mutual fund, etc) are to be valued on a daily basis. The Bank carefully evaluates the market value and liquidation value of collateral (adjusted for haircut), based on the valuations provided by the external evaluators. Standard predetermined haircut is applied to each category of collaterals, based on the central bank guidelines.

The bank monitors the types of the collaterals in its portfolio and monitors the concentration in any particular type of collaterals. The majority of the Bank's financing portfolio is secured through mortgage of real estate properties. The bank monitors the market and liquidation prices of the collaterals and maintains the target minimum collateral coverage ratio for various types of collaterals and facilities, as specified in the policy. If required, additional collateral can be demanded from the corporate customers.

In case of default by any customer, the Bank makes all possible efforts for the recovery of amount and only resorts to the disposal of collateral when all other efforts have been exhausted. The bank has a senior management level collections committee, who decide on a case by case basis on the recovery of the collaterals.



2. Guarantees

Guarantees supplement collateral in improving the quality of credit. It is the policy of the Bank to obtain legally enforceable, unconditional, continuing and written guarantees. In cases where a letter of guarantee from a parent company or a third party is accepted as credit risk mitigants, the Bank ensures that all guarantees are irrevocable, legal opinion is obtained from a legal counsel domiciled in the country of guarantor regarding the enforceability of the guarantee and all guarantees should be valid until full settlement of the financing contract. Also no maturity (negative) mismatch is permissible between the guarantee and exposure. The Group only consider bank guarantee as credit risk mitigants for the purpose of Capital adequacy ratio calculations.

3.5.8 Counterparty Credit Risk

3.5.8.1 Introduction

A counterparty is defined as an obligor (individual, company, other legal entity), a guarantor of an obligor, or person receiving funds from the Group. It also includes the issuer of a security in case of a security held by the Group, or a party with whom a contract is made by the Group for financial transactions.

The measurement of exposure reflects the maximum loss that the Group may suffer in case the counterparty fails to fulfil its commitments. The Group exposure is defined as the total exposure to all counterparties closely related or connected to each other. Large exposure is any exposure whether direct, indirect or funded by restricted investment accounts to a counterparty or a group of closely related counterparties which is greater than or equal to 10% of the Group's capital base.

The Group has adopted the Standardised Approach to allocate capital for counterparty credit risk. The Bank has put in place an internal counterparty limit structure which is based on internal/external ratings for different types of counterparties. The Bank has also set concentration limits as a percentage of portfolio exposure based on grades. In case of a counterparty rating degrade, the Bank may require further collateral or advise the counter party to reduce its exposure on a case by case basis.

The Bank has developed a provisioning policy in order to ensure that it maintains adequate provisions for past due and impaired assets.



3.5.8.2 Credit Limit Structure

Approval of counterparty exposure in excess of 10% of the Bank's capital

Exposure financed by direct, unrestricted investment accounts and/or restricted investment accounts, in excess of 10% of the Bank's Capital Base shall be approved only in exceptional cases. In such cases, proposal highlights the fact that the limits proposed are in excess of 10% of the Bank's capital base and valid justification for recommending such a large exposure is given. The proposal is reviewed by Credit Review and Credit Administration Department, RMD and the Credit Committee and approved by the appropriate authorities within the Bank.

Reporting

The Group reports large counterparty exposures to CBB and senior management on periodic basis. The Group reports the exposures on a gross basis without any offsetting. However, debit balances on accounts may be offset against credit balances where both are related to the same counterparty, provided the Group has a legally enforceable and Shari'a right to do so.

Early warning indicators

The Bank maintains a strong focus on identification of signs of deterioration in credit quality at an early stage in order to take remedial measures before the facility becomes non-performing.

3.5.9 Related Party Transactions

The disclosure relating to related party transactions and balances has been made in the consolidated financial statements of the Group for the year ended 31 December 2010. All related party transactions have been made on an arm's length basis.



3.5.10 Quantitative disclosures

Table – 5. Average and Gross Credit Risk Exposure

CREDIT RISK: QUANTITATIVE DISCLOSURES				
Credit Risk Exposure (PD-1.3.23(a))				
	Self Financed		Financed by Unrestricted Investment Accounts	
Portfolios	Total Gross Credit Exposure	* Average Gross Credit Exposure Over the Period	Total Gross Credit Exposure	* Average Gross Credit Exposure Over the Period
Balances with Banks	4,440	4,961	4,943	5,871
Murabaha and Mudaraba contracts with Banks	-	-	51,370	40,753
Financing contracts with customers	315,869	311,333	324,522	334,017
Investments – Sukuk	-	-	53,672	53,202
Receivables	56,985	57,723	-	-
Total	377,294	374,017	434,507	433,843
Credit commitments and contingent items	44,850	39,112	-	-
Grand Total	422,144	413,129	434,507	433,843

* Average credit exposure has been calculated using quarterly consolidated financial statements and PIRI forms submitted to CBB.

Table – 6. Portfolio Geographic Breakdown.

CREDIT RISK: QUANTITATIVE DISCLOSURES												
Geographic Breakdown (PD-1.3.23(b))												
Portfolios	Self Financed						Financed by Unrestricted Investment Accounts					
	Geographic Area						Geographic Area					
	Middle East	North America	Europe	NZ / Australia	Others Countries	Total	Middle East	North America	Europe	NZ / Australia	Others Countries	Total
Balances with Banks	2,341	1,260	811	-	28	4,440	2,607	1,402	902	-	32	4,943
Murabaha and Mudaraba contracts with Banks	-	-	-	-	-	-	51,370	-	-	-	-	51,370
Financing contracts with customers	314,498	978	-	393	-	315,869	323,171	963	-	388	-	324,522
Investments - Sukuk	-	-	-	-	-	-	50,777	985	-	-	1,910	53,672
Receivables	52,428	-	4,492	65	-	56,985	-	-	-	-	-	-
Total	369,267	2,237	5,303	458	28	377,294	427,925	3,351	902	388	1,942	434,507
Un-funded												
Credit commitments and contingent items	42,914	-	1,710	-	226	44,850	-	-	-	-	-	-
Grand Total	412,181	2,237	7,013	458	254	422,144	427,925	3,351	902	388	1,942	434,507

Table – 7. Industrial Sector Breakdown by Portfolio

CREDIT RISK: QUANTITATIVE DISCLOSURES										
Industry Sector Breakdown (PD-1.3.23(c))										
	Self Financed					Financed by Unrestricted Investment Accounts				
Portfolios	Industry Sector					Industry sector				
	Trading and Manufacturing	Banking and Financial	Construction and Real Estate	Others	Total	Trading and Manufacturing	Banking and Financial	Construction and Real Estate	Others	Total
Funded										
Balances with Banks	-	4,440	-	-	4,440	-	4,943	-	-	4,943
Murabaha and Mudaraba contracts with Banks	-	-	-	-	-	-	51,370	-	-	51,370
Financing contracts with customers	27,138	38,690	191,971	58,070	315,869	40,083	38,115	189,118	57,206	324,522
Investments - Sukuk	-	-	-	-	-	-	18,687	34,985	-	53,672
Receivables	-	-	22,477	34,508	56,985	-	-	-	-	-
Total	27,138	43,130	214,448	92,578	377,294	40,083	113,115	224,103	57,206	434,507
Un-funded										
Credit commitments and contingent items	30,814	226	12,100	1,710	44,850	-	-	-	-	-
Grand Total	57,952	43,356	226,548	94,288	422,144	40,083	113,115	224,103	57,206	434,507

Table – 8. Exposures in Excess of 15% Limit

CREDIT RISK: QUANTITATIVE DISCLOSURES		
Concentration of risk (PD-1.3.23(f)) Exposure as a Percentage of Capital Base		
Counterparties	Self Financed	Financed by Unrestricted Investment Accounts
	Concentration of Risk	Concentration of Risk
Counterparty # 1	34.63%	-
Counterparty # 2	27.47%	-

Restructured Islamic Financing Contracts:

The outstanding amount of financing contracts with customers for which financing terms have been renegotiated (restructured facilities) during the year, amounted to BD 150,361 thousand (2009: BD 118,234 thousand) and these are secured with collateral amounting to BD 110,521 thousand (2009: BD 192,037 thousand). For restructured facilities amounting to BD 87,936 thousand (2009: BD 62,862 thousand) either six months or more have elapsed since the date of restructuring and the customers have made regular payments on a timely basis or the deals have been settled. As a condition to restructuring, the Bank has received partial payment from customers and/or obtained additional collateral.

The restructuring does not have any significant impact on provision and present and future earnings of the Group as most of the exposures are sufficiently collateralised and restructuring is based on the market terms. The concession provided to the restructured relationships mainly relates to the extension of the repayment dates.

Table – 9. Maturity Breakdown of Credit Exposures

CREDIT RISK: QUANTITATIVE DISCLOSURES							
Residual Contractual Maturity Breakdown (PD-1.3.23(g))							
Portfolios	Self Financed						
	Maturity Breakdown						
	Up to 3 Months	3-12 Months	1-5 Years	5-10 Years	10-20 Years	Over 20 Years	Total
Balances with Banks	2,220	-	-	-	2,220	-	4,440
Murabaha and Mudaraba contracts with Banks	-	-	-	-	-	-	-
Financing contracts with customers	25,026	121,717	124,187	38,239	6,700	-	315,869
Investments - Sukuk	-	-	-	-	-	-	-
Receivables	5,989	-	39,996	11,000	-	-	56,985
Total	33,235	121,717	164,183	49,239	8,920	-	377,294
Credit commitments and contingent items	17,189	27,426	235	-	-	-	44,850
Grand Total	50,424	149,143	164,418	49,239	8,920	-	422,144

CREDIT RISK: QUANTITATIVE DISCLOSURES**Residual Contractual Maturity Breakdown (PD-1.3.23(g))**

Portfolios	Financed by Unrestricted Investment Accounts						
	Maturity breakdown						
	Up to 3 Months	3-12 Month	1-5 Years	5-10 Years	10-20 Years	Over 20 Years	Total
Balances with Banks	2,472	-	-	-	2,471	-	4,943
Murabaha and Mudaraba contracts with Banks	51,263	107	-	-	-	-	51,370
Financing contracts with customers	26,723	126,042	126,914	38,241	6,601	-	324,522
Investments - Sukuk	-	19,861	33,811	-	-	-	53,672
Receivables	-	-	-	-	-	-	-
Total	80,458	146,010	160,725	38,241	9,072	-	434,507
Credit commitments and contingent items	-	-	-	-	-	-	-
Grand Total	80,458	146,010	160,725	38,241	9,072	-	434,507

Table – 10. Break-up of Impaired Loans by Industry Sector

CREDIT RISK: QUANTITATIVE DISCLOSURES														
Impaired Loans, Past Due Loans and Allowances (PD-1.3.23(h))														
Industry Sector	Total Portfolio	Good	Substandard	Past due but not impaired	Past due or individually impaired	Self Financed								Collective Impairment
									Specific Impairment					
						Over 3 Months	Over 1 Year	Over 3 Years	Balance at the Beginning of the Period	Charges During the Period	Transfer from collective provision	Balance at the End of the Period		
Trading and manufacturing	27,138	16,605	4,242	17,847	320	-	320	-	-	-	-	-	*	
Banking and financial institutions	38,690	15,790	4,034	16,971	304	-	304	-	-	-	-	-	*	
Construction & real estate	191,971	78,345	20,016	84,204	1,510	-	1,510	-	-	-	-	-	*	
Others	58,070	23,699	6,055	25,471	457	-	457	-	1,183	408	216	1,807	*	
Total	315,869	134,439	34,347	144,492	2,591	-	2,591	-	1,183	408	216	1,807	-	

* This amounts to BD 11,742 thousands representing collective impairment against exposures which, although not specifically identified, have a greater risk of default than when originally granted.

Impaired Loans, Past Due Loans and Allowances (PD-1.3.23(h))													
Industry Sector	Total Portfolio	Good	Substandard	Past due but not impaired	Past due or individually impaired	Financed by Unrestricted Investment Accounts							Collective Impairment
									Specific Impairment				
						Over 3 Months	Over 1 Year	Over 3 Years	Balance at the Beginning of the Period	Charges During the Period	Transfer from collective provision	Balance at the End of the Period	
Trading and manufacturing	40,083	40,083	-	-		-	-	-	-	-	-	-	-
Banking and financial institutions	38,115	38,115	-	-		-	-	-	-	-	-	-	-
Construction & real estate	189,118	189,118	-	-		-	-	-	-	-	-	-	-
Others	57,206	57,206	-	-		-	-	-	-	-	-	-	-
Total	324,522	324,522	-	-		-	-	-	-	-	-	-	-

Table – 11. Break-up of Provision by Geographic Area

CREDIT RISK: QUANTITATIVE DISCLOSURES						
Impaired Loans, Past Due Loans And Allowances (PD-1.3.23(i))						
Geographic Area	Own Capital and Current Account			Unrestricted Investment Account		
	Past Due and Impaired Islamic Financing Contracts (Greater Than 90 Days)	Specific Impairment	Collective Impairment	Past Due Islamic Financing Contracts	Specific Impairment	Collective Impairment
Middle East	45,654	1,242	*	-	-	*
North America	-	-	-	-	-	-
Europe	-	-	-	-	-	-
Asia / Pacific	-	-	-	-	-	-
Others countries	1,131	565	-	-	-	-
Total	46,785	1,807	-	-	-	-

* This amounts to BD 11,742 thousands representing collective impairment against exposures which, although not specifically identified, have a greater risk of default than when originally granted.



Table – 12. Break-up of Eligible Collateral by Portfolio

CREDIT RISK MITIGATION (CRM): DISCLOSURES FOR STANDARDISED APPROACH		
Credit Risk Exposure Covered By CRM (PD-1.3.25 (b) and (c))		
Portfolios	Total Exposure Covered by	
	Eligible Collateral *	Guarantees
Murabaha	94,768	-
Ijarah	128,889	-
Total	223,657	-

* Over and above the collateral, considered as eligible under the CA Module, the Bank maintains additional collateral in the form of mortgage of residential properties, corporate guarantees and other tangible assets, which could be invoked to claim the amount owed in the event of default.

Table – 13. Counter Party Credit Risk

DISCLOSURES FOR EXPOSURES RELATED TO COUNTERPARTY CREDIT RISK (CCR)							
General Disclosures (PD-1.3.26 (b))							
Current Credit Exposure by Type of Islamic Financing Contracts	Gross Positive Fair Value	Netting Benefits	Netted Current Credit Exposures	Eligible Collaterals Held *			
				Cash	Govt. Securities	Others	Total
Murabaha	388,402	-	388,402	15,934	-	78,834	94,768
Ijarah	232,991	-	232,991	20	-	128,869	128,889
Musharakah	18,998	-	18,998	-	-	-	-
Total	640,391	-	640,391	15,954	-	207,703	223,657

* Over and above the collateral, considered as eligible under the CA Module, the Bank maintains additional collateral in the form of mortgage of residential properties, corporate guarantees and other tangible assets, which could be invoked to claim the amount owed in the event of default.

3.6 Market Risk

3.6.1 Introduction

Market risk is the risk that movements in market risk factors, including foreign exchange rates, profit rates, commodity prices, equity prices and credit spreads will reduce the Group's income or the value of its portfolios. The Group is also exposed to profit rate and potential foreign exchange risks arising from financial assets and liabilities. The Group also accepts the definition of market risk as defined by the CBB as "the risk of losses in on and off-balance sheet positions arising from movements in market prices."

The Board has approved the overall market risk appetite in terms of market risk strategy and market risk limits. RMD is responsible for the market risk control framework and sets a limit framework within the context of the approved market risk appetite. The Bank separates market risk exposures into either trading or non-trading portfolios. Trading portfolios include those positions arising from market-making, proprietary position-taking and other marked-to-market positions. Non-trading portfolios include all other positions that are not included in the trading book.

Daily market risk reports are produced for the Bank's senior management covering the different risk categories. These reports are discussed with the senior management committees such as ALCO which take appropriate action to mitigate the risk.

3.6.2 Market Risk Factors

For the Group, market risk may arise from movements in profit rates, foreign exchange markets, equity markets or commodity markets. A single transaction or financial product may be subject to any number of these risks.

Profit Rate Risk is the sensitivity of financial products to changes in the profit rates. Profit rate risk arises from the possibility that changes in profit rates will affect future profitability or the fair values of financial instruments.

Foreign Exchange Risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. The Board has set limits on positions by currency. Positions are monitored on a daily basis to ensure risk is maintained within established limits using VaR methodology.

The Group is exposed to the currency risk mainly due to the bank's banking book FX net open positions and due to the fact that the assets and liabilities of its foreign subsidiaries are denominated in their respective functional currencies. Net assets of the Group's foreign subsidiaries, located in Jordan, as at 31 December 2010 is BD 34,523 thousand (31 December 2009: BD 35,926 thousand). Net assets of the Group's foreign subsidiary, located in United Kingdom, as at 31 December 2010 is BD 12,222 thousand (31 December 2009: BD 13,725 thousand). The assets and liabilities are translated into Bahraini Dinar (presentation currency of the Group) using the closing rate at the date of statement of financial position for the purpose of consolidated financial statements. The impact of foreign currency translation is recognised in the statement of comprehensive income and will be routed to statement of income at the time of disposal of investment in subsidiaries.

Equity Risk is the risk that the fair values of equities decrease as the result of changes in the levels of equity indices and the value of individual stocks. The equity price risk exposure arises from the Group's investment portfolio.

Commodity Price Risk is the risk arises as a result of sensitivity to changes in commodity prices. Since prices in commodity markets are determined by fundamental factors (i.e. supply and demand of the underlying commodity) these markets may be strongly correlated within a particular sector and less correlated across sectors. The Group is not exposed to material commodity price risk.



3.6.3 Market Risk Strategy

The Board is responsible for approving and reviewing the market risk strategy and policy. The Bank's senior management is responsible for implementing the market risk strategy approved by the Board, and continually enhancing the market risk policies and procedures for identifying, measuring, monitoring and controlling market risks.

In line with the Bank's risk management objectives and risk tolerance levels, the specific strategies for market risk management include:

- The Bank strives to reduce the market risk through diversification of its risk exposures across currencies, markets and sectors.
- The Bank proactively measures and monitors the market risk in all its risk exposures on a regular basis using appropriate measurement techniques.
- The Bank has established a limit structure to monitor and control the market risk in its portfolio on daily basis. These limits are monitored on a regular basis and any exceptions to the limits are immediately dealt with.
- The Bank carries out stress testing periodically to assess the effect of extreme movements in market variables.
- The Bank, at all times, hold sufficient capital in order to meet the capital requirement of the CBB as well as maintain a cushion to cover any adverse movements in the market risk factors.
- At all times, the Bank will ensure that it follows the overall market risk strategy while taking any new market risk exposures.

3.6.4 Market Risk Measurement Methodology

The various techniques which are used by the Bank for the measurement, monitoring and control of market risk are as follows:

- a) Value at Risk (VaR) Monte Carlo simulation
- b) Value at Risk (VaR) Historical simulation
- c) Variance covariance for FX



3.6.5 Market Risk Monitoring and Limits Structure

The Board and ALCO set the tolerance for market risk. Based on these tolerances, RMD and Treasury Department have established appropriate risk limits that maintain the Bank's exposure within the strategic risk tolerances over a range of possible changes in market prices and rates. The Bank has developed the following combination of limits to control its market risk:

- a) Stop loss limits;
- b) Value at risk (VaR) limits;
- c) FX trigger at notional level;
- d) Concentration limits for country, geography and sector for equity and Sukuk portfolios; and
- e) Tenor limits for sukuks

The Treasury Department monitors the risk limits for each transaction and ensures that they are not exceeded. A regular limit monitoring is carried out by the market risk department within RMD to ensure adherence to approved limits. ALCO also monitors the limit adherence on a regular basis.

In case a limit is breached, the Board approved limit breach procedure is followed and the reports are provided to the ALCO, the ARGC Committee and the Board depending upon materiality of the breach. The limits are reviewed at least annually or as deemed necessary.

3.6.6 Portfolio Review Process

As part of the review, RMD also monitors the Bank's overall market exposure against the risk tolerance limits set by the Board.

3.6.7 Reporting

The Bank generates a number of market risk management reports. These reports aim to provide the Bank's senior management with an up-to-date view of its market risk exposure. These include summary of the Bank's aggregate market risk sensitive exposures, VaR and limits monitoring reports.

3.6.8 Stress Testing

Stress testing produces information summarising the Bank's exposure to extreme, but plausible, circumstances and offers a way of measuring and monitoring the portfolio against extreme price movements of this type. The Bank's RMD simulates stress scenarios such as Black Monday (1987) and September 11, 2001 (2001) to calculate the maximum loss due to extreme movements in FX rates.



3.6.9 Quantitative disclosures

Table – 14. Minimum and Maximum Capital Requirement for Market Risk

MARKET RISK: DISCLOSURES FOR BANKS USING THE STANDARDISED APPROACH					
Level Of Market Risks In Terms Of Capital Requirements (PD-1.3.27 (b))					
Particulars	Price Risk	Foreign Exchange Risk	Equity Position Risk	Market Risk on Trading Positions in Sukuks	Commodity Risk
Capital requirements	375	5,347	-	-	-
Maximum value	964	5,993	-	-	-
Minimum value	375	4,784	-	-	-

This disclosure is based on the figures from the PIRI from the four quarters of 2010.

3.7 Operational Risk

3.7.1 Introduction

Operational risk is the risk of loss arising from inadequate or failed internal processes, people and systems or from external events, whether intentional, unintentional or natural. It is an inherent risk faced by all business and covers a large number of operational risk events including business interruption and systems failures, internal and external fraud, employment practices and workplace safety, customer and business practices, transaction execution and process management, and damage to physical assets.

The Group cannot expect to eliminate all operational risks, but through a control framework and by monitoring and responding to potential risks, the Group is able to manage the risks. Controls include effective segregation of duties, access, authorisation and reconciliation procedures, staff education and assessment processes, including the use of internal audit.

The Board acknowledges that it has the ultimate responsibility for operational risk. Oversight rests with the ARGC Committee. The Board has approved the operational risk framework in terms of strategy, policy and limits. The Bank has implemented Risk Controls and Self Assessment (RCSA) and departments report the incidents and Key Risk Indicators (KRIs) values to the operational risk unit for monitoring and reporting the key operational risks in the Bank.

3.7.2 Sources of Operational risk

The different sources of operational risks faced by the Group can be classified broadly into the following categories:

People Risk which may arise due to staffing inadequacy, unattractive remuneration structure, lack in staff development policies, lack in procedures for appointment, unhealthy professional working relationship and unethical environment.

Processes Risk which may arise due to inadequate general controls, inadequate application controls, improper business and market practices and procedures, inappropriate/inadequate monitoring and reporting,

Systems (Technology) Risk which may arise due to the integrity of information – lacking in timelines of information, omission and duplication of data etc.; hardware failures due to power surge, obsolescence, low quality etc.; software failure due to unauthorised or incorrect modifications to software programs, computer virus, programming bug etc.

External Risk which can comprise legal / public liability, criminal activities, outsourcing / supplier risk, disasters and infra-structural utilities failures, regulatory risk and political / government risk.

3.7.3 Operational Risk Management Strategy

The Bank's Board is responsible for approving and reviewing (at least annually) the operational risk strategy and significant amendments to the operational risk policies. The Bank's senior management is responsible for implementing the operational risk strategy approved by the Board to identify measure, monitor and control the risks faced by the Bank. The Bank continuously monitors the process and controls framework surrounding all business units to assess their effectiveness and efficiency.

As a strategy the Bank will identify the sources of operational risks in coordination with each business unit. On an ongoing basis, the operational risk tolerance is determined by the RMD based on a bottom-up approach following a discussion with the business units. Operational risk tolerance will need to be approved by the ARGC Committee, ratified by the Board and documented and communicated via the Board-approved policy.

The RCSA methodology enables the Bank to identify risk events within each activity, process and support unit of the Bank, document existing controls, establish quantitative measurement metrics - impact and likelihood - for each event as well as early warning indicators for key risks as defined in the risk tolerance in the form of Key Risk Indicators (KRIs) and capture operational loss data. The operational risk identification, assessment and measurement process involves the following steps:

Identification of KRI's

The Bank's RCSA process identifies the KRIs.

Incident reporting

An incident is the occurrence of an operational or compliance risk event that has caused, or has the potential to cause a financial, reputation or regulatory impact on the Bank. It includes credit or market risk events, which have been caused by an operational risk event, and non-compliance with any legal or regulatory requirement, license, internal policy or procedure or code. The incidents are reported by the business and control units as a part of the RCSA framework.

Operational Loss Database (OLD)

The OLD is a key component to enable the Bank to quantify its past operational risk exposures. The OLD contains a subset of the information captured by the incident reporting process since all incidents involving an actual or potential financial impact (including near misses) is captured.

Scenario analysis

The Bank uses scenario analysis to help it to evaluate its exposure to high-severity events. The Bank identifies the stress events and scenarios to which it is exposed and assesses its potential impact, and the probability of aggregated losses from a single event leading to other risks. Scenario analysis is conducted in a workshop format, using a combination of expert judgment; including business management representatives and external risk management experts, as well as external data relevant to the risks being evaluated.

3.7.4 Operational Risk Monitoring and Reporting

The internal monitoring and reporting process ensures a consistent approach for providing pertinent information to senior management and the ARGC Committee for the quick detection and correction of deficiencies in the policies, processes and procedures for managing operational risk through ongoing, periodic reviews.

The objective of the reporting process is to ensure relevant information is provided to senior management and the Board to enable the proactive management of operational risk. The process ensures a consistent approach for providing information that enables appropriate decision making and action taking. The KRIs and incidents are reported by the operational risk unit.

3.7.5 Operational Risk Mitigation and Control

Control activities are necessary to address the specific operational risks that the Bank has identified through the RSCA process. For the material risks identified by the Bank, the Bank decides whether to use procedures to control, mitigate, transfer, or bear the risks.

The Group has several options for controlling and/or mitigating these risks:

- Decline to accept the risk (i.e. by avoiding certain business strategies/customers)
- Accept and retain the risk but introduce mitigating internal/external controls
- Accept the risk and transfer it in part/in whole.

Key controls

The Group aims to control the operational risks it is exposed to by strengthening its internal controls, continuing its efforts to identify, assess, measure and monitor its risks, evolving in its risk management sophistication and promoting a strong control culture within the Group.

Each business unit head is responsible for ensuring that the internal controls relevant to its operations are complied with on a day to day basis in spirit as well as in letter. The Group will furthermore establish control processes and procedures and implement a system for ensuring compliance with these internal risk control processes and procedures.

3.7.6 Business Continuity Plan and Disaster Recovery Plan

In 2010, the Bank completed its Business Continuity Plan (BCP) based on a Business Impact Analysis and risk review of the Bank's activities. An Information Technology Disaster Recovery site has also been completed and is fully operational whilst undergoing a testing phase. A primary business continuity site has been completed with the option to fit out two further sites should the need arise. The Bank will embark on a six month periodic testing of plans and procedures to ensure that the BCP process is current and effective.

3.7.7 Quantitative disclosures

Table – 15. Indicators of Operational Risk

OPERATIONAL RISK : QUANTITATIVE DISCLOSURES FOR BASIC INDICATOR APPROACH	
Indicators of Operational Risk (PD-1.3.30 (b) & (c))	
Particulars	Total
Gross Income (average)	51,684
Amount of non-Shari'a-compliant income	-
Number of Shari'a violations that were identified and reported during the financial year	-
Material legal contingencies including pending legal actions	-
Penalties amounting to BD 200 paid to the CBB due to failure of cleaning four erroneously open accounts in Bahrain Credit Reference Bureau	-

3.8 Equity Positions in the Banking Book

Equity price risk is the risk that the fair values of equities decrease as a result of changes in the levels of equity indices and the value of individual stocks. The equity price risk exposure arises from the Group's investment portfolio.

The accounting policies, including valuation methodologies and their related key assumptions, are disclosed in the consolidated financial statements. All of the Group's investments are for strategic long term holdings.

3.8.1 Quantitative disclosures

Table – 16. Total and Average Gross Exposures

EQUITY POSITION IN BANKING BOOK - DISCLOSURE REQUIREMENTS				
Total and Average Gross Exposure - (PD-1.3.31 (b) & (c))				
Type and Nature of Investment	Total Gross Exposure	* Average Gross Exposure	Publicly Traded	Privately held
Equity investments	319,233	309,416	-	319,233
Managed funds	34,642	15,824	-	34,642
Total	353,875	325,240	-	353,875

* Average exposure has been calculated using quarterly consolidated financial statements or PIRI forms submitted to CBB.

Table – 17. Break-up of Capital Requirement for Equity Groupings

EQUITY POSITION IN BANKING BOOK - DISCLOSURE REQUIREMENTS	
Capital Requirement - (PD-1.3.31 (f))	
Equity Grouping	Capital Requirement
Listed	-
Unlisted	125,850
Managed Funds	2,138
Total	127,988

Table – 18. Gain and Loss Reported

EQUITIES: DISCLOSURES FOR BANKING BOOK POSITIONS	
Gains / Losses Etc. (PD-1.3.31 (d) and (e))	
Particulars	Total
Total realised (losses) arising from sales or liquidations in the reporting period	(7,548)
Total unrealised gains (losses) recognised in statement of other comprehensive income	1,200
Unrealised gross (losses) included in Tier One Capital	(6,135)
Unrealised gains included in Tier Two Capital	-

3.9 Unrestricted Investment Accounts (“URIA”)

The Investment Account Holder (“IAH”) authorizes the Bank to invest the account holder’s funds on the basis of Mudaraba contract in a manner which the Bank deems appropriate without laying down any restrictions as to where, how and for what purpose the funds should be invested. Under this arrangement the Bank can commingle the IAH funds with its own funds (owner’s equity) and with other funds the Bank has the right to use (e.g. current accounts or any other funds which the Bank does not receive on the basis of Mudaraba contract). The IAH and the Bank participate in the returns on the invested funds.

The Bank has developed a Profit Sharing Investment (PSIA) policy which details the manner in which the URIA funds are deployed and the way the profits are calculated for the URIA holders. The strategic objectives of the investments of the IAH funds are:

- Investment in Shari’a compliant opportunities;
- Targeted returns;
- Compliance with investment policy and overall business plan;
- Diversified portfolio; and
- Preparation and reporting of periodic management information.

URIA holders’ funds are invested in short and medium term Murabaha, Sukuks and Ijarah Muntahia Bittamleek. The Bank invests these funds through various departments including Treasury, corporate, consumer, and debt capital markets. The experience of relevant department heads is mentioned in Section 4. No priority is granted to any party for the purpose of distribution of profits. According to the terms of acceptance of the URIA, 100% of the funds are invested after deductions of mandatory reserve and

sufficient operational cash requirements. URIA funds are invested and managed in accordance with Shari'a requirements. Income generated through invested funds is allocated proportionately between URIA holders and shareholders on the basis of the average balances outstanding and share of the funds invested. The Bank does not share income from fee based services with the URIA holders. Administrative expenses incurred by the Bank are allocated to the URIA holders in the proportion of average URIA funded assets to average total assets of the Bank. The process has not changed significantly from the past years.

The mudarib share on investment accounts ranges from 20% to 40% depending on the investment period and in case of saving accounts, where there is no restriction of cash withdrawal, the mudarib share ranges from 50% to 60%. However, during the year, in addition to investors' share of profit, the Bank has distributed profit to investors from its own share of mudarib share. There is no change in mudarib share from the year 2009.

The Bank has a Corporate Communications Department which is responsible for communicating new and/or extended products information through various channels of communication which may include publications, website, direct mailers, electronic mail and local media. The URIA products available to the customers can be classified broadly under two categories, 1) Term URIA and 2) Saving URIA. Term URIA are fixed term URIA having maturity of 1, 3, 6 and 12 months whereas Saving URIA can be withdrawn on demand. Detailed information about the features of various products offered by the Bank can be obtained from the website of the Bank, brochures at the branches, call centre and customer service representatives at the branches of the Bank. Branches of the Bank are the primary channel through which products are made available to the customers.

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 PSIA, when the return on assets is under performing as compared with competitors' rates. Fiduciary risk is the risk that arises from Bank's failure to perform in accordance with explicit and implicit standards applicable to their fiduciary responsibilities. Although KFHB will discourage subsidizing its URIA holders, the Bank may forgo a portion of its mudarib share from assets funded by PSIA and apportion its share to the IAH as part of smoothing returns and to mitigate potential withdrawal of funds by depositors.

Complete mudarib share or part thereof, based on the approval of ALCO of the Bank, can be waived to pay a competitive rate to URIA holders. There are no instances where the Bank, as Mudarib, has taken any share greater than the agreed/disclosed profit sharing ratio. There were instances where the Bank has forgone part of its profit to distribute that to the Bank's customers or investors

The rate of return payable to URIA holders is decided by ALCO, keeping in view the rate of return earned is from the portfolio financed by URIA. Major considerations while deciding the rate of return payable to URIA holders include rates offered by peer banks, cost of funds from various sources, liquidity position of the Bank and market interest rates (LIBOR etc). The bank does not use a fixed market benchmark rate for comparison to the returns paid to URIA holders.

In order to ensure smooth returns and to mitigate the potential withdrawal of funds by URIA Investors; the Bank can use Profit Equalisation Reserve (PER). Similarly Bank can use Investment Risk Reserve (IRR) to cater against future losses for URIA holders. The amount of PER and IRR as at 31 December 2010 and 2009 is Nil but the Bank may transfer amount into PER and IRR in future after prior notice to its customers.

3.9.1 Quantitative Disclosures

Table – 19. Break-up of URIA

UNRESTRICTED INVESTMENT ACCOUNTS:			
Unrestricted Investment Account (PD-1.3.33 (a) &(g))			
	Amount	Financing to Total URIA %	Ratio of Profit Distributed
Savings URIA	43,972	10%	7%
Term URIA	408,991	90%	93%
Total	452,963	100%	100%

Table – 20. Percentage of Return on Average URIA Assets

UNRESTRICTED INVESTMENT ACCOUNTS:	
Unrestricted Investment Account (PD-1.3.33 (d))	
	Percentage
Average profit paid on average URIA assets	2.87%
Average profit earned on average URIA assets	3.97%

Table – 21. Percentage of Mudarib share to Total URIA Profits

UNRESTRICTED INVESTMENT ACCOUNTS:			
Unrestricted Investment Account (PD-1.3.33 (f))			
	URIA Return Before Mudarib shares	Share of Profit Paid to Bank as Mudarib	Percentage
Mudarib share to total URIA profits	18,599	5,300	28.5%

Table – 22. Percentage of Islamic Financing Contracts Financed by URIA to Total URIA

UNRESTRICTED INVESTMENT ACCOUNTS:		
Unrestricted Investment Account (PD-1.3.33 (h))		
Shari'a-Compliant Contract	Financing	Financing to Total URIA %
Balances at banks	23,399	5.17%
Banks Murabaha	51,370	11.34%
Investments – Sukuk	53,672	11.85%
Murabaha	205,070	45.27%
Ijarah Muntahia Bittamleek	119,452	26.37%
Total	452,963	100.00%

Table – 23. Percentage of Counterparty Type Contracts Financed by URIA to Total URIA

UNRESTRICTED INVESTMENT ACCOUNTS:		
Unrestricted Investment Account (PD-1.3.33 (i))		
Counterparty Type	Financing	Financing to Total URIA %
Claims on sovereigns	27,352	6.04%
Claims on banks	62,304	13.75%
Claims on corporate	130,500	28.81%
Regulatory retail portfolio	25,169	5.56%
Mortgage	166,963	36.86%
Holding of real estate	28,690	6.33%
Others	11,985	2.65%
Total	452,963	100.00%

Table – 24. Percentage of Profit Paid to URIA Holders to Total URIA Investment

UNRESTRICTED INVESTMENT ACCOUNTS:			
Unrestricted Investment Account (PD-1.3.33 (l) (m) & (n))			
	Share of Profit Paid to IAH Before Transfer To/From Reserves %	Share of Profit Paid to IAH After Transfer To/From Reserves %	Share of Profit Paid, as a % of Funds Invested, to Bank as Mudarib %
URIA	2.87%	2.87%	1.10%

Table – 25. Range of Declared Rate of Return

UNRESTRICTED INVESTMENT ACCOUNTS:				
Unrestricted Investment Account (PD-1.3.33 (q))				
	1-Month	3-Month	6-Month	12-Month
Declared rate of return for Investments accounts denominated in USD and BHD.	2.80% - 3.50%	3.40% - 4.00%	3.60% - 4.50%	4.20% - 5.00%

Table – 26. Movement of URIA by Type of Assets

UNRESTRICTED INVESTMENT ACCOUNTS:			
Unrestricted Investment Account (PD-1.3.33 (r) & (s))			
Type of Assets	Opening Actual Allocation as at 01 July 2010	Net Movement During the Period	Closing Actual Allocation as at 31 Dec 2010
Cash and Balance with banks and CBB	27,412	(4,013)	23,399
Murabaha due from banks	43,406	7,964	51,370
Investments – Sukuk	51,121	2,551	53,672
Murabaha due from customers	183,000	22,070	205,070
Ijarah Muntahia Bittamleek due from customers	140,398	(20,946)	119,452
Total	445,337	7,626	452,963

Note: There are no limits imposed on the amount that can be invested by URIA funds in any one asset. However, the bank monitors its URIA deployment classifications so that to ensure that URIA funds are not invested in the bank's long term Investment Portfolio (including Private Equity and Real Estate).

Table – 27. Capital Charge on URIA by Type of Claims

UNRESTRICTED INVESTMENT ACCOUNTS:			
Unrestricted Investment Account (PD-1.3.33 (v))			
Type of Claims	Amount	RWA for Capital Adequacy Purposes	Capital Charge
Cash items	2,816	-	-
Claims on sovereign	27,352	-	-
Claims on MDBs	985	-	-
Claims on banks	62,304	15,213	570
Claims on corporate	130,500	123,924	4,647
Regulatory retail portfolio	25,169	18,877	708
Mortgages	166,963	44,953	1,686
Claims in holdings of Real Estate	28,690	57,380	2,152
Other assets	8,184	8,184	307
Total	452,963	268,531	10,070

Table – 28. Percentage of Profit Earned and Profit Paid to Total URIA Funds

UNRESTRICTED INVESTMENT ACCOUNTS:					
Unrestricted Investment Account (PD-1.3.33 (w))					
	** URIA Funds (Average)	Profit Earned ***	Profit Earned as a percentage of funds invested	Profit paid	# Profit paid as a percentage of funds invested (after smoothing)
2010	480,308	19,104	3.97%	13,804	2.87%
2009	503,207	25,045	4.98%	20,817	4.14%
2008	211,917	10,862	5.13%	9,865	4.66%
2007	78,055	1,807	2.32%	1,662	2.13%
2006	*	*	*	*	*

* Data not available

** Average assets funded by URIA have been calculated using monthly consolidated management accounts.

*** This is the rate of return gross of mudarib share which ranges from 20% to 40% for term URIA, depending on the investment period of the Investment, and from 50% to 60% for saving URIA.

During the year the Bank waived its mudarib share resulting in higher return paid to URIA holders by 18% (2009: 22%)

Table – 29. Administrative Expenses Allocated to URIA

UNRESTRICTED INVESTMENT ACCOUNTS:	
Unrestricted Investment Account (PD-1.3.33 (x))	
Unrestricted IAH	Amount
Amount of administrative expenses charged to URIA	7,559

3.10 Restricted Investment Accounts (“RIA”)

Under RIA, the IAH has authorized the Bank to invest the funds on the basis of Mudaraba contract for investments, but imposes certain restrictions as to where, how and for what purpose this funds are to be invested. Further, the Bank may be restricted from commingling its own funds with the RIA funds for purposes of investment. In addition, there may be other restrictions which IAH may impose. RIA funds are invested and managed in accordance with Shari’a requirements. The funds are managed by the Bank under fiduciary capacity as per the instructions of the RIA holder and accordingly the Bank is not liable to make good any losses occurred due to normal commercial reasons.

The Bank has developed the PSIA policy, approved by the Board, which details the manner in which the RIA funds are deployed and the way the profits are calculated for the RIA.

The Bank as fund manager (mudarib) carries out its fiduciary duties and administers the scheme in a proper, diligent and efficient manner, in accordance with the Shari’a principles and applicable laws and relevant rules and guidelines issued by the CBB.

The Bank has appropriate procedures and controls in place which commensurate with the size of its portfolio which includes:

- a) Organising its internal affairs in a responsible manner, ensuring it has appropriate internal controls and risk management systems and procedures and controls designed to mitigate and manage such risk;
- b) Observing high standards of integrity and fair dealing in managing the scheme to the best interest of its investors; and
- c) Ensuring that the Bank has the requisite level of knowledge and experience for the tasks that is undertaken and is competent for the work undertaken.

RIA products are made available to the customers through Priority Banking and Investment Placement Department. Detailed product information about various RIA products is available in the respective RIA information pack. The bank has undertaken RIA for the real estate projects. The detailed risks are disclosed in the respective RIA information pack for the investors to make informed decision. Such disclosure includes the disclosure on participation risks, default risks, investment risks and exchange rate risks.

The participation risk factors elaborate the range and measures of risks faced by the RIA holders. It mentions that the entities in which the RIA funds are deployed may not be generating enough operating cash flows and these could be operating at loss. These entities may face difficulties in obtaining financing facilities from external debt providers. Due to the early or turnaround stage of the business, the cash flows of these entities can be projected only to a limited degree of reliability and can experience significant fluctuations. As a result of this, it is possible that those entities may default on meeting their financial commitments as they fall due thus resulting in an event of default to the investor. The facilities are usually extended on an unsecured basis and thus there are no assets to resort to in case of a default except for the underlying businesses. If the corporate entity fails to fulfil its obligations under the transaction



documents, the Bank may not be able to liquidate RIA holder's capital or pay their share of profit on the expiry of the participation term. The risk of capital loss will be borne by the RIA Investor and not KFH. Investors must agree and acknowledge that they shall share in all losses incurred by the pooled funds in proportion to the capital they placed in the restricted Mudaraba account. The capital structure of these entities can be subject to changes due to the need for raising new capital for the underlying businesses. This could result in subordination of RIA investment within the overall debt structure of the entity. Depending on the level of seniority of the debt default risk may be higher.

3.10.1 Quantitative Disclosures

Table – 30. History of Profit Paid to RIA Holders

RESTRICTED INVESTMENT ACCOUNTS:						
Restricted Investment Account (PD-1.3.35 (a) & (b))						
	2010	2009	2008	2007	2006	2005
Return to RIA holders	5,440	4,191	3,852	2,122	944	N/A

Table – 31. Break-up of RIA by Type of Deposits

RESTRICTED INVESTMENT ACCOUNTS:	
Restricted Investment Account (PD-1.3.33 (a))	
	Amount
RIA funds	87,031

Table – 32. Percentage of Profit Paid to RIA Holders to RIA Assets

RESTRICTED INVESTMENT ACCOUNTS:	
Restricted Investment Account (PD-1.3.33 (d))	
	Percentage
Return on average* RIA assets	6.23%

* Average RIA funds have been calculated using consolidated management accounts.

Table – 33. Mudarib share as a Percentage of Total RIA Profits

RESTRICTED INVESTMENT ACCOUNTS:	
Restricted Investment Account (PD-1.3.33 (f))	
	Percentage
Mudarib share to total (gross) RIA profits	7.87%

Table – 34. Share of Islamic Financing Contracts in Total RIA Financing

RESTRICTED INVESTMENT ACCOUNTS:		
Restricted Investment Account (PD-1.3.33 (h))		
Shari'a-Compliant Contract	Financing	Financing to Total Financing %
Murabaha	84,584	97.19%
Ijarah Muntahia Bittamleek	2,447	2.81%
Total	87,031	100.00%

Table – 35. Percentage of Counterparty Type Contracts Financed by RIA to Total RIA

RESTRICTED INVESTMENT ACCOUNTS:		
Restricted Investment Account (PD-1.3.33 (i))		
Counterparty Type	Financing	Financing to Total Financing %
Claims on corporate	87,031	100.00%

Table – 36. Share of Profit Paid to RIA Holders as a Percentage of Total RIA

RESTRICTED INVESTMENT ACCOUNTS:						
Restricted Investment Account (PD-1.3.33 (l) (m) (n) & (o))						
Type of RIA	Total RIA	RIA Return Before Mudarib shares	RIA Return after Mudarib shares	Share of Profit Paid to Bank as Mudarib	Share of Profit Paid to IAH Before Transfer to / from Reserves %	Share of Profit Paid to IAH after Transfer to / from Reserves %
	A	B	C	D	E = C / A	F = C / A
Murabaha	84,584	5,533	5,156	377	6.10%	6.10%
Ijarah Muntahia Bittamleek	2,447	372	284	88	11.61%	11.61%
Total	87,031	5,905	5,440	465	6.25%	6.25%

Table – 37. Average Declared Rate of Return of RIA

RESTRICTED INVESTMENT ACCOUNTS:				
Restricted Investment Account (PD-1.3.33 (q))				
	3-Month	6-Month	12-Month	24-Month
Declared rate of return	7.00%	6.00% - 6.50%	6.50%	7.50%

Table – 38. Treatment of Assets Financed by RIA in the Calculation of RWA for Capital Adequacy Purposes

RESTRICTED INVESTMENT ACCOUNTS:		
Restricted Investment Account (PD-1.3.33 (v))		
Type of IAH	Exposure	Risk Weighted Amount While Calculating CAR
Murabaha	84,584	-
Ijarah Muntahia Bittamleek	2,447	-
Total	87,031	-

Table – 39. Profit Earned and Profit Paid as a Percentage of Total RIA Funds

RESTRICTED INVESTMENT ACCOUNTS:					
Restricted Investment Account (PD-1.3.33 (w))					
	* RIA Funds (Average)	Profit Earned	Profit Earned as a Percentage of RIA Funds	Profit Paid	Profit Paid as a Percentage of RIA Funds
2010	87,277	5,905	6.77%	5,440	6.23%
2009	71,272	4,481	6.29%	4,191	5.88%
2008	71,729	4,839	6.75%	3,852	5.37%
2007	28,475	2,739	9.62%	2,122	7.45%
2006	14,913	1,258	8.44%	944	6.33%

* Average RIA funds have been calculated using consolidated management accounts.

3.11 Liquidity Risk

3.11.1 Introduction

Liquidity risk is the risk that the Group does not have sufficient financial resources to meet its obligations as they fall due, or will have to do so at an excessive cost. This risk arises from mismatches in the timing of cash flows.

Funding risk arises when the necessary liquidity to fund illiquid asset positions cannot be obtained at the expected terms and when required.

To control this risk, management has taken various measures including but not limited to arrangement of diversified funding sources in addition to its core deposit base, management of assets with liquidity in mind, and monitoring of future cash flows and liquidity gaps and needs on a daily basis.

This incorporates an assessment of expected cash flows and gaps and the availability of high grade collateral which could be used to secure additional funding if required.

The Group maintains a portfolio of highly marketable and diverse assets that can be easily liquidated in the event of an unforeseen interruption of cash flow. The Bank also has lines of credit that provide it with access to funds to meet liquidity needs. In addition, the Bank maintains a statutory deposit with the CBB equal to 5% of customer deposit denominated in Bahraini Dinar.

The liquidity position is assessed and managed under a variety of scenarios, giving due consideration to stress factors relating to both the market in general and specifically to the Bank.

The Group maintains liquid assets to counter liquidity issues. The short–and long–term liquid assets of the Group, are listed below:

- Current account and reserves with the CBB
- Cash–in–hand and held with other financial institutions in nostro accounts
- Short–term Murabaha placements with financial institutions
- Investments in marketable sukuks and equities
- Maturing investments and financing



3.11.2 Sources of liquidity risk

Liquidity risk may arise and materialise in the following ways:

- Contractual mismatch between the cash flows of assets and liabilities
- Insufficient diversification of funding sources or concentration of funding sources
- Operating in different currencies, which creates cross currency funding and liquidity risk
- Unexpected withdrawal of funds by depositors
- Non-performance or late payment by customers
- Name issue, credit down grade or adverse publicity may result in mass movements of deposits to other banks
- Default of entities who are large borrowers and whose shares are held as collateral
- Unexpected funding required for off-balance sheet items, such as payments to beneficiaries under letters of credit that have been defaulted by customers
- Fall in income when the profit earned from assets are lower than the profit paid on liabilities and the profit rates revise downwards
- Loss of confidence in the banking system

3.11.3 Liquidity Risk Strategy

The Board is responsible for approving and reviewing (at least annually) the liquidity risk strategy and significant amendments to the liquidity risk policies. The Bank's senior management is responsible for implementing the liquidity risk strategy approved by the Board to identify measure, monitor and control the risks faced by the Bank.

The Bank monitors the liquidity positions and gaps by comparing maturing assets and liabilities in different time buckets of up to 1 month, 1–3 months, 3–6 months, 6 months to 1 year and 1 year and above. As a strategy the Bank maintains a large customer base and good customer relationships.

The Bank has established a liquidity contingency plan to meet urgent liquidity requirements in stressed conditions that addresses how funding liquidity would be managed if either their specific financial conditions were to decline or broader conditions created a liquidity problem. The plan is reviewed and updated regularly. The plan is also tested periodically.

The Bank has also created a policy for its subsidiaries to report the liquidity needs arising from their activities via the investment team.

The Treasury Department, in conjunction with RMD periodically reviews/updates the liquidity risk strategy which is approved by ALCO and the Board.

3.11.4 Liquidity Risk Measurement Tools

The methods used by the Bank for measuring liquidity risk are:

Static gap analysis

Gap analysis refers to the maturity gap between assets and liabilities. Static gap analysis refers to the gap analysis of the current assets and liabilities of the Bank. The gap analysis involves measuring the gap between assets and liabilities maturing within a single time bucket and cumulatively over several buckets. This analysis is conducted on a stress and business as usual scenario.

These time buckets are set by Board, on recommendation of RMD within an oversight from the ALCO and ARGC Committee. The buckets are in line with the nature of the markets the Bank operates in and the Bank's own risk appetite. For the purpose of analysis, the Bank also conducts core and non-core analysis for non maturing analysis using statistical methods. The results are approved by ALCO.

Dynamic gap analysis

Dynamic gap analysis refers to the gap analysis for the forecasted statement of financial position of the Bank. The statement of financial position is forecasted based on the current statement of financial position and estimates of the assets and liabilities positions from the various business heads and the Treasurer. The business heads provide the RMD with forecasts for their department's assets and liabilities. The analysis is done on a Bank wide level and on an individual currency basis for the major foreign currencies.

Liquidity Ratios

A number of liquidity ratios are monitored for assessing the risk exposures arising out of various sources of funding including the effect of concentration of particular sources. These ratios act as indicators to measure a Bank's ability to meet its liquidity needs under business as usual and stressed market conditions. Some of the ratios which the Bank monitors are the Liquid assets to Customer deposit ratio, URIA Deployment matrix, Financing to Customer deposits ratio, FX funding Ratio and Deposit Concentration ratio.

Limits

The limits are in line with the overall liquidity risk management strategy approved by the Board. The breach of the limits is reported to the Board. The Bank monitors the limits on the liquidity gaps in various tenor buckets and on the ratios.

Stress Tests

On a monthly basis, the Bank conducts stress tests on its liquidity profile. The institution specific and market wide stress tests are conducted. The gaps are created under stress conditions to understand the liquidity needs in case of stress situations.

3.12 Profit Rate Risk

3.12.1 Introduction

Profit rate risk is the potential impact of the mismatch between the rate of return on assets and the expected rate of funding due to the sources of finance. Profit rate risk arises from the possibility that changes in profit rates will affect future profitability or the fair values of financial instruments.

The Bank has established a Profit Rate Risk Management strategy and policy and manages the profit rate risk accordingly.

The profit rate risk in the Bank may arise due to the following transactions:

- a) Murabaha transactions;
- b) Mudaraba transactions;
- c) Ijarah Muntahia Bittamleek; and
- d) Sukuks.

3.12.2 Sources of Profit Rate Risk

The different profit rate risks faced by the Group can be classified broadly into the following categories:

Maturity mismatch

The non-alignment of maturities/re-pricing dates of assets and liabilities give rise to profit rate risk. In the case of fixed profit rates, maturities are considered whereas for floating or variable profit rates the re-pricing/rollover dates are considered.

Basis value risk

Assets and liabilities with similar maturities / re-pricing dates and highly, though imperfectly, correlated profit rate benchmarks (USD–LIBOR and BIBOR) are exposed to basis risk.

Profit rate curve risk

Changes to the values, slope and shape of the profit rate curve that impact the assets and liabilities of the Group in a dissimilar manner give rise to profit rate risk.

Risk of counterparty's options underlying assets

The availability of options, with the Group's counterparties, to make prepayments or early withdrawals can leave the Group with excess or deficit funds that need to be invested or funded again at unknown profit rates. This imposes a profit rate risk on the Group.



3.12.3 Profit Rate Risk Strategy

The Bank's Board is responsible for approving and reviewing (at least annually) the profit rate risk strategy and significant amendments to the profit rate risk policies. The Bank senior management is responsible for implementing the profit rate risk strategy approved by the Board to identify, measure, monitor and control the risks faced by the Bank.

The Bank's strategy includes taking the following steps:

- Identify and document the profit rate risk sensitive products and exposures it wishes to engage in;
- Strive to reduce the maturity / re-pricing mismatch between assets and liabilities on its statement of financial position;
- Abstain from entering into fixed price assets / liabilities with unusually long tenure / maturity e.g., Murabaha contracts of more than 5 years etc;
- Reduce the reliance on short term inter-bank borrowings to avoid short term earnings pressure. The Bank will strive to reduce the proportion of inter-bank liabilities as a percentage of total liabilities;
- Periodically review the profit rates offered on savings, VIP savings, Investment accounts and VIP Murabaha keeping in view the profit rates offered by competitors, cost of funds, market conditions etc;
- Establish a limit structure to quantify its overall profit rate risk tolerance. These limits will be monitored on a periodic basis and any exceptions to the limits will be immediately dealt with;
- Strive to maintain a minimum spread between cost of funding and profit generated from assets while simultaneously ensuring the liquidity mismatch does not exceed a certain threshold for a maturity bucket;
- Periodically review the changes in major market rates (Fed rates, LIBOR, BIBOR) and anticipated trends and their potential impact on expected rate of return on their liabilities;
- If needed, the Bank may take a natural hedge on its rate sensitive assets by raising liabilities having similar re-pricing profile;
- Conduct periodic stress tests to assess the effect of extreme movements in profit rates for all major currencies which may expose the Bank to high risks; and
- At all times, the Bank will ensure that it follows the overall profit rate risk strategy while taking any new profit rate risk exposures.

3.12.4 Profit Rate Risk Measurement Tools

The Bank is in the stage of implementing and will adopt the following methods to quantify profit rate risk in the banking book.

Re-pricing gap analysis

As part of the re-pricing gap analysis, the Bank defines certain assumptions based on the re-pricing date and profit rate sensitivity for allocating each instrument/position to a given time bucket. The periodic gap compares Rate Sensitive Assets (RSAs) with Rate Sensitive Liabilities (RSLs) across each single time bucket while the cumulative gap compares RSAs with RSLs over all time buckets from the present day through the last day in each successive time bucket. This is done for each major currency the Bank operates in. A positive gap indicates that if reference rates fall, net income will be adversely affected.

Economic value of equity (EVE)

The EVE measures the change in the Bank's market value of equity resulting from upward and/or downward movements in the yield curve. The Bank uses the analysis to measure the impact on its equity that could occur due to the yield curve movements, at a particular point of time.

Earnings-at-Risk (EaR)

Earnings-at-risk will measure the loss in earnings resulting from upward and/or downward movements in the yield curve. The Bank will use the analysis to evaluate the profit rate risk exposure of the banking book over a particular time horizon and calculate the potential impact on earnings over the specified horizon. The Bank is planning to implement this measure in 2011.

Limits

The Board specified the limits on the re-pricing gaps. The reports are regularly monitored.

Stress Testing

The Bank conducts the stress tests on the re-pricing gaps and economic value of the equity by shocking the yield curves by various amounts such as 50 basis points, 100 basis points and 200 basis points.

3.12.5 Profit Rate Risk Monitoring and Reporting

The Bank is monitoring the profit rate through the Focus ALM system implemented by the Bank. The report is then presented to ALCO and the Board to review the results of gap limits and exceptions, if any, and recommend corrective actions to be taken.

3.12.6 Quantitative Disclosures

Table – 40. Profit Rate Shock

PROFIT RATE RISK IN THE BANKING BOOK			
200bp Profit Rate Shocks (PD-1.3.40 (b)) Total			
Assets	Amount	Change in Basis Points	Effect on Net Income for the Year
Murabaha due from banks	51,370	200	1,027
Financing contracts with customers	232,991	200	4,660
Investments – Sukuk	53,672	200	1,073
Liabilities			
Murabaha and due to Banks	246,406	200	(4,928)
Murabaha contracts with non-banks	187,785	200	(3,756)
Subordinated Murabaha payable	99,423	200	(1,988)
Unrestricted investments accounts	452,963	200	(9,059)
		Total	(12,971)

3.13 Financial Performance and Position

Table – 41. Ratios

Financial Performance and Position					
(PD-1.3.9(b))					
Quantitative Indicator	2010	2009	2008	2007	2006
Return on average equity	2%	1%	15%	26%	27%
Return on average assets	0.5%	0.2%	4%	6%	6%
Staff cost to net operating income ratio	28%	31%	15%	15%	17%

Formula is as follows:

ROAE = Net Income/average equity

ROAA= Net profit/ average Assets

4 Corporate Governance and Transparency

The Bank is committed to adopting the highest international standards and global best practices in corporate governance. The Bank has established a strong corporate governance framework that is designed to protect the interests of all stakeholders, ensure compliance with regulatory requirements, and enhance organisational efficiency.

The Bank has established a robust organisational structure that clearly segregates functions and responsibilities, and reflects a division of roles and responsibilities of the Board of Directors and Management. Clear mandates exist for the Board, Chairman of the Board, Board Committees, Managing Director and Chief Executive Officer, the Management, and Senior Management Committees.

Responsibilities

The Board of Directors is accountable to the shareholders for the creation and delivery of strong and sustainable financial performance and long-term sustainable shareholder value by providing effective governance over the Bank's affairs. It determines the strategic objectives and policies of the Bank to deliver such long term value, providing overall strategic direction to the Bank within a framework of rewards, incentives and controls. Detailed responsibilities of the Board are provided in KFH-Bahrain's Articles of Associations.

The Chairman is responsible for leading the Board, ensuring its effectiveness, monitoring the performance of the Executive Management, and maintaining a dialogue with the Bank's shareholders.

The Board currently has three committees: the Audit Risk Governance & Compliance Committee; the Executive Committee and the Nomination and Remuneration Committee. Each committee has specific terms of references that define its scope and powers. Detailed responsibilities of the Board and its committees are provided in the Bank's Corporate Governance Charter.

The remuneration/incentive structure of the Managing Director and the Chief Executive Officer, Board Members and Shari'a Members is discussed at the Board level. Remuneration of the Managing Director and the Chief Executive Officer and Board Members is approved in the AGM. For all Bank staff there is a fixed bonus and a performance bonus scheme. Performance bonus is based on staff performance and recommendation of respective departmental heads. The Board approves all fixed and performance bonus schemes for staff.

Corporate Governance Charter

The Bank has developed a Corporate Governance Charter that provides the basis for promoting high standards of corporate governance in the Bank. It sets out high level guidelines and lays the foundation for the overall corporate governance system in the Bank. It outlines the key elements of an effective corporate governance framework and describes the roles and responsibilities of the Board of Directors which outlines the role of the Board in its review, approval and monitoring of the Bank's strategy and financial performance within a framework of sound corporate governance. It also contains the terms of references for all the Board and Senior Management Committees.

Board of Directors

The Bank's Board comprises of six directors, including the Chairman of the Board and the Managing Director ("MD") and the Chief Executive Officer ("CEO"). The Board will periodically assess its composition and size, and where appropriate re-constitute itself and its committees. While deciding upon the composition of the Board, the Bank will ensure compliance with the requirements of the High Level Controls Module, Volume 2 issued by the CBB.

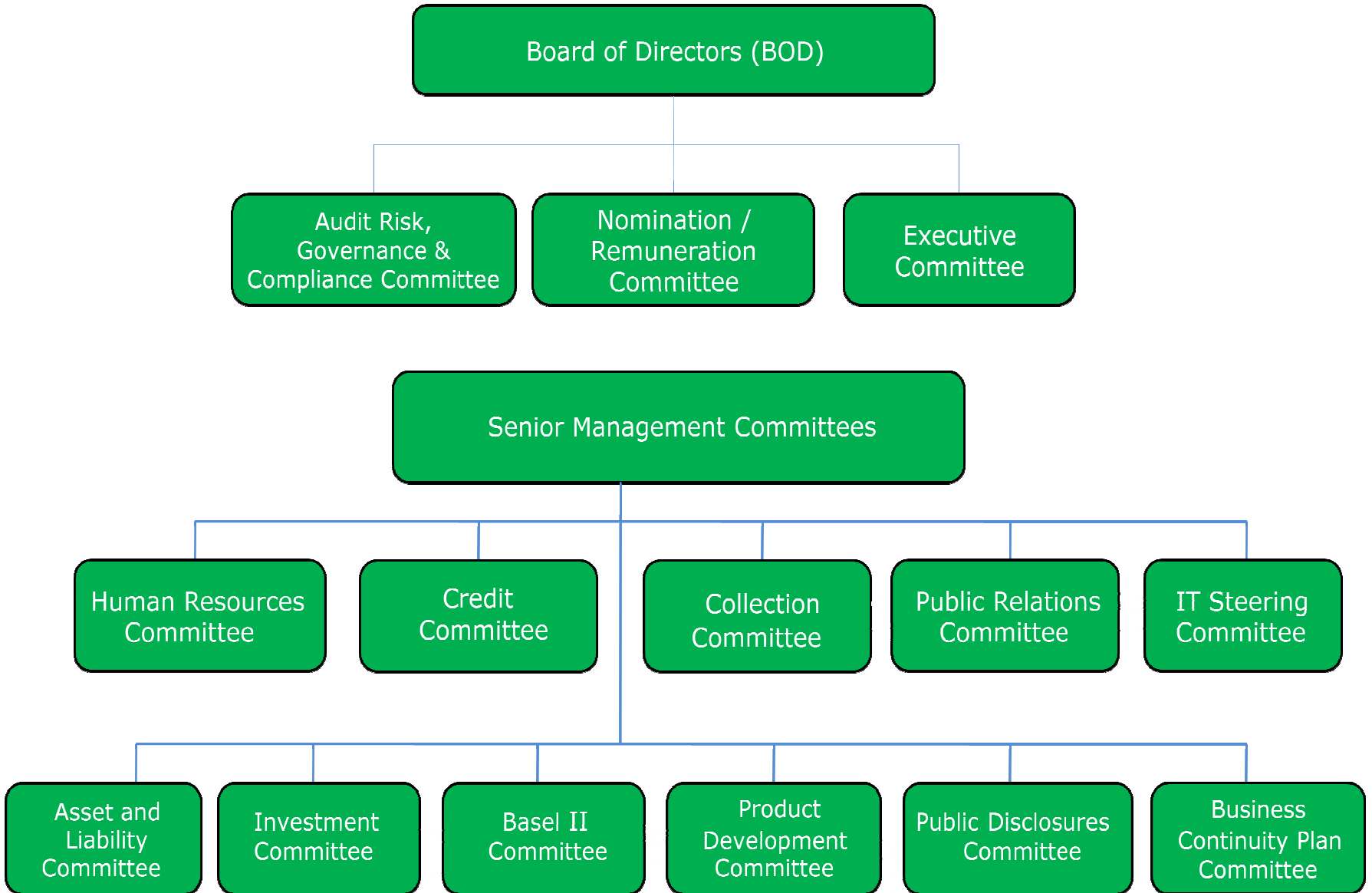
All the Directors of the Bank are adequately qualified in order to carry out the Bank's activities efficiently and effectively. The levels of qualifications required shall be consistent to those outlined under the articles provided in the Bahrain Commercial Companies Law and the CBB. Furthermore, the Bank will constantly review the qualification requirements and take necessary actions in order to fulfil them.

Table – 42. Corporate Governance

Corporate Governance and Transparency					
(PD-1.3.10(b))					
Name of Board Member	Independency	Profession	Business Title	Experience in Years	Qualification
Bader A.M. Mukhaizeem (Chairman)	Independent Non Executive	Banker	Chairman KFH – Bahrain	More than 30 years	Bachelors in Commerce
Mohammed bin Sh. Eshaq (Deputy Chairman)	Independent Non Executive	Business	Businessman	More than 30 years	Bachelors in Economics
Mohammed Sulaiman Al Omar	Non-Independent Executive	Banker	CEO – KFH Kuwait	More than 20 years	Bachelors in Business Administration
Yaqoob Yousaf Majeed	Independent Non Executive	Govt. Sector	Consultant – GOSI	More than 30 years	Done various professional courses
Adel Ahmed Al Banwan	Non-Independent Executive	Banker	Direct Investments Manager – KFH Kuwait	More than 14 years	Master of Business Administration
Abdulhakeem Y. Alkhayyat	Non-Independent Executive	Banker	MD and CEO KFH Bahrain	More than 17 years	CPA , BBA and Bachelors in Accounting

The Board is responsible for the overall conduct of the Bank's affairs and for filling the information gap between the shareholders and the more informed executive management. This is done by closely monitoring the management on behalf of the stakeholders of the Bank on an on-going basis.

In order to perform its duties more efficiently (i.e. to ensure that an adequate, effective, comprehensive and transparent corporate governance process is in place), the Board and senior management have set up committees with specific responsibilities. These committees meet regularly and maintain adequate minutes to facilitate the Board carrying out its oversight responsibilities. Although the Board has delegated some of its responsibilities to specialised Board level committees, the individual directors of the Board will be accountable for the responsibilities as stated in the Bank's Corporate Governance Charter. The diagram below represents the various Board and senior management committees of the Bank. There was no change in the year 2010 in the Board structure, the Board committees and the senior management committees from the year 2009.

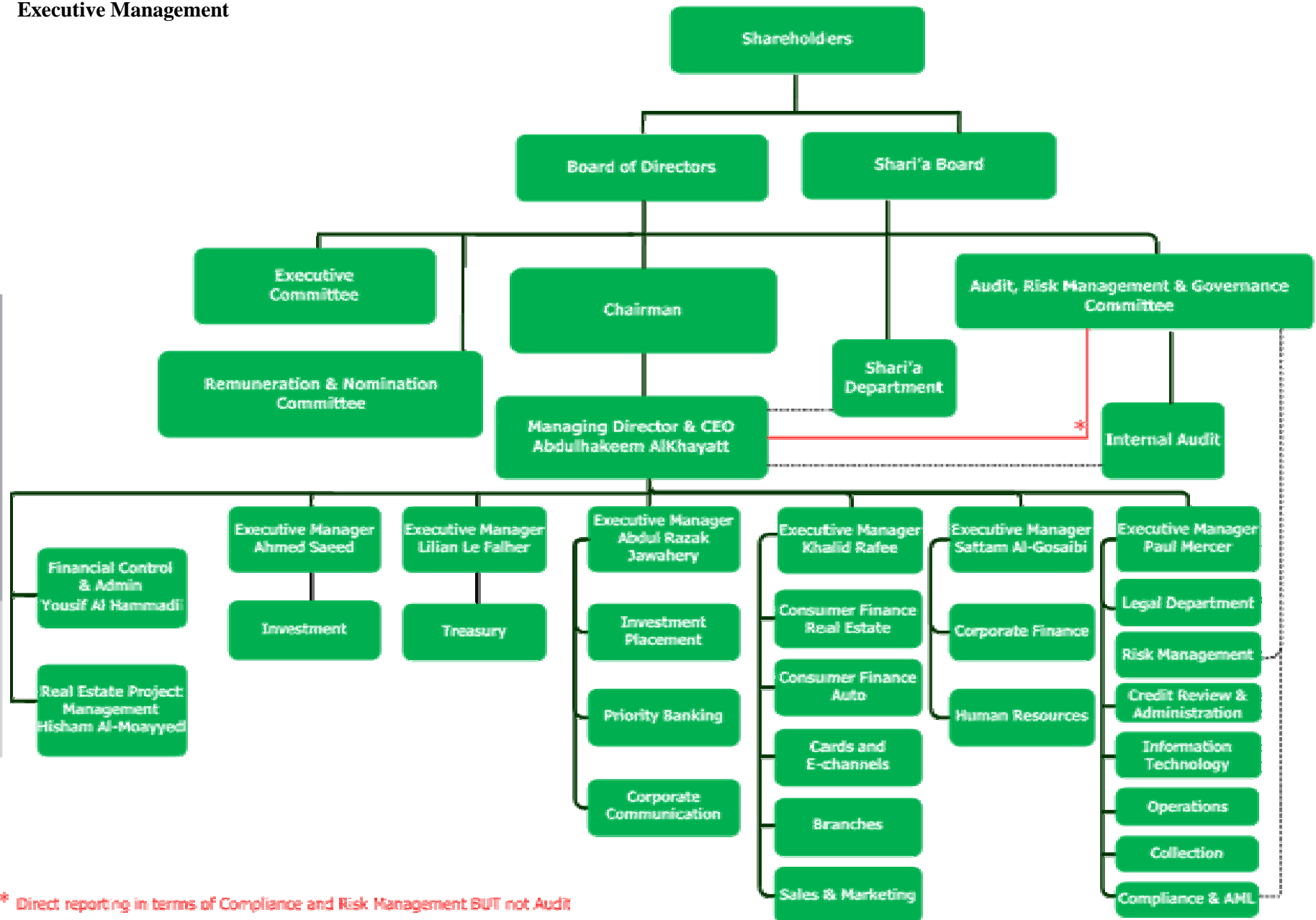


Board committees with their respective objectives and members are as follows:

Board Committee	Membership	Objective
Executive Committee	<ol style="list-style-type: none"> 1. Bader A.M. Mukhaizeem 2. Mohammed bin Sh. Eshaq 3. Abdulhakeem Y. Alkhayyat 	<p>Role of this committee is to develop the strategy of the Bank, for the Board; and to guide, monitor, co-ordinate the management and the performance in line with the strategy, business plan and budget approved by the Board. The Committee assists the Board in maintaining oversight of financing requirements including raising capital and investment management, asset liability management and other financial matters. The committee is also responsible for assisting the Board in maintaining oversight of the Bank's internal controls, risk management and overall control environment.</p>
Audit, Risk, Governance and Compliance Committee	<ol style="list-style-type: none"> 1. Mohammed Sulaiman Al Omar 2. Adel Ahmed Al Banwan 3. Yaqoob Yousaf Majeed 4. Abdulhakeem Al Adhami 	<p>The Committee was established as an oversight committee to ensure the Bank complies with the requirements of the CBB and the Basel Committee of the Bank of International Settlements ("BIS"), and in particular in one of the working papers published by Basel Committee "Internal Audit in banks and the relationship between the auditors and the regulators" that was issued in August 2001 and the Internal Audit Institute Standards for the Professional Practice on Internal Auditing. The Committee assists the Board in carrying out its responsibilities with respect to assessing the quality and integrity of financial reporting, the audit thereof, the soundness of the internal controls of the Bank, the measurement system of risk assessment and relating these to the Bank's capital, and the methods for monitoring compliance with laws, regulations and supervisory and internal policies and procedures. It also has the overall responsibility for the development of the risk strategy and implementing principles, frameworks, policies and limits and manages and monitors relevant risk decisions.</p>
Nomination and Remuneration Committee	<ol style="list-style-type: none"> 1. Bader A.M. Mukhaizeem 2. Mohammed Sulaiman Al Omar 3. Abdulhakeem Y. Alkhayyat 	<p>The primary objective of the NRC is to assist the Board in providing a formal and transparent procedure and in identifying and nominating individuals qualified to serve as Board, CEO and Sub-committee members as well as the assessment of effectiveness of individual Directors and the CEO. In addition, recommend the remuneration and rewards policy for the CEO and for the accomplishments he has achieved for the bank.</p>

Executive Management

www.kfh.bh



* Direct reporting in terms of Compliance and Risk Management BUT not Audit

(PD-1.3.10(b))				
Name	Business Title	Experience in Years	Qualification	Duties and Responsibilities
Abdul Razak Jawahery	Executive Manager	More than 20 years	BBA, MBA	Executive Manager Investment Placement, Priority Banking and Corporate Communication: Manage the Investment Placement, Priority Banking and Corporate Communication activities of the bank; as well as developing and managing the implementation of their strategies.
Ahmed Saeed	Executive Manager	More than 14 years	Chartered Accountant	Executive Manager Investment: Establish and execute overall strategies, financial and operational direction for Investment Department in a manner, which ensures that the desired financial and non-financial targets of the bank's direct investments are met.
Hisham Almoayyed	Senior Manager	More than 30 years	BSC (Civil Engineering), MSc (Structural Engineering)	Identify real estate investment opportunities, provide internal consultancy and manage real estate projects.
Isa Duwaishan	Shari'a Advisor	More than 21 years	(BACC) Bachelors of Accounting, (MIB) Masters of Islamic Banking, (CSAA) Certified Shari'a Adviser and Auditor, Holder of the Riwayat Hafs an Assem and Legal Accountant certificate ACBA	<ul style="list-style-type: none"> ▪ Ongoing reviews of the Bank's transactions, products and services to ensure that they are compliant with current Islamic Banking methods. ▪ The development of innovative solutions for the introduction of new Shari'a compliant products, services and financing mechanisms. ▪ Working closely with Management and staff to ensure awareness of relevant Shari'a issues and correct implementations.

(PD-1.3.10(b))				
Name	Business Title	Experience in Years	Qualification	Duties and Responsibilities
Khaled Al Maarafi	Executive Manager	More than 30 years	Diploma in Basic Supervision, Diploma in Accounting, Associate Diploma in Accounting, BSC in Accounting, CPA	Executive Manager Banking Group: Develop and execute the operational and financial strategy of the Banking Group in a manner, which ensures the achievement of financial and non-financial targets by all Branches , Consumer Finance , Sales & Marketing , and Cards Departments
Lilian Le Falher	Executive Manager	More than 14 years	Masters in Management (Banking and Finance), CFA Charter holder	Executive Manager Treasury, Financial Institutions and Debt Capital Markets: Manage the bank's liquidity and interbank and Financial Institutions relationships, recommend and execute strategies pertaining to his area in a manner which ensure that the desired financial targets are met
Paul Mercer	Executive Manager	More than 15 years	BA (Law), MA (Law), Postgraduate Diploma (Law), Officer of the Supreme Court of England and Wales	Executive Manager Support Group: Recommend, get the consensus on the strategic objectives of the Support Services Group and deliver the desired financial and non-financial objectives of the Group. The following departments report to him: <ul style="list-style-type: none"> - Legal Department - Risk management - Credit Review & Administration - Information Technology - Operations - Compliance & AML - Collection
Sattam Algozaibi	Executive Manager	More than 13 years	Bachelor of Science and MBA	Executive Manager Corporate Finance & HR: Manage the Corporate Finance and Human Resources Departments activities, develop and manage the implementation of their strategies.
Yousif Al Hammadi	Senior Manager	More than 20 years	MBA	Manage the Financial Control & Administration Department in accordance with the Bank regulations.

Raed Ajawi	Head of Internal Audit	More than 10 years	BSC in Accounting, Certified Public Accountant (CPA), Certified Sharia Advisor and Auditor (CSAA).	Provide independent appraisal of all the activities of KFHB, advising and recommendation to the management of KFHB's aiming to add value, improve operational efficiency, risk management and internal control systems through examining and evaluating KFHB's framework of risk management, controls and governance process.
Alya AlShakhoory	Compliance Officer & MLRO	More than 8 years	Bachelor in Chemical Engineering, Certified Anti Money Specialist (CAMS), Master Compliance Professional.	Ensures the implementation of appropriate Compliance and AML Frameworks and adherence to the applicable laws, regulations , AML Law of the Kingdom of Bahrain, FATF recommendations and the Bank's Compliance & AML Policies.

Code of Conduct

The Bank has developed a Code of Conduct that governs the professional and personal behaviour of the Banks' directors, management and staff.

Compliance

The Bank is committed to conduct its business in a Shari'a compliant manner, to deliver its strategic and operational objectives with the highest professional and ethical standards and to comply fully with the spirit and letter of any applicable regulatory requirements, Kingdom of Bahrain legislation, code of best practice promoted by industry associations and internal codes of conduct.

In this context and in compliance with the Central Bank of Bahrain requirements, the Bank has appointed a Compliance Officer pursuant to the provisions of the CBB rulebook volume 2 and established an independent Compliance/Anti-Money Laundering (AML) Department that is responsible for ensuring the appropriate implementation of the Compliance Framework, and adherence to the Compliance Policies documented in the Compliance Policy Manual approved by the Board. The Compliance Framework is based upon the premise that compliance with laid down policies is intended to help the Bank to efficiently realise its goals while complying with applicable laws, rules and regulations. The primary purpose of the Compliance Policy Manual is to establish a strong compliance culture within the Bank by providing a framework of policies and guidelines that the Bank must adhere to ensure appropriate management of Compliance Risk and discharge of its duties relating to regulatory authorities' requirements. It aims at ensuring that the Bank adheres to all applicable regulations, violations if any, are identified on a timely basis and corrective action is taken at the earliest. The Manual provides the basis for the creation of the Bank's Compliance Function Infrastructure thus facilitating the optimisation of shareholder value, as well as meeting the emerging regulatory compliance and leading industry practice standards. It is envisaged that by implementing these guidelines the Bank would be able to monitor and control its Compliance Risk exposures more effectively.

The Board of Directors has the overall responsibility for ensuring that all activities of the Bank are conducted in accordance and in full compliance with applicable laws and regulations. The Board has approved the Compliance Policy. The Policy shall be reviewed as and when there is a significant change in the Bank's business model or regulatory requirements to ensure that it is in line with the Bank's current practices or any other changes introduced by the CBB and other regulatory authorities that may have an impact on the Compliance Function.

In addition to the Policy, the Bank has adopted Compliance Procedures which allow the Bank to appropriately manage compliance risk and discharge its responsibilities relating to regulatory authorities. The objective of the procedures is to ensure that:

- All regulatory requirements are adequately complied with;
- Potential non-compliance is detected, reported and rectified in a timely manner; and
- Non-compliances are reported to the appropriate statutory body and internally to the Managing Director & Chief Executive Officer and ARGC Committee.

Disclosures

A Public Disclosure Policy has been developed as part of the Bank's commitment to adopting the highest standards of transparency and fairness in disclosing information for the benefit of all stakeholders. The Public Disclosure Policy provides the approach adopted towards managing and controlling the process of public disclosure of financial and non-financial communication to shareholders and the customers in order to ensure that the information disseminated complies with the CBB directives and is accurate, complete and fairly presents the Bank's financial position and results of operations in all material respects within regulatory stipulated timelines. The purpose of the policy is to assist the Board, senior management and relevant department to understand their roles and responsibilities in the Disclosure Process. The Bank is committed to disclosing information to the public in a manner consistent with guidelines provided by the CBB, and in line with Basel II Pillar III requirements.

Anti-money Laundering

The Bank has adopted detailed policies and procedures in line with the CBB's directives to combat money laundering, financing of terrorism and other financial crimes. Detailed procedures are included on account opening and customer due diligence, internal and external reporting, staff training and record keeping. It aims to assist all members of management and staff to understand:

- The legal requirements and the different penalties for non-compliance;
- What the Bank requires of all members of management and staff; and
- How to recognise money laundering and the action one must take.

It is a firm policy of the Group not to allow itself to be directly or indirectly used by any elements for unlawful activities. From the Group's perspective, the prevention of money laundering, financing of terrorism and other financial crimes has three objectives:

- **Ethical** – taking part in the fight against crime;
- **Professional** – ensuring that the Bank is not involved in recycling the proceeds of crime that could call into question its reputation, integrity and, if fraud is involved, its solvency; and
- **Legal** – complying with Bahrain legislation and regulations that impose a series of specific obligations on financial institutions and their employees.

In this context and in compliance with the CBB requirements, the Bank has appointed a Money Laundering Reporting Officer pursuant to the provisions of the CBB rulebook volume 2 and established Compliance/AML Department that is responsible for ensuring the appropriate implementation of and adherence to the AML Policies and Procedures as approved by the Board.

Corporate Communications Policy

The Bank maintains an effective communications policy that enables both the Board and Management to communicate effectively with its shareholders, stakeholders and the general public. Main communications channels include the annual staff meeting, annual report, corporate website and corporate brochure, and regular announcements in the appropriate local press.

The Communications Policy has been approved by the Board. This Policy is set to ensure the disclosure of all relevant information to stakeholders on a timely basis in a timely manner and the provision of at least the last three years of financial data on the Bank's website.

The Bank has a Corporate Communications Department which is responsible for communicating new products information through various channels of communication which may include publications, website, direct mailers, electronic mail and local media.

The department supports the Compliance Officer of the Bank on any communication required to the investors and customers as set up by the Bank. The Corporate Communications Department has assisted, where required, with all business units of the Bank in support of their awareness programs or marketing of new products and services for the year 2010. The department has assisted the Bank throughout the year with its various social functions and charitable contributions. These are highlighted in the Corporate Social Responsibility section of the Annual Report.

Consumer / Investor Awareness Program

The Bank employs a range of communication channels to reach the consumer and investor, to create awareness of the Bank products, services and investments.

Communication channels for consumers normally adopt an integrated approach, depending on the level of exposure and awareness required. This can include mass media, publishing advertisements in the press and magazine publications, billboards, lamp posts, LED display Boards, direct mail, SMS messaging and emails.

The External communication program is supported by in-branch communication including; roll-ups, banners, posters, leaflets, flyers, brochures and danglers and online media via the Bank's website, Call Centre and eBanking site.

Communication to Investors is predominantly via Private Placement Memorandums and Investor Reports. The Bank also communicates information about its investments via its website. All other Investment communication is directly via the Bank's Investment Placement Team as part of its investor relations program.



Complaints and Feedback

The Bank has appointed a Complaints Officer to manage customer complaints and ensure that all complaints are properly addressed and issues are solved in a timely manner. After receiving a complaint, the Complaints Officer internally address the complaint to the concerned department for their response. After analysing the responses of the concerned department the Complaints Officer finds suitable solution and this will be communicated to the complainant. There are various channels in place to assist in receiving feedback/complaints from customers including the Bank's website and suggestion boxes that have been placed at each of the Bank's branches.

Other Disclosures

The information on the nature and extent of transactions with related parties is reported in consolidated financial statement of the Group.

Consolidated financial statements of the Group provides the information on systems and controls employed by the Bank to ensure Shari'a compliance which include the information if there was any non-Shari'a-compliant earnings and expenditure occur and the manner in which they were disposed of and the annual zakah contributions of the Bank. As per Bank's policy, all non-Shari'a compliant earnings are given away to charity. During the year 2010, Bank did not receive any significant income or incurred significant expenses which were prohibited by the Shari'a.

