Public Disclosures 2008

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بيت التمويل الكويتي
Kuwait Finance House
Bahrain B.S.C.(c) البحرين ش.م.ب (م)

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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 commercial banking license, and its subsidiaries together known as "the Group".

The Board at KFH Bahrain seeks to optimize the Bank's performance by enabling the various group business units to realize the Group's business strategy and meet agreed business performance targets by operating within the agreed capital and risk parameters and the Group 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 Central Bank of Bahrain 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 maximize shareholders' value.

Regulatory capital consists of Tier 1 capital (core capital) and Tier 2 capital (supplementary capital). Tier 1 comprises share capital, share premium, retained earnings, foreign currency translation and minority interests less goodwill. Tier 2 capital includes collective impairment provision, current year's profit and revaluation reserves. Certain adjustments are made to IFRS–based results and reserves, as prescribed by the Central Bank of Bahrain in order to compiy with Capital Adequacy Module issued by the Central Bank of Bahrain. From the regulatory perspective, the significant amount of the Bank's capital is in Tier 1 form.

The Bank'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 Standardized Approaches for its Credit Risk and Market Risk, and the Basic Indicator Approach for its 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, future sources and uses of funds.

For the purpose of computing CAR the Bank is consolidating its financial subsidiaries (KFH Jordan and Baytik Investment Advisory) only. None of the Bank's investment in subsidiaries exceeds the materiality thresholds specified in Prudential Consolidation and Deduction Module hence not deducted from 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.

TABLE – 1. CAPITAL STRUCTURE

CAPITAL STRUCTURE

Capital Structure (PD–1.3.12, 1.3.13,1.3.15) *

Components of capital	Tier 1 BHD'000	Tier 2 BHD'000
Core capital – Tier 1:		
Issued and Paid up Share Capital	161,036	
Less: Employee stock incentive program funded by the Bank (outstanding)	15,059	
Shares premium accounts	71,403	
Statutory reserve	11,806	
General reserve	30,896	
Total Tier 1 Capital	260,082	
Deductions from Tier 1:		
Unrealized gross losses arising from fair valuing equity securities	10,282	
Tier 1 Capital before PCD deductions	**249,800**	
Supplementary capital – Tier 2:		
Current years profits		16,314
Asset revaluation reserve – Property, plant, and equipment (45% only)		6,776
Investment risk reserve		12,072
Tier 2 Capital before PCD deductions		35,162
Total Available Capital before PCD deductions (Tier 1 & 2)		**284,962**
Deductions		
Excess amount over materiality thresholds in case of investment in commercial entities	22,453	22,453
Investment in insurance entity greater than or equal to 20%	1,230	1,230
Excess amount over maximum permitted large exposure limit	5,089	5,089
Additional deduction from Tier 1 to absorb deficiency in Tier 2	14,618	
Other deductions	21,008	21,008
Total Deductions	**64,398**	**49,780**
Total Eligible Capital	**185,402**	**–**

* 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 contract BHD'000

Components of capital	
Murabaha contracts with Banks	483
Murabaha	66,093
Ijarah	18,403
Musharakah	3,236
Total	**88,215**

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) & (PD–1.3.30(a)) BHD'000

Particulars	Capital Requirement
Market Risk – Standardised Approach	5,529
Operational Risk – Basic indicator approach	9,796

TABLE – 4. CAPITAL RATIOS

CAPITAL ADEQUACY

Capital Adequacy Ratios (PD–1.3.20)

Particulars	Total Capital Ratio	Tier 1 Capital Ratio
Top consolidated group in Bahrain	18.09%	18.09%

3. Risk Management

3.1 BANK–WIDE RISK MANAGEMENT OBJECTIVES

At KFH Bahrain we believe 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 Bank. The risk management objective for each area of risk is to adopt the best practices available to adhere to Basel II and CBB requirements. The Bank is able to identify, capture, monitor and manage different dimensions of risk with the aim of protecting asset values and income streams, and hence, optimize the Bank's shareholder return, while maintaining its risk exposure within defined parameters.

To effectively manage risk, Board approval is sought on a regular basis. We are currently at various stages of implementing sophisticated risk management systems such as asset and liability management (ALM), credit risk systems and various analytical models. The Bank is implementing advanced internal models for credit and market risk.

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 plan of the Bank, which includes fluctuations in economic and market conditions and future forecasts. The Bank also assesses on a regular basis its tolerance for specific risk categories 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 Risk Charter and Capital Management policies. These policies 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 management 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 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 Bank is exposed to various types of risk, such as market, credit, rate of return, liquidity and operational, all of which require the comprehensive controls and ongoing oversight. The risk management framework encapsulates the spirit behind Basel II, which includes management oversight & control, risk culture & ownership, risk recognition & assessment, control activities, adequate information & 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 has established a limit structure to avoid concentration of risks for counterparty, sector and geography.

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. It will complete this exercise by the end of the second quarter in 2009.

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 Group manages and monitors its public equity using VAR and its private equity using sector, geography 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.

3.2.7 Displaced Commercial Risk

Displaced Commercial Risk (DCR) refers to the market pressure to pay returns that exceeds the rate that has been earned on the assets financed by the liabilities, when the return on assets is under performing as compared with competitor's rates.

The Bank manages DCR through the Asset Liability Committee (ALCO). The Bank is currently in the process of developing written policies and procedures for Displaced Commercial Risk. The bank will forego its fee in case Displace Commercial Risk arises. The bank benchmarks its rates with other leading banks in the market.

The quantitative disclosures regarding Displaced Commercial Risk are discussed in tables 28 and 39.

3.3 STRUCTURE AND ORGANIZATION OF RISK MANAGEMENT FUNCTION

The Risk Management structure at the Bank encompasses all levels of authorities, organizational 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 of Directors retains ultimate responsibility and authority for all risk matters of, including:
a. Establishing overall policies and procedures; and
b. Delegating authority to the Executive Committee, Risk and Governance Committee, Audit Committee and further delegation to the management to approve and review.

ORGANIZATIONAL CHART

3.4 RISK MEASUREMENT & REPORTING SYSTEMS

Based on the risk appetite of KFH Bahrain, the Bank has put in place various limits. These limits have been approved by the Board of Directors. Any limit breaches are reported to the respective senior management committees and the Board by the Risk Management Group (RMG). The limits are reviewed and revised at least on annual basis or when is deemed required.

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 Group 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 financed or other tangible securities.

KFH Bahrain 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 and industry. The Group has established a credit quality review process to provide early identification of possible changes in the creditworthiness of counterparties, including regular collateral revisions. Counterparty limits are established by the use of a credit risk classification system, which assigns each counterparty a risk rating. Risk ratings are subject to regular revision by the Risk Management Department. Any changes to the Credit risk policy will be approved by the Board.

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. In addition our internal risk rating model scores these quantitative and qualitative factors. The credit approval decision is then made and terms and conditions are set.

Exposure limits are based on the aggregate exposure to counterparty and any connected entities across the group. Corporate contracts/facilities are reviewed on annual basis by Corporate Finance and Risk Management.

3.5.2 Types of credit risk

Financing contracts mainly comprise of, Ijarah, Istisna, Murabahah, Murabahah (International Commodity), Murabahah Letter of Credit, Musharakah (Diminishing), and Qard Al Hassan.

Ijarah financing

The Group enters into a contract under which the Bank purchases and leases out equipment required by its client for a rental fee. The duration of the lease and rental fees are agreed in advance. Ownership of the equipment remains in the hands of the Bank until last payment is received from the customer.

Istisna financing
A contract of acquisition of goods 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 commodity must be fixed as at the time of the contract.

Murabahah
Murabahah is a contract sale 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, in this case a vehicle, by the Bank as requested by its client. The vehicle is sold to the client with a profit. Repayment, usually in installments, is specified in the contract.

Murabahah (International Commodity)
A commodity murabahah 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 instrument is called an international commodity Murabahah because the profits are made on the international buying and selling of a commodity, usually metal, such as copper, aluminum or lead.

Murabahah 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. In a Murabahah Letter of Credit, the Bank imports the goods in its own name. The customer then purchases the goods from the Bank under a Murabahah arrangement.

Musharakah (Diminishing)
This arrangement allows equity participation and sharing of profit on a pro rata basis but also provides a method for the non–Bank partner to make payments to increase its equity in the project and ultimately transfers the complete ownership of the asset.

Qard Al Hassan
The Group enters into a benevolent loan. This is an interest–free loan given mainly for welfare purposes. The recipient of the loan is only required to pay back principal.

3.5.3 Past Due and Impaired Islamic Financing

The Group defines non–performing facilities as the facilities that are overdue for a period of 90 or more days. These exposures are placed on a non–accrual status with income being recognized to the extent that it is actually received. It is the Group'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 installments/payments.

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.

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 and Moody's to provide ratings for such counterparties. In case of unrated FIs, the Bank will assess the credit risk on the basis of 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 Risk Management Department 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 CBB's single obligor regulations, Banks incorporated in Bahrain are required to obtain the CBB's approval for any planned exposure to a single counterparty, or group of connected counterparties, exceeding 15% of the regulatory capital base.

In order to avoid excessive concentrations of risk, the Group's policies 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 utilization of a number of techniques, such as collaterals and guarantees to mitigate the credit risks that the Bank is exposed to.

The group's first priority when establishing loans is to determine the borrower's capacity to repay and not to rely principally on security or collateral.

Acceptable forms of collateral are defined within the group risk framework and conservative valuation parameters 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 fulfill their intended purpose and remain in line with local market practice.

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

This section establishes the policy relating to collateral management. The business units review and recommend detailed guidelines relating to collateral in consultation with RMG. These guidelines cover the following:

- Permissible collateral types – based on size, age, value, location, manufacturer
- Maximum financing to 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 valuator
- Collateral documentation requirements, custody (for securities) and Takaful requirements
- Ongoing processes for margin maintenance, continuation of Takaful, etc.

The majority of the Bank's current credit portfolio is secured through mortgage of commercial real estate properties. The bank may dispose off the assets as a last resort after legal procedures imposed by the court.

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 has been obtained from a legal counselor domiciled in the country of guarantor (overseas) regarding the enforceability of the guarantee, if the guarantor / prime obligor is domiciled outside Bahrain and all guarantees should be valid until full settlement of the debt. Also no maturity (negative) mismatch is permissible between the guarantee and exposure.

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 Bank. It also includes the issuer of a security in case of a security held by the Bank, or a party with whom a contract is made by the Bank for financial transactions.

The measure of exposure reflects the maximum loss that the Bank may suffer in case the counterparty fails to fulfill its commitments. 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 Bank's Capital Base.

The bank has adopted Standardized 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 its capital based on internal and external 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.

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 should highlight 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 should also be given. The proposal should be reviewed by RMG and the Credit Committee and approved by appropriate authorities within the Group.

Reporting

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

Early warning indicators

The Bank will maintain 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 sub-standard or doubtful as defined in the provisioning section.

3.5.9 Related Party Transactions

The disclosure relating to related party transactions has been made in the financial statements. All related party transactions have been made on arm's length basis.

3.5.10 Quantitative disclosures

TABLE – 5. GROSS AND AVERAGE CREDIT RISK EXPOSURE

CREDIT RISK: QUANTITATIVE DISCLOSURES

Credit Risk Exposure (PD–1.3.23(a)) BHD'000

	Own Capital and Current Account		Unrestricted Investment Account	
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 and Central Bank of Bahrain	35,092	28,307	32,173	25,069
Murabaha and Mudaraba contracts with Banks	–	–	64,421	80,239
Financing contracts with customers *	376,862	302,134	213,880	55,735
Investments – sukuk	34,375	28,790	–	–
Receivables	81,162	–	–	–
Total	527,490	–	310,474	–
Credit commitments and contingent items	198,017	99,653	–	–
Grand Total	**725,507**		**310,474**	**–**

* Total gross credit exposure does not include the impact of collective provisions of BD 12,259 thousand.
Average gross credit exposure has been calculated using quarterly management accounts or PIRI forms submitted to CBB.

TABLE – 6. PORTFOLIO GEOGRAPHIC BREAKDOWN

CREDIT RISK: QUANTITATIVE DISCLOSURES

Geographic Breakdown (PD–1.3.23(b)) BHD'000

	Own Capital And Current Account						Unrestricted Investment Account					
Portfolios	Geographic Area						Geographic Area					
	Middle East	North America	Western Europe	NZ/ Australia	Other Countries	Total Amount	Middle East	North America	Western Europe	NZ/ Australia	Other Countries	Total Amount
Balances with Banks and Central Bank of Bahrain	35,324	(173)	(67)	–	8	35,092	32,173	–	–	–	–	32,173
Murabaha and Mudaraba contracts with Banks	–	–	–	–	–	–	64,421	–	–	–	–	64,421
Financing contracts with customers*	372,228	–	855	1,280	2,499	376,862	213,880	–	–	–	–	213,880
Investments – sukuk	34,375	–	–	–	–	34,375	–	–	–	–	–	–
Receivables	80,548	590	16	2	6	81,161	–	–	–	–	–	–
Total	522,475	416	805	1,282	2,513	527,490	310,474	–	–	–	–	310,474
Un–funded												
Credit commitments and contingent items	198,017	–	–	–	–	198,017	–	–	–	–	–	–
Grand Total	**720,492**	**416**	**805**	**1,282**	**2,513**	**725,507**	**310,474**	**–**	**–**	**–**	**–**	**310,474**

* Total gross credit exposure does not include the impact of collective provisions of BD 12,259 thousand.

TABLE – 7. INDUSTRIAL SECTOR BREAKDOWN BY PORTFOLIO

CREDIT RISK: QUANTITATIVE DISCLOSURES

Industry Sector Breakdown (PD–1.3.23(c)) BHD'000

	Own capital and current account					Unrestricted Investment Account				
Portfolios	Industry sector					Industry sector				
	Trading and Manufacture	Banking and and Financial Institutions	Construction/ Real Estate	Others	Total Amount	Trading and Manufacture	Banking and and Financial Institutions	Construction/ Real Estate	Others	Total Amount
Balances with Banks and Central Bank of Bahrain	–	35,092	–	–	35,092	–	32,173	–	–	32,173
Murabaha and Mudaraba contracts with Banks	–	–	–	–	–	–	64,421	–	–	64,421
Financing contracts with customers*	74,984	34,187	189,022	78,668	376,862	43,986	20,055	113,555	36,283	213,880
Investments – sukuk	–	19,641	14,735	–	34,375	–	–	–	–	–
Receivables	3,728	2,913	72,294	2,226	81,161	–	–	–	–	–
Total	78,712	91,832	276,051	80,894	527,490	43,986	116,649	113,555	36,283	310,474
Un–funded										
Credit commitments and contingent items	53,386	28,161	108,570	7,901	198,017	–	–	–	–	–
Grand Total	**132,098**	**119,994**	**384,621**	**88,795**	**725,507**	**43,986**	**116,649**	**113,555**	**36,283**	**310,474**

* Total gross credit exposure does not include the impact of collective provisions of BD 12,259 thousand.

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	Own Capital and Current Account Concentration of Risk	Unrestricted Investment Account Concentration of Risk
Counterparty # 1	31%	
Counterparty # 2	27%	
Counterparty # 3 *		20%
Counterparty # 4	19%	

* Counter party #3 is an interbank counterparty.

TABLE – 9. MATURITY BREAKDOWN OF CREDIT EXPOSURES

CREDIT RISK: QUANTITATIVE DISCLOSURES

Residual Contractual Maturity Breakdown (PD–1.3.23(g)) BHD'000

	Own Capital And Current Account							
Portfolios	Maturity Breakdown							
	Not Later Than One Month	1–3 Month	3–12 Month	1–5 Years	5–10 Years	10–20 Years	Over 20 Years	Total Amount
Balances with Banks and Central Bank of Bahrain	35,092	–	–	–	–	–	–	35,092
Murabaha and Mudaraba contracts with Banks	–	–	–	–	–	–	–	–
Financing contracts with customers	17,614	22,396	131,242	177,023	24,188	3,876	521	376,862
Investments – sukuk	5,000	–	2,270	27,105	–	–	–	34,375
Receivables	35,913	11,956	33,292	–	–	–	–	81,161
Total	**93,619**	**34,352**	**166,804**	**204,128**	**24,188**	**3,876**	**521**	**527,490**

CREDIT RISK: QUANTITATIVE DISCLOSURES

Residual Contractual Maturity Breakdown (PD–1.3.23(g)) BHD'000

	Unrestricted Investment Account							
Portfolios	Maturity Breakdown							
	Not Later Than One Month	1–3 Month	3–12 Month	1–5 Years	5–10 Years	10–20 Years	Over 20 Years	Total Amount
Balances with Banks and Central Bank of Bahrain	–	–	–	–	–	–	32,173	32,173
Murabaha and Mudaraba contracts with Banks	64,421	–	–	–	–	–	–	64,421
Financing contracts with customers	10,333	13,138	76,988	96,653	14,189	2,274	306	213,880
Investments – sukuk	–	–	–	–	–	–	–	–
Receivables	–	–	–	–	–	–	–	–
Total	**74,754**	**13,138**	**76,988**	**96,653**	**14,189**	**2,274**	**32,479**	**310,474**

TABLE – 10. BREAKUP OF IMPAIRED LOANS BY INDUSTRY SECTOR

CREDIT RISK: QUANTITATIVE DISCLOSURES

Impaired Loans, Past Due Loans and Allowances (PD–1.3.23(h)) BHD'000

	Own Capital and Current Account											
					Impaired Financing Contracts			Specific Allowances				
Industry Sector	Total Portfolio	Good Standard	Past Due but not Impaired	Impaired Financing Contracts	Over 3 Months	Over 1 Year	Over 3 Years	Balance at the Beginning	Charges During the Period	Charge–offs During the Period	Balance at the End of the Period	Collective Provisions
Trading and manufacturing	74,984	74,517	429	39	–	–	39	–	–	–	–	*
Banking and financial institutions	53,828	53,828	–	–	–	–	–	–	–	–	–	*
Construction & real estate	191,498	187,726	3,445	327	–	327	–	–	107	–	107	*
Others	91,943	83,172	7,879	892	–	410	482	336	574	–	910	*
Total	**412,253**	**399,242**	**11,754**	**1,257**	**–**	**737**	**520**	**336**	**681**	**–**	**1,017**	**–**

* This amounts to BD 12,259 thousands representing collective impairment provision against (both self financed and URIA financed exposures) which, although not specifically identified, have a greater risk of default then when originally granted.

CREDIT RISK: QUANTITATIVE DISCLOSURES

Impaired Loans, Past Due Loans and Allowances (PD–1.3.23(h)) BHD'000

Unrestricted Investment Account												
					Impaired Financing Contracts			Specific Allowances				
Industry Sector	Total Portfolio	Good Standard	Past Due but not Impaired	Impaired Financing Contracts	Over 3 Months	Over 1 Year	Over 3 Years	Balance at the Beginning	Charges During the Period	Charge–offs During the Period	Balance at the End of the Period	Collective Provisions
Trading and manufacturing	43,986	43,986	–	–	–	–	–	–	–	–	–	*
Banking and financial institutions	84,476	84,476	–	–	–	–	–	–	–	–	–	*
Construction & real estate	113,555	113,555	–	–	–	–	–	–	–	–	–	*
Others	36,283	36,283	–	–	–	–	–	–	–	–	–	*
Total	**278,301**	**278,301**	–	–	–	–	–	–	–	–	–	–

* This amounts to BD 12,259 thousands representing collective impairment provision against (both self financed and URIA financed exposures) which, although not specifically identified, have a greater risk of default then when originally granted.

TABLE – 11. BREAKUP OF PROVISION BY GEOGRAPHIC AREA

CREDIT RISK: QUANTITATIVE DISCLOSURES

Impaired Loans, Past Due Loans And Allowances (PD–1.3.23(i)) BHD'000

	Own Capital And Current Account			Unrestricted Investment Account		
Geograpic Area	Past Due And Impaired Islamic Financing Contracts	Specific Impairment Provision	Collective Impairment Provision	Past Due Islamic Financing Contracts	Specific Impairment Provision	Collective Impairment Provision
Bahrain	13,010	1,017	*	–	–	–
Other GCC	–	–	–	–	–	–
Middle East	–	–	–	–	–	–
North America	–	–	–	–	–	–
Europe	–	–	–	–	–	–
Asia / Pacific	–	–	–	–	–	–
Others countries	–	–	–	–	–	–
Total	**13,010**	**1,017**	**–**	**–**	**–**	**–**

* This amounts to BD 12,259 thousands representing collective impairment provision against exposures which, although not specifically identified, have a greater risk of default then when originally granted.

TABLE – 12. BREAKUP OF ELIGIBLE COLLATERAL BY PORTFOLIO

CREDIT RISK MITIGATION (CRM): DISCLOSURES FOR STANDARDIZED APPROACH

Credit Risk Exposure Covered By CRM (PD–1.3.25 (b) and (c)) BHD'000

Particulars	Total Exposure Covered by	
	Eligible (after haircut) Collateral	Guarantees
Murabaha	61,402	–
Ijarah	137,732	–
Total	**199,134**	**–**

TABLE – 13. COUNTER PARTY CREDIT RISK

DISCLOSURES FOR EXPOSURES RELATED TO COUNTERPARTY CREDIT RISK (CCR)

General Disclosures (PD–1.3.26 (b))

				Collaterals held			
Particulars	Gross Positive Fair	Netting Benefits	Netted Current Credit	Cash	Government Securities	Others Islamic	Total
Murabaha	333,718	–	333,718	*	*	*	*
Ijara	235,747	–	235,747	*	*	*	*
Total	**569,465**	**–**	**569,465**	*****	*****	*****	*****

* Collateral type wise breakup is not available in this format.

Out of total collateral value of BD 199,134 an amount of BD 197,783 (99%) represents collateral as commercial real estate.

The applicable haircut on the commercial real estate collateral is 30%

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 benchmark profit rate and potential foreign exchange risks arising from financial assets and liabilities not held for trading. The Bank also accepts the definition of market as defined by Central Bank of Bahrain (CBB) as "the risk of losses in on–and off–balance–sheet positions arising from movements in market prices."

The Board approves the overall market risk appetite. Group Risk Management is responsible for the market risk control framework and sets a limit framework within the context of the approved market risk appetite. The group 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 Bank, 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 bank has the following foreign subsidiaries, namely:

S. No.	Name of Subsidiary	Located In	Net Assets (2008) in BHD 000's	Net Assets (2007) in BHD 000's
1	Al Kindi Pharmaceutical Industries	Hashemite Kingdom of Jordan	3,021	4,099
2	KFH – Jordan	Hashemite Kingdom of Jordan	19,427	9,425
3	Motherwell Bridge Limited	United Kingdom	11,858	–

The bank is exposed to the currency risk due the fact that the assets and liabilities of the above subsidiaries are denominated in their respective functional currencies. The assets and liabilities are translated into Bahraini dinar using the closing rate at the balance sheet date for the purpose of consolidated financial statements. The impact of foreign currency translation is recognized in the statement of changes of equity and will be routed to P&L 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 Risk: Products may have an inherent risk 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.

3.6.3 Market Risk Strategy

The Bank's Board of Directors (Board) is responsible for approving and reviewing the market risk strategy. The Bank's senior management is responsible for implementing the market risk strategy approved by the Board, and continually enhancing the market 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 will strive to reduce the market risk through diversification of its risk exposures across currencies, markets and sectors.
- The Bank will proactively measure and monitor the market risk in all its risk exposures on a regular basis using appropriate measurement techniques.
- The Bank will establish a limit structure to monitor and control the market risk in its portfolio on daily basis. These limits will be monitored on a regular basis and any exceptions to the limits will be immediately dealt with.
- The Bank will carry out stress testing periodically to assess the effect of extreme movements in market variables.
- The Bank will, 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

Market Risk Measurement Techniques includes the use of a number of techniques for market risk measurement.The risk measurement techniques mentioned in this section are used for measuring FX risk in the Banking book. 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 Asset and Liability Committee (ALCO) have set the tolerance for market risk. Based on these tolerances, RMG and Treasury 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. Cut loss limits;
b. Value at risk limits;
c. FX trigger at notional level

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

In case a limit is breached, an immediate report is provided to the ALCO. The limits are reviewed at least annually or as deemed necessary.

3.6.6 Portfolio Review Process

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

3.6.7 Reporting

RMG 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.

3.6.8 Stress Testing

Stress testing produces information summarizing 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 RMG simulates stress scenarios such as Black Monday (1987) and Russian Ruble crisis (1998) to calculate the maximum loss due to extreme movements in FX rates by employing techniques such as historical and Monte Carlo VaR. The Bank's liquidity and real estate portfolios are also stress tested.

3.6.9 Quantitative disclosures

TABLE – 14. MINIMUM AND MAXIMUM CAPITAL REQUIREMENT FOR MARKET RISK

MARKET RISK: DISCLOSURES FOR BANKS USING THE STANDARDIZED APPROACH

Level Of Market Risks In Terms Of Capital Requirements (PD–1.3.27 (b)) BHD'000

Particulars	Price Risk Exposure	Equity Position Risk	Foreign Exchange Risk
Capital requirements	309	–	3,230
Maximum value	576	588	7,303
Minimum value	299	–	3,096

This disclosure is based on the figures from the PIRI from the four quarters of 2008.

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, authorization 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 Risk and Governance Committee. The Board has approved the operational risk framework and the Bank is in the process of implementing risk and control self assessment [RCSA] and this will be completed by the end of the second quarter 2009.

3.7.2 Sources of Operational risk

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

People Risk which 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 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 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 unauthorized or incorrect modifications to software programs, computer virus, programming bug etc.;

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. The operational risk identification, assessment and measurement process involves the following steps:

Identification of KRI's
The Bank will integrate the process of identifying Key Risk Indicators (KRIs) into the RCSA process.

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.

Operational Loss Database
The Operational Loss Database (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 will use scenario analysis to help it to evaluate its exposure to high–severity events.

Scenario analysis will be 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. The facilitation of the workshops will be the responsibility of the operational risk unit of RMG.

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 Risk and Governance 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.

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 Bank 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 Bank will aim 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 Bank.

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 Bank will furthermore establish control processes and procedures and implement a system for ensuring compliance with these internal risk control processes and procedures.

Outsourcing activities
Outsourcing of activities is one of the approaches employed by the Bank to transfer some of its risks.

3.7.6 Business Continuity Plan and Disaster Recovery Plan

The Bank has developed a Business Continuity Plan (BCP) which is Board approved based on risk review of the banks activities. The Bank ensures that business recovery / contingency plans are reviewed / updated periodically, and these plans are tested. The Disaster recovery plan is also board approved and is currently in the implementation stage.

In particular, the Business Continuity Plan (BCP) will satisfy the following:

- The BCP will cover incidents related to IT, communication and premises.
- BCP testing will include critical business processes.
- BCP testing will cover critical types of plausible scenarios to which the Bank may be vulnerable.

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)) BHD'000

Particulars	Total
Gross Income (average)	41,795
Amount of non–Shari'a income	–
Number of Shari'a violations that were identified and reported during the financial year	–

3.8 EQUITY POSITIONS 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 accounting policies, including valuation methodologies and their related key assumptions, are disclosed in the financial statements. All of Bank'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)) BHD'000

Type of Investment	Total Gross Exposure	Average Gross Exposure	Publicly Traded	Privately Held
Equity investments	230,342	179,746	17,619	212,723
Managed funds	11,106	8,888	–	11,106
Total	**241,448**	**188,634**	**17,619**	**223,829**

* Average exposure has been calculated using quarterly management accounts or PIRI forms submitted to CBB.

TABLE – 17. BREAKUP OF CAPITAL REQUIREMENT FOR EQUITY GROUPINGS

EQUITY POSITION IN BANKING BOOK – DISCLOSURE REQUIREMENTS

Capital Requirement – (PD–1.3.31 (f)) BHD'000

Particulars	Capital Requirement
Listed	1,049
Unlisted	87,453
Managed Funds	2,082
Total	**90,584**

TABLE – 18. GAIN AND LOSS REPORTED

EQUITIES: DISCLOSURES FOR BANKING BOOK POSITIONS

Gains / Losses Etc. (PD–1.3.31 (d) and (e)) BHD'000

Particulars	Total
Cumulative realized gains (losses) arising from sales or liquidations in the reporting period	(302)
Total unrealized gains (losses) recognized in the balance sheet but not through P&L	(4,769)
Unrealized gross losses included in Tier One Capital	10,282
Unrealized gains included in Tier Two Capital	–

3.9 UNRESTRICTED INVESTMENT ACCOUNTS

The supervisor, CBB, may require the Bank to make good losses or lower profit on certain unrestricted investments for the purpose of income smoothing. Thus the Bank is exposed to some of the price risk on assets funded by unrestricted IAH. The CBB has prescribed that the Bank maintains capital to cover the price risk arising from 30% of assets funded by unrestricted IAH on a pro–rata basis.

The Bank is currently in the process of developing written policies and procedures applicable to its portfolio of unrestricted investment accounts. URIA funds are invested and managed in accordance with Shari'a requirements.

3.9.1 Quantitative disclosures

TABLE – 19. BREAKUP OF URIA

UNRESTRICTED INVESTMENT ACCOUNTS

Unrestricted Investment Account (PD–1.3.33 (a) &(g))

	Amount BHD'000	Financing to Total URIA %	Ratio of profit distributed
On demand	37,568	12%	14%
Term deposit	272,906	88%	86%
Total	**310,474**	**100%**	**100%**

TABLE – 20. PERCENTAGE OF RETURN ON AVERAGE URIA ASSETS

PERCENTAGE OF RETURN ON AVERAGE URIA ASSETS:

Unrestricted Investment Account (PD–1.3.33 (d))

	Percentage
Average profit paid on average URIA Assets	4.66%

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

TABLE – 21. PERCENTAGE OF MUDARIB FEE TO TOTAL URIA PROFITS

UNRESTRICTED INVESTMENT ACCOUNTS

Unrestricted Investment Account (PD–1.3.33 (f))

	URIA Return Before Mudarib Fees BHD'000	Mudarib Share of Profit BHD'000	Percentage
Mudarib fee to total URIA profits	10,862	997	9.18%

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 BHD'000	Financing to Total URIA %
Balances at Banks	32,173	10.36%
Short–term investments and treasury securities	64,421	20.75%
Murabaha	155,823	50.19%
Ijarah	58,057	18.70%
Total	**310,474**	**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))

Shari'a–Compliant contract	Financing BHD'000	Financing to Total URIA %
Claims on Sovereigns	32,173	10.36%
Claims on Banks	64,421	20.75%
Claims on Corporate	191,269	61.61%
Others	22,611	7.28%
Total	**310,474**	**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 %
URIA	4.66%	4.66%

TABLE – 25. WEIGHTED AVERAGE DECLARED RATE OF RETURN

UNRESTRICTED INVESTMENT ACCOUNTS

Unrestricted Investment Account (PD–1.3.33 (q))

	3–month	6–month	12–month	36–month
Range of declared rate of return	4.5% to 5.5%	4.75% to 5.75%	5.0% to 6.0%	–

TABLE – 26. MOVEMENT OF URIA BY TYPE OF ASSETS

UNRESTRICTED INVESTMENT ACCOUNTS

Unrestricted Investment Account (PD–1.3.33 (r) & (s)) BHD'000

	Opening Actual Allocation	Net Movement during the year	Closing Actual Allocation
Cash and Balances with CBB	5,309	26,864	32,173
Banks Murabahas	47,782	16,639	64,421
Murabaha	–	155,823	155,823
Ijara	–	58,057	58,057
Total	**53,091**	**257,383**	**310,474**

Note: There are no limits imposed on the amount that can be invested by URIA funds in any one asset.

TABLE – 27. CAPITAL CHARGE ON URIA BY TYPE OF CLAIMS

UNRESTRICTED INVESTMENT ACCOUNTS

Unrestricted Investment Account (PD–1.3.33 (v)) BHD'000

Type of claims	RWA	RWA for Capital Adequacy Purposes	Capital Charge
Claims on Banks	12,884	3,865	483
Claims on Corporate	126,143	37,843	4,730
Regulatory Retail Portfolio	21,041	6,312	789
Mortgages	35,033	10,510	1,314
Total	**195,102**	**58,530**	**7,316**

TABLE – 28. PERCENTAGE OF PROFIT EARNED AND PROFIT PAID TO TOTAL URIA FUNDS

EQUITY POSITION IN BANKING BOOK – DISCLOSURE REQUIREMENTS

Unrestricted Investment Account (PD–1.3.33 (w))

	* *Average URIA Funds invested BHD'000	Profit Earned BHD'000	As a percentage of funds invested	Profit Paid BHD'000	As a percentage of funds invested
2008	211,917	10,862	5.13%	9,865	4.66%
2007	78,055	1,807	2.32%	1,662	2.13%
2006	*	*	*	*	*
2005	*	*	*	*	*
2004	*	*	*	*	*

* Data not available

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

TABLE – 29. ADMINISTRATIVE EXPENSES ALLOCATED TO URIA

UNRESTRICTED INVESTMENT ACCOUNTS

Unrestricted Investment Account (PD–1.3.33 (w)) BHD’000

Unrestricted IAH	Administrative Expenses
Amount of Administrative expenses allocated to URIA	5,648

3.10 RESTRICTED INVESTMENT ACCOUNTS

RIA funds are invested and managed in accordance with Shari’a requirements.

The following guidelines are applicable regarding the RIA holders. The bank as fund manager (as agent) will manage and administer the scheme in a proper, diligent and efficient manner, in accordance with the applicable laws as issued by the CBB.

The Bank has appropriate procedures and controls in place which commensurate with the size of its portfolio which includes:
(a) Organizing 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.

The Bank is currently in the process of developing written policies and procedures applicable to its portfolio of restricted investment accounts.

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)) BHD’000

	2008	2007	2006	2005	2004	2003
Return to RIA holders	3,852	2,122	944	–	–	–

TABLE – 31. BREAKUP OF RIA BY TYPE OF DEPOSITS

RESTRICTED INVESTMENT ACCOUNTS

Restricted Investment Account (PD–1.3.33 (a))

	BHD'000
RIA Funds	93,269

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	9.59%

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

TABLE – 33. MUDARIB FEE AS A PERCENTAGE OF TOTAL RIA PROFITS

RESTRICTED INVESTMENT ACCOUNTS

Restricted Investment Account (PD–1.3.33 (f))

	Percentage
Mudarib fee to total (gross) RIA profits	20.40%

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 BHD'000	Financing to Total Financing %
Murabaha	86,667	92.92%
Ijara	6,602	7.08%
Total	**93,269**	**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 BHD'000	Financing to Total Financing %
Claims on Banks	33,382	35.79%
Claims on corporate	59,887	64.21%
Total	**93,269**	**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))

Type of RIA	Total RIA BHD'000	RIA return before Mudarib Fees BHD'000	RIA return after Mudarib Fees BHD'000	Share of Profit paid to Bank as Mudarib BHD'000	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	86,667	4,225	3,388	837	3.91%	3.91%
Ijarah	6,602	614	464	150	7.03%	7.03%
Total	**93,269**	**4,839**	**3,852**	**987**	**–**	**–**

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
Average declared rate of return/ profit rate of return	8.00%	7.78%	8.02%	7.18%

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 BHD'000	Risk Weighted Amount while calculating CAR
Murabaha	86,667	–
Istisna'a	6,602	–
Total	**93,269**	**–**

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) BHD'000	Profit Earned BHD'000	As a percentage of RIA funds	Profit Paid BHD'000	As a percentage of RIA funds
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%
2005	–	–	–	–	–
2004	–	–	–	–	–

* Average RIA funds have been calculated using monthly 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 arranged diversified funding sources in addition to its core deposit base, manages assets with liquidity in mind, and monitors future cash flows and liquidity on a daily basis.

This incorporates an assessment of expected cash flows 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 Group 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 Central Bank of Bahrain equal to 7% of customer deposit.

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 most important of these is to maintain limits on the ratio of liquid assets to customer liabilities. Liquid assets consists of cash and balances with Banks and Central Bank of Bahrain, Murabaha and Mudaraba contracts with Banks, listed equities and Central Bank of Bahrain sukuk.

The Bank maintains liquid assets to counter liquidity crunches. The short–and long–term liquid assets internally, within KFH Bahrain, are listed below:

- Cash/reserves with CBB
- Cash–in–hand and held with other financial institutions
- Short–term placements
- Investments in marketable Sukuk and equity
- Maturing investments and financing

3.11.2 Sources of Liquidity Risk

Liquidity risk may arise and materialize 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 Bank's Board is responsible for approving and reviewing (at least annually), the liquidity risk strategy and significant amendments to the liquidity risk policies. The Bank 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 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 contingency liquidity 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 Treasury Department, in conjunction with RMG periodically reviews/updates the liquidity risk strategy which is evaluated by ALCO.

3.11.4 Liquidity Risk Measurement Tools

The methods 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 RMG within an oversight from the ALCO and Risk and Governance Committee (RGC). The buckets are in line with the nature of the markets the Bank operates in and the Bank's own risk appetite.

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 plan and currently manages the profit rate risk through ALCO.

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 Bank can be classified broadly into the following categories:

Maturity mismatch

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

Basis value risk

Assets and liabilities with similar maturities/revaluation 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 Bank in a dissimilar manner give rise to profit rate risk.

Risk of counterparty's options underlying assets

The availability of options, with the Bank's counterparties, to make prepayments or early withdrawals can leave the Bank 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 Bank.

3.12.3 Profit Rate Risk Strategy

Currently the Bank is managing profit rate risk using the ALCO process.

The Bank has a strategy in place and is in the process of implementing it, which will include 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 balance sheet;
- 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 amount to be retained in Profit Equalization Reserves (PER) and Investment Risk Reserve (IRR) to smooth the fluctuations in the benchmark rates to mitigate Displaced Commercial Risk (DCR);
- 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.

Earnings–at–risk

EaR is the maximum loss of expected income from profit rates, with a given confidence, that the Bank is likely to suffer due to variations in the profit rates. This measure informs the RGC and senior management of the amount of profit rate income at risk, due to variations in the profit rates.

The Bank is currently implementing the systems to perform an EaR analysis on its portfolio. Once the Bank implements the system with EaR analysis capability, the Bank will define its EaR limits and run an EaR analysis on its portfolio on a regular basis.

Economic value of equity – duration gap

This measures the loss in value of the portfolio due a small change in profit rates.

The Bank will adopt EVE measure using duration (weighted–average term–to–maturity of the security's cash–flows) estimates for various time bands. Depending on the nature of the instrument, the Head of MIRD will use modified or effective duration.

Present value of basis point

PVBP or PV01 measures the change in the value of a financial instrument corresponding to a change in profit rates by 1 basis point. ALCO will set limits to each time band based on this measure.

3.12.5 Profit Rate Risk Monitoring and Reporting

The Bank is implementing information systems for monitoring, controlling and reporting profit rate risk. Once the system is implemented, reports will be provided on a timely basis to the ALCO, and the Board of Directors. Once system is implemented, the Bank will define its limits. RMG will then review the results of gap limits and exceptions, if any, and recommends corrective actions to be taken which are approved by ALCO or Excom, according to authority levels approved by the Board. Currently, ALCO monitors these exposures in its meetings.

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)) BHD'000

	Exposure	Change in Basis Points	Effect on Net income for the Year
Assets			
Murabaha due from Banks	64,421	200	1,288
Financing contracts with customers	253,081	200	5,062
Investments – sukuk	34,375	200	688
Liabilities			
Murabaha due to Banks	301,452	200	(6,029)
Murabaha contracts with non–banks	224,880	200	(4,498)
Unrestricted investments accounts	310,474	200	(6,209)
Total			**(9,699)**

TABLE – 41. RATIOS

FINANCIAL PERFORMANCE AND POSITION

(PD–1.3.9(b))

Quantitative Indicator	Year 2008	Year 2007	Year 2006	Year 2005	Year 2004
ROAE	15%	26%	27%	26%	25%
ROAA	4%	6%	6%	7%	8%
Staff cost to operating income ratio	15%	15%	17%	19%	16%

Formula is as follows:
ROAE = Net Income/Average equity
ROAA= Net profit/ Average Assets

CORPORATE GOVERNANCE AND TRANSPARENCY

(PD–1.3.10(b))

Name of Board Member	Profession	Business Title	Experience in years	Qualification
Bader A. M. Mukhaizeem (Chairman)	Banker	Chairman and MD of KFH – Kuwait	More than 30 years	Bachelors in Commerce
Mohamed bin Sh. Eshaq (Deputy Chairman)	Business	Businessman	More than 30 years	Bachelors in Economics
Mohammed Sulaiman Al Omar	Banker	CEO of KFH–Kuwait	More than 20 years	Bachelors in Business Administration
Yaqoob Yousef Majed	Govt. Sector	Consultant – GOSI	More than 30 years	Done various professional courses
Adel Ahmed Al Banwan	Banker	Head of Direct Investments of KFH–Kuwait	More than 14 years	Master of Business Administration
Abdulhakeem Y. Alkhayyat	Banker	MD and CEO of KFH–Bahrain	More than 17 years	CPA , BBA and Bachelors in Accounting

CORPORATE GOVERNANCE AND TRANSPARENCY

(PD–1.3.10(b))

Name of Board Member	Designation	Profession	Business Title	Experience in years	Qualification
Bader A. M. Mukhaizeem	Chairman	Banker	Chairman and MD of KFH–Kuwait	More than 30 years	Bachelors in Commerce
Abdulhakeem Y. Alkhayyat	MD and CEO	Banker	MD and CEO of KFH–Bahrain	More than 17 years	CPA , BBA and Bachelors in Accounting

The remuneration/incentive structure of the MD andCEO, Board Members and Shari'a Members is discussed at the Board level. Remuneration of MD and CEO 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.

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

Board Committee	Membership	Objective
Executive Committee	1. Bader A. M. Mukhaizeem 2. Mohamed bin Sh. Eshaq 3. Abdulhakeem Y. Alkhayyat	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 is also responsible for assisting the Board in maintaining oversight of the Bank's internal controls, risk management and overall control environment.
Audit Committee	1. Mohammed Sulaiman Al Omar 2. Adel Ahmed Al Banwan 3. Yaqoob Yousaf Majed	The Board Audit 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.
Risk and Governance Committee	1. Yaqoob Yousaf Majed 2. Abdulhakeem Y. Alkhayyat 3. Abdulhakeem Al Adhami 4. Paul Mercer	The Risk and Governance Committee has the overall responsibility for the development of the risk strategy and implementing principles, frameworks, policies and limits. It is responsible for the fundamental risk issues and manages and monitors relevant risk decisions.

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.

Customer complaints are managed by Corporate Communications Department. After receiving a complaint, the department rotates the complaint to the concerned department for their response. After analyzing the responses of the concerned department the customer is communicated accordingly. The customers may use banks website for lodging a complaint. The bank has also placed suggestion boxes at each of its branches. The Consumer Group manages the suggestions put in the boxes and addresses them accordingly.