
Risk and Capital Management Disclosure

CONTENTS

1. Background	91
2. Statement of Financial Position Under The Regulatory scope of Consolidation	91
3. Capital Adequacy	92
4. Risk Management	94

Risk and Capital Management Disclosure

31 December 2016

1. Background

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 Bahrain Islamic Bank B.S.C. (the "Bank") being a locally incorporated Bank with a retail banking license, and its subsidiaries together known as (the "Group").

The Board of Directors seeks to optimise the Group's performance by enabling the various Group 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 Group risk policy framework.

2. Statement of Financial Position Under The Regulatory scope of Consolidation

The table below shows the link between the statement of financial position in the published financial statements (accounting statement of financial position) and the regulatory statement of financial position.

Table – 1. Statement of Financial Position (PD- 1.3.14)

	Statement of Financial position as per in published financial statements 2016 BD'000	Statement of Financial position as per Regulatory Reporting 2016 BD'000	Reference
Assets			
Cash and balances with banks and Central Bank	63,208	63,208	
Placements with financial institutions	63,805	63,805	
Gross financing assets	553,338	553,338	
Less: sepcific impairment provisions	(16,560)	(16,560)	a
Less: collective impairment provisions	(10,141)	(10,141)	a
Net financing assets	526,637	526,637	
Investment securities	145,731	145,731	
Ijarah Muntahia Bittamleek	151,752	151,752	
Gross ijarah rental receivables	21,888	21,888	
Less: sepcific impairment provisions	(10,977)	(10,977)	b
Less: collective impairment provisions	(2,293)	(2,293)	b
Net ijarah rental receivables	8,618	8,618	
Investment in associates	26,487	26,487	
Investment in real estate	28,066	28,066	
Property and equipment	15,881	15,881	
Other assets	12,003	12,003	
TOTAL ASSETS	1,042,188	1,042,188	
Liabilities, Equity Of Investment Accountholders and Owners' Equity			
Placements from financial institutions	103,874	103,874	
Customers' current accounts	152,647	152,647	
Other liabilities	14,879	14,879	
Total Liabilities	271,400	271,400	
Equity of Investment Accountholders	654,316	654,316	
Owners' Equity			
Share capital	101,339	101,339	c
Treasury shares	(563)	(563)	d
Shares under employee share incentive scheme	(604)	(604)	e
Share premium	56	56	f
Statutory reserve	1,963	1,963	g
Real estate fair value reserve	5,361	5,361	h
Investment fair value reserve	531	531	i
Profit for the year	7,578	7,578	j
Retained earnings brought forward	811	811	k
Total Owners' Equity	116,472	116,472	
TOTAL LIABILITIES, EQUITY OF INVESTMENT ACCOUNTHOLDERS AND OWNERS' EQUITY	1,042,188	1,042,188	

Risk and Capital Management Disclosure

31 December 2016

3. Capital Adequacy

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

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

The Group's capital structure is primarily made up of its paid-up capital, and including reserves. From a regulatory perspective, the significant amount of the Group's capital is in Tier 1 form as defined by the CBB, i.e., most of the capital is of a permanent nature.

The Group'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 financing facilities growth expectations for each business group, expected growth in off-balance sheet facilities, and future sources and uses of funds. To assess its capital adequacy requirements in accordance with CBB requirements, the Group adopts the Standardised Approach for its Credit Risk, Basic Indicator Approach for its Operational Risk, and Standardised Approach for its Market Risk. All assets funded by profit sharing investment accounts are subject to Board approval.

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

For the purposes of guidance every table was cross referenced with the relevant paragraph number of the Central Bank of Bahrain's Public Disclosures Module.

Table – 2. Capital Structure (PD-1.3.12, 1.3.13, and 1.3.14)

The following table summarises the eligible capital as of 31 December 2016 after deductions for Capital Adequacy Ratio (CAR) calculation:

Components of capital	Source based on reference letters of the statement of financial position under the regulatory scope of consolidation		
	CET 1 BD'000	T2 BD'000	
Issued and fully paid ordinary shares	101,339	-	c
General reserves	-	-	
Legal / statutory reserves	1,963	-	g
Share premium	56	-	f
Retained earnings brought forward	811	-	k
Current year profits	7,578	-	j
Unrealized gains and losses on available for sale financial instruments	531	-	i
Less:			
Employee stock incentive program funded by the bank (outstanding)	604	-	e
Treasury Shares	563	-	d
Total Common Equity Tier 1 capital after the regulatory adjustments above (CET1 d)	111,111	-	
Assets revaluation reserve - property, plant, and equipment		5,363	h
General financing loss provisions		6,598	53% (a+b)
Total Available AT1 & T2 Capital		11,961	
Total Capital		123,072	

Risk and Capital Management Disclosure

31 December 2016

3. Capital Adequacy (Continued)

Table – 2. Capital Structure (PD-1.3.12, 1.3.13, and 1.3.14) (Continued)

	Amount of exposures BD'000
Total Credit Risk Weighted Assets	527,820
Total Market Risk Weighted Assets	12,226
Total Operational Risk Weighted Assets	66,722
Total Regulatory Risk Weighted Assets	606,768
Investment risk reserve (30% only)	227
Equalization reserve (30% only)	374
Total Adjusted Risk Weighted Exposures	606,167
CAPITAL ADEQUACY RATIO	20.30%
Minimum requirement	12.5%

Table – 3. Capital requirements by type of Islamic financing contracts (PD-1.3.17)

The following table summarises the amount of exposures as of 31 December 2016 subject to standardised approach of credit risk and related capital requirements by type of Islamic financing contracts:

	Exposure			Risk Weighted Asstes*			Capital Requirments		
	Self-Financed	IAH	Total	Self-Financed	IAH	Total	Self-Financed	IAH	Total
	BD'000	BD'000	BD'000	BD'000	BD'000	BD'000	BD'000	BD'000	BD'000
Credit Risk Weighted Assets									
Funded									
Cash and balances with banks and Central Bank	31,847	31,361	63,208	6,372	-	6,372	797	-	797
Placements with financial institutions	63,805	-	63,805	15,566	-	15,566	1,946	-	1,946
Financing assets*	154,883	371,754	526,637	137,988	91,561	229,549	17,249	11,445	28,694
Investments	31,982	113,749	145,731	25,296	30,495	55,791	3,162	3,812	6,974
Ijarah muntahia bittamleek*	35,022	125,348	160,370	39,762	26,384	66,146	4,970	3,298	8,268
Investment in associates	26,487	-	26,487	63,156	-	63,156	7,895	-	7,895
Investment in real estate	24,870	3,196	28,066	49,739	1,918	51,657	6,217	240	6,457
Property and equipment	15,881	-	15,881	15,881	-	15,881	1,985	-	1,985
Other assets	3,096	8,907	12,003	3,099	4,747	7,846	387	593	980
	387,873	654,315	1,042,188	356,859	155,105	511,964	44,608	19,388	63,996
Unfunded									
Commitments and contingent liabilities	76,607	-	76,607	15,856	-	15,856	1,982	-	1,982
Total Credit Risk Weighted Assets	464,480	654,315	1,118,795	372,715	155,105	527,820	46,590	19,388	65,978
Total Market Risk Weighted Assets	-	-	-	12,226	-	12,226	-	-	-
Total Operational Risk Weighted Assets	-	-	-	66,722	-	66,722	-	-	-
Total RWA	464,480	654,315	1,118,795	451,663	155,105	606,768	46,590	19,388	65,978

*The risk wighted asstes are net off credit risk mitigant.

Table – 4. Capital requirements for market risk (PD-1.3.18)

The following table summarises the amount of exposures as of 31 December 2016 subject to standardised approach of market risk and related capital requirements:

Market Risk - Standardised Approach	
Foreign exchange risk (BD'000)	978
Total of Market Risk - Standardised Approach	978
Multiplier	12.5
RWE for CAR Calculation (BD'000)	12,226
Total Market Risk Exposures (BD'000)	12,226
Total Market Risk Exposures - Capital Requirement (BD'000)	1,528

Risk and Capital Management Disclosure

31 December 2016

3. Capital Adequacy (Continued)

Table – 5. Capital requirements for operational risk (PD-1.3.30 (a & b) and PD-1.3.19)

The following table summarises the amount of exposures as of 31 December 2016 subject to basic indicator approach of operational risk and related capital requirements:

Indicators of operational risk	
Average Gross income (BD'000)	35,585
Multiplier	12.5
	444,813
Eligible Portion for the purpose of the calculation	15%
Total Operational Risk Exposure (BD'000)	66,722
Total Operational Risk Exposures - Capital Requirement (BD'000)	8,340

Table – 6. Capital Adequacy Ratios (PD-1.3.20)

The following are Capital Adequacy Ratios as of 31 December 2016 for total capital and CET1 capital:

	Total capital ratio	CET1 capital ratio
Top consolidated level	20.30%	18.33%

4. Risk Management

4.1 Bank-wide Risk Management Objectives

The risk management philosophy of the Group is to identify, capture, monitor and manage the various dimensions of risk with the objective of protecting asset values and income streams such that the interest of the Group's shareholders (and others to whom the Group owes a liability) are safeguarded, while maximising the returns intended to optimise the Group's shareholder return while maintaining its risk exposure within self-imposed parameters.

In addition to satisfying the minimum regulatory capital requirements of CBB, the Group seeks to constantly identify and quantify, to the extent possible, the various risks that are inherent in the normal course of its business and maintain appropriate internal capital levels as per the ICAAP framework. The main objective of the Group's ICAAP is to ensure that adequate capital is retained at all times to support the risks the Group undertakes in the course of its business.

The Group has an established internal capital adequacy assessment process (ICAAP) as per the requirements under Pillar III of Basel III. ICAAP prescribed measures are designed to ensure appropriate identification, measurement, aggregation and monitoring of the Group's risk. It also defines an appropriate level of internal capital in relation to the Group's overall risk profile and business plan.

4.2 Strategies, Processes, and Internal Controls

4.2.1 Group's risk strategy

Risk Charter defines the Group's risk strategy. Comprehensive Risk Management Policy Framework is approved by the Board. These are also supported by appropriate limit structures. These policies provide an enterprise-wide integrated risk management framework for the Group.

The risk charter identifies risk objectives, policies, strategies, and risk governance both at the Board and management level. The capital management policy is aimed at ensuring financial stability by allocating enough capital to cover unexpected losses.

Limit structures serve as key components 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.

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

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.2 Strategies, Processes, and Internal Controls (Continued)

4.2.2 Credit risk

The Group manages its credit risk exposure by evaluating each new product/activity with respect to the credit risk introduced by it. The Group has established a limit structure to avoid concentration of risks for counterparty, sector, and geography.

4.2.3 Market risk

The Group proactively measures and monitors the market risk in its portfolio using appropriate measurement techniques such as limits on its foreign exchange open positions although they are insignificant. The Group regularly carries out stress testing to assess the impact of adverse market conditions on its market risk sensitive portfolio.

The Group has established a limit structure to monitor and control the market risk in its equity type instruments portfolio. These limits include maximum Stop-loss limits, position limits, VaR limits, and maturity limits. As at 31 December 2016, the group did not have any trading portfolio.

4.2.4 Operational risk

The Group has carried out Risk Control Self-Assessment ("RCSA") exercises on a regular basis to record potential risks, controls and events on a continuous basis across different business and support functions.

The Group has established a clear segregation of duties, through documentation and implementation of policies and procedures. This ensures objectivity, security, and avoids conflicts of interest. Maker checker concept and dual eye principles are applied across the Group, where possible.

4.2.5 Equity price risk

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 investment portfolio. The Group manages this risk through diversification of investments in terms of geographical distribution and industry concentration.

4.2.6 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 Group's management believes that the Group is not exposed to material profit rate risk as a result of mismatches of profit rate repricing of assets, liabilities, and equity of investment account holders. The profit distribution to investment account holders is based on profit sharing agreements. Therefore, the Group is not subject to any significant profit rate risk.

However, the profit sharing agreements will result in displaced commercial risk when the Group's results do not allow the Group to distribute profits inline with market rates.

4.2.7 Displaced Commercial Risk

Displaced commercial risk ("DCR") refers to the market pressure to pay returns that exceed the rate that has been earned on the assets financed by the liabilities, when the return on assets is underperforming as compared with competitors rates.

The Group manages its Displaced Commercial Risk by placing gap limits between the returns paid to investors and market returns.

The Group manages its Displaced Commercial Risk as outlined in the Risk Charter of the Group. The Group may forego its fee in case displaced commercial risk arises. The Group benchmarks its rates with other leading banks in the market.

All the above strategies used have been effective throughout the reporting year.

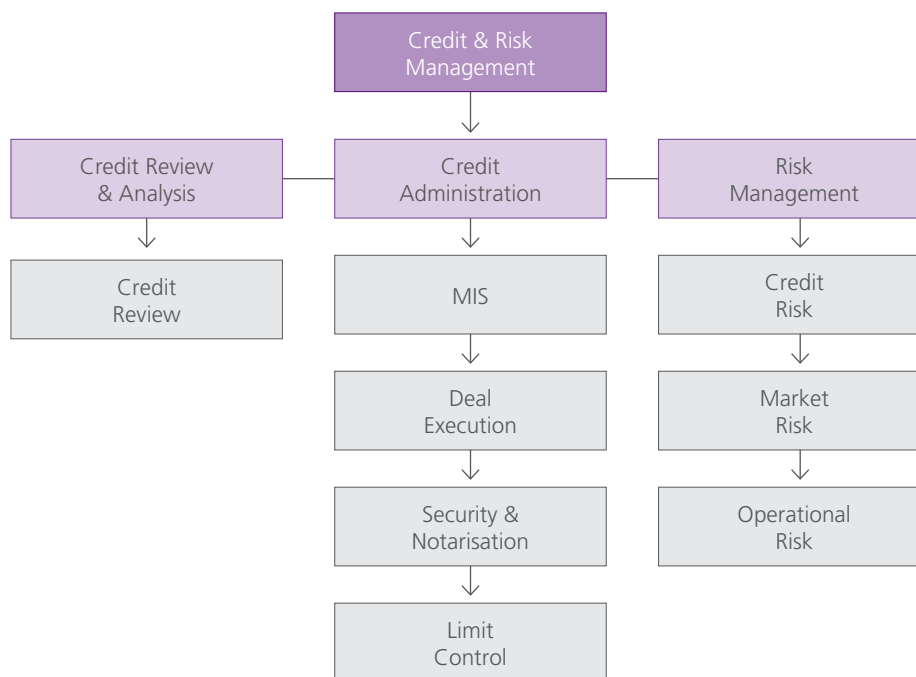
Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.3 Structure and Organisation of Risk Management Function

Risk Management Structure includes all levels of authorities (including Board level Risk committee), organisational structure, people, and systems required for the smooth functioning of risk management processes in the Group. The responsibilities associated with each level of risk management structure and authorities include the following:



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

- Establishing overall policies and procedures; and
- Delegating authority to Executive Committee, Credit Committee, the Chief Executive Officer and further delegation to management to approve and review.

4.4 Risk Measurement and Reporting Systems

Based on risk appetite of the Group, the Group 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 Credit and Risk Management Department ("CRMD"). The limits are reviewed and revised at least on an annual basis or when is deemed required.

The Group has developed a risk measurement and reporting system that generates various types of reports which has enhanced the monitoring process of the Group.

4.5 Credit Risk

4.5.1 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 and investment 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 the form of mortgage financed or other tangible securities.

The Group 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 area, and industry sector. 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 Credit Review and Analysis Unit ("CRAU"). Any changes to the Credit Risk Policy will be approved by the Board.

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.5 Credit Risk (Continued)

4.5.1 Introduction (Continued)

All credit proposals undergo a comprehensive risk assessment examining the customer's financial condition, trading performance, nature of the business, quality of management, and market position, etc. In addition, the Group has implemented Moody's Risk Analyst system in 2016 which has different rating models and generates ratings after taking into consideration quantitative and qualitative factors. This has further strengthened the approval process. 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 an annual basis by CRAU.

4.5.2 Types of credit risk

Financing contracts mainly comprise of due from banks and financial institutions, Murabaha receivables, Musharaka investments, and Ijarah muntahia bittamleek.

Due from banks and financial institutions

Due from banks and financial institutions comprise commodity murabaha receivables and wakala receivables.

Murabaha receivables

The Group finances these transactions through buying the commodity which represents the object of the Murabaha contract and then reselling this commodity to the Murabeh (beneficiary) at a profit. The sale price (cost plus profit margin) is repaid in installments by the Murabeh over the agreed period. The transactions are secured at times by the object of the Murabaha contract (in case of real estate finance) and other times by a total collateral package securing the facilities given to the Murabeh.

Musharaka investments

Musharaka is a form of partnership between the Group and its clients whereby each party contributes to the capital of partnership in equal or varying degrees to establish a new project or share in an existing one, whereby each of the parties becomes an owner of the capital on a permanent or declining basis. Profits are shared in an agreed ratio, but losses are shared in proportion to the amount of capital contributed.

Ijarah Muntahia Bittamleek

The legal title of the assets under Ijarah muntahia bittamleek only passes to the lessee at the end of the Ijarah term, through gift, consideration, or gradual sale, provided that all Ijarah instalments are settled.

4.5.3 Past Due and impaired Islamic financing

The Group defines non-performing facilities as the facilities that are overdue for a period of 90 days or more. These exposures are placed on a non-accrual status with income being recognised 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 days or more, the whole financing facility extended is considered as non performing, not only the overdue instalments/payments.

As a policy, the Group places on a non-accrual basis 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.

4.5.4 External credit assessment institutions

The Group relies on external ratings for rated corporate customers and counterparties. The Group uses Standard & Poor's, Fitch, Moody's and Capital Intelligence to provide ratings for such counterparties. In case of unrated counterparties, the Group will assess the credit risk on the basis of defined parameters. These ratings are used for risk assessment and calculation of risk weighted equivalents. The Group's policy has the mapping of the external ratings with the ratings used by the Group and the corresponding rating is allocated to the exposure accordingly to transfer it in the Group's banking book.

4.5.5 Definition of Geographical distribution

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

4.5.6 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 prior 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.

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.5 Credit Risk (Continued)

4.5.7 Credit risk mitigation

Credit risk mitigation refers to the use of a number of techniques, like collaterals and guarantees to mitigate the credit risks that the Group is exposed to. Credit risk mitigants reduce the credit risk by allowing the Group to protect against counterparty non-performance of credit contracts through collaterals, netting agreements, and guarantees.

Generally, the Group extends credit facilities only where supported by adequate tangible collateral security and/or audited financial statements. Facilities may be considered without adequate tangible collateral security, when audited financial statements reveal satisfactory financial position/repayment ability and the facilities are properly structured and supported by assignments, guarantees, etc. as appropriate.

In general, personal guarantees of the partners/promoters/directors of the borrowing entity are obtained in support of credit facilities. In all cases, a statement of net worth of the guarantor is to be compiled by the Account Officer, so that adequate information is available at a future date in case the guarantees need to be enforced.

The market value of tangible collateral security is properly evaluated by the Group's approved valuers (for properties) or based on publicly available quotations. The value of such security is considered only to the extent of the outstanding exposure of relevant credit facilities.

From time to time, the Credit and Investment Committee reviews and approves the loan-able value of securities. It has also approved a list of acceptable securities.

The majority of the Group's current credit portfolio is secured through mortgage of commercial real estate properties. The Group may dispose off the assets as a last resort after carrying out due legal process.

4.5.7.1 General policy guidelines of collateral management

Acceptable Collaterals:

The Group has developed guidelines for acceptable collaterals. Assets offered by customers must meet the following criteria to qualify as acceptable collateral:

- a. Assets must be maintaining their value, at the level prevalent at inception, until maturity date of the facility granted;
- b. Such assets should be easily convertible into cash, if required (liquidity);
- c. There should be a reasonable market for the assets (marketability); and
- d. The Group should be able to enforce its rights over the asset if necessary (enforceability).

Ownership:

Prior to valuation or further follow up on the offered collateral, Credit Administration ensures satisfactory evidence of the borrower's ownership of the assets.

Valuation:

All assets offered as collateral are valued by an appropriate source either in-house (through another department in the Group) or by an external appraiser (real estate related collateral). The Group maintains a list of independent appraisers, approved by management.

a. Valuation of shares and goods: Where competent staff is available within the Group, the valuation is conducted in-house. The Group performs in-house valuation on the following types of securities:

- Pledge of shares of local companies;
- Pledge of international marketable shares and securities; and
- Pledge and hypothecation of goods.

Quoted shares are valued at the quotes available from stock exchanges, periodicals, etc.

b. Valuation of real estate and others: Besides assets mentioned above the valuation, of following securities are also conducted:

- Real Estate;
- Equipment and machinery; and
- Precious metals and jewels.

The Credit Administration requests the concerned department to arrange for the valuation from approved valuers.

The following additional guidelines are also followed by the Group:

- a. No facility should be disbursed until credit documentation is properly signed and security/guarantees required have been signed and registered, where required. Exceptional cases can be considered by sanctioning authorities; and
- b. All documents received as security or support for credit facilities will be lodged in the safe custody through the Credit Administration and should be kept under dual control. Group must ascertain that collateral providers are authorised and acting within their capacity.

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.5 Credit Risk (Continued)

4.5.7.2 Guarantees

In cases where a letter of guarantee from parent company or a third party is accepted as a credit risk mitigant, the Group ensures that all guarantees are irrevocable, legal opinion has been obtained from a legal counsellor 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 facilities. Also no maturity negative mismatch is permissible between the guarantee and exposure.

4.5.7.3 Custody / collateral management

The assets, or title to the asset, will be maintained in the Group's custody or with custodian approved by the Group. The Credit Administration will obtain confirmation of the assets held with each custodian on an annual basis.

The release of collateral without full repayment of all related financial obligations requires authorisation of the same level that originally approved and sanctioned the facility. Substitution of collateral is permitted if the new collateral would further minimise the Group's risk exposure.

When collateral is released to the customer, the Head of Credit Administration obtains and maintains in his records acknowledgement of receipt from the customer or his/her authorised representative.

4.5.8 Counterparty credit risk

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

4.5.8.1 Exposure

The measure of exposure reflects the maximum loss that the Group may suffer in case counterparty fails to fulfil its commitments. Exposure shall always be calculated on the basis of approved limits or actual outstanding exposure (Financing facilities, Investments or others), whichever is higher.

4.5.8.2 Counterparty

A counterparty is defined as an obligor (individual/company/other legal entity), a guarantor of an obligor, or a person receiving funds from the Group, 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.

4.5.8.3 Group exposure

Group exposure is defined as the total exposure to all counterparties closely related or connected to each other. For this purpose, a Group is two or more counterparties related in such a way that financial soundness of one may affect the financial soundness of the other(s) and one of them has a direct or indirect control over the other(s).

4.5.8.4 Connected counterparties

Connected counterparties are companies or individuals connected with the Group or its subsidiaries and associated companies (whether such association is due to control or shareholding or otherwise), Directors and their associates (whether such association is due to control, family links or otherwise), members of the Shari'a Supervisory Board, management and other staff, and shareholders holding more than 10% or more of the equity voting rights in the Group.

4.5.8.5 Large exposure

Large exposure is any exposure whether direct, indirect, or funded by equity of investment accountholders to a counterparty or a group of closely related counterparties which is greater than or equal to 10% of the Group's capital base.

Prior written approval from the CBB is required in the following cases:

- a. If any counterparty (single/group) exposure exceeds 15% of Group's Capital Base; and
- b. If any facility (new/extended) to an employee is equal or above BD100,000 (or equivalent).

4.5.8.6 Maximum exposure

The Group has set an internal maximum exposure limit in the light of CBB guidelines.

4.5.8.7 Reporting

The Group reports large counterparty exposures (as defined above) to CBB on a periodic basis. The Group reports the exposures on a gross basis without any set-off. 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 right to do so.

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.5 Credit Risk (Continued)

4.5.8.8 Other matters

As a Group's strategy, exposure to connected counterparties may be undertaken only when negotiated and agreed on an arm's length basis.

The Group shall not assume any exposure to its external auditors.

4.5.9 Related party transactions

The disclosure relating to related party transactions has been made in the consolidated financial statements as of 31 December 2016. All related party transactions have been made on arm's length basis.

Table – 7. Credit Risk Exposure (PD-1.3.23(a))

The following table summarises the amount of gross funded and unfunded credit exposure as of 31 December 2016 and average gross funded and unfunded exposures over the year ended 31 December 2016:

	Total gross credit exposure BD'000	*Average gross credit exposure over the year BD'000
Funded		
Cash and balances with banks and central Bank	63,208	64,938
Placements with financial institutions	63,805	63,349
Financing assets	526,637	516,382
Investments securities	145,731	132,924
Ijarah muntahia bittamleek & rental receivables	160,370	150,534
Investment in associates	26,487	27,548
Investment in real estate	28,066	33,001
Property and equipment	15,881	16,166
Other assets	12,003	11,564
Total	1,042,188	1,016,406
Unfunded		
Commitments and contingent liabilities	76,607	76,059
Total	1,118,795	1,092,465

*Average balances are computed based on quarter end balances.

Table – 8. Credit Risk – Geographic Breakdown (PD-1.3.23(b))

The following table summarises the geographic distribution of exposures as of 31 December 2016, broken down into significant areas by major types of credit exposure:

	North America BD'000	Europe BD'000	Middle East BD'000	Total BD'000
Cash and balances with banks and central Bank	5,801	91	57,316	63,208
Placements with financial institutions	-	-	63,805	63,805
Financing assets	-	-	526,637	526,637
Investments securities	-	5,692	140,039	145,731
Ijarah muntahia bittamleek & rental receivables	-	-	160,370	160,370
Investment in associates	-	-	26,487	26,487
Investment real estate	-	-	28,066	28,066
Property and equipment	-	-	15,881	15,881
Other assets	-	-	12,003	12,003
Total	5,801	5,783	1,030,604	1,042,188

* Geographical distribution of exposure into significant areas by major type of credit exposure is based on counterparty's country of incorporation.

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.5 Credit Risk (Continued)

4.5.9 Related party transactions (Continued)

Table – 9. Credit Risk – Industry Sector Breakdown (PD-1.3.23(c))

The following table summarises the distribution of funded and unfunded exposures as of 31 December 2016 by industry, broken down into major types of credit exposure:

	Trading and Manufacturing BD'000	Banks and Financial Institutions BD'000	Real Estate BD'000	Aviation BD'000	Personal & Consumer Finance BD'000	Governmental Organisation BD'000	Others BD'000	Total BD'000
Funded								
Cash and balances with banks and central Bank	-	25,566	-	-	-	37,642	-	63,208
Placements with Financial institutions	-	63,805	-	-	-	-	-	63,805
Financing assets	76,668	16,214	76,834	-	275,663	4,750	76,508	526,637
Investments securities	-	20,594	34,956	-	-	82,147	8,034	145,731
Ijarah muntahia bittamleek & rental receivables	3,233	312	44,151	-	103,747	7,559	1,368	160,370
Investment in associates	-	7,648	6,311	-	-	-	12,528	26,487
Investment in real estate	-	-	28,066	-	-	-	-	28,066
Property and equipment	-	-	-	-	-	-	15,881	15,881
Other assets	-	1,991	6,916	-	1,674	-	1,422	12,003
Total	79,901	136,130	197,234	-	381,084	132,098	115,741	1,042,188
Unfunded								
Commitments and contingent liabilities	14,276	669	2,298	820	427	-	58,117	76,607
Total	94,177	136,799	199,532	820	381,511	132,098	173,858	1,118,795

Table – 10. Credit Risk – Financing Facilities to Highly Leveraged or Other High Risk Counterparties (PD-1.3.23(e))

The following balances represent the financing facilities to highly leveraged or other high risk counterparties as of 31 December 2016:

	Gross BD'000	Provision BD'000	Net BD'000
Counterparties			
Counterparty # 1	8,338	3,335	5,003
Counterparty # 2	8,627	-	8,627
Counterparty # 3	3,755	1,730	2,025
	20,720	5,065	15,655

Table – 11. Credit Risk – Concentration of Risk (PD-1.3.23(f))

The following balances represent the concentration of risk to individual counterparties as of 31 December 2016:

	Total BD'000
Counterparties	
Counterparty # 1	12,528
	12,528

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.5 Credit Risk (Continued)

4.5.9 Related party transactions (Continued)

Table – 12. Credit Risk – Residual Contractual Maturity Breakdown (PD-1.3.23(g) PD-1.3.38)

The following table summarises the residual contractual maturity of the whole credit portfolio as of 31 December 2016, broken down by major types of credit exposure:

	Up to One month BD'000	1-3 months BD'000	3-6 months BD'000	6-12 months BD'000	1-3 years BD'000	3-5 years BD'000	5-10 years BD'000	10-20 years BD'000	Over 20 years BD'000	No fixed maturity BD'000	Total BD'000
Assets											
Cash and balances with banks and central Bank	29,442	-	-	-	-	-	-	-	-	33,766	63,208
Placements with financial institutions	63,805	-	-	-	-	-	-	-	-	-	63,805
Financing assets	23,480	15,488	23,248	49,452	82,910	105,926	171,378	36,518	18,237	-	526,637
Investments securities	97	1,504	3,798	-	38,685	4,161	95,910	-	1,576	-	145,731
Ijarah muntahia bittamleek & rental receivables	11,542	2,091	21	63	1,506	6,178	25,893	60,083	52,993	-	160,370
Investment in associates	-	-	-	-	-	-	-	-	-	26,487	26,487
Investment real estate	-	-	-	-	-	-	-	-	-	28,066	28,066
Property and equipment	-	-	-	-	-	-	-	-	-	15,881	15,881
Other assets	379	1,665	-	-	3,044	-	-	-	-	6,915	12,003
Total Assets	128,745	20,748	27,067	49,515	126,145	116,265	293,181	96,601	72,806	111,115	1,042,188

Table – 13. Credit Risk – Impaired Exposures, Past Due Exposures and Allowances by industry sector (PD-1.3.23(h) PD-1.3.24(b) PD-1.3.24(d))

The following table summarises the impaired facilities, past due facilities, and allowances disclosed by major industry sector as of 31 December 2016:

	Non/ performing or past due or impaired Islamic financing contracts BD'000	Aging of non-performing or past due or impaired Islamic financing contracts				Specific allowances			* General allowances			
		Less than 3 months** BD'000	3 months to 1 year BD'000	1 to 3 years BD'000	Over 3 years BD'000	Balance at the beginning of the year BD'000	Charge during the year BD'000	Charge-offs and recoveries during the year BD'000	Balance at the end of the year BD'000	Balance at the beginning of the year BD'000	Net charge for the period BD'000	Balance at the end of year BD'000
Trading and Manufacturing	34,173	27,966	4,412	1,496	299	530	863	352	1,041	-	-	-
Real Estate	70,277	18,749	10,077	857	40,594	28,240	2,150	4,563	25,827	-	-	-
Banks and Financial Institutions	-	-	-	-	-	-	-	-	-	-	-	-
Personal / Consumer Finance	34,694	27,821	2,714	1,566	2,593	352	198	535	15	-	-	-
Others	18,960	9,278	8,257	1,184	241	24	713	82	655	-	-	-
No specific sector	-	-	-	-	-	-	-	-	-	11,326	1,108	12,434
Total	158,104	83,814	25,460	5,103	43,727	29,146	3,924	5,532	27,538	11,326	1,108	12,434

* General allowance represents collective impairment provision against exposures which, although not specifically identified, have a greater risk of default than when originally granted.

** This includes amounts not due and amounts past due less than 90 days relating to non-performing or past due or impaired Islamic financing contracts.

The Group's collective retail model uses the net flow rate method, where probability of default is calculated on an account level segregated by buckets of number of days past due. Loss given default is at annual average recovery rates, which is reviewed annually.

The Group's collective corporate model uses the expected loss method. Data is grouped in economic sectors and probability of default and loss given default is calculated for these sectors.

In assessing specific impairments, the Group uses different criteria including Discounted Cash Flow method to ascertain the impairment, if any.

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.5 Credit Risk (Continued)

4.5.9 Related party transactions (Continued)

Table – 14. Credit Risk – Impaired Exposures, Past Due Exposures and Allowances by geographic area (PD-1.3.23(i) PD-1.3.24(c))

The following table summarises the past due facilities and allowances financed by own capital and current account and profit sharing investment account disclosed by geographical area as of 31 December 2016:

	Non-performing or past due or impaired Islamic financing contracts BD'000	Specific Impairment provision BD'000	Collective Impairment provision BD'000
Middle East	158,104	27,538	12,434
Total	158,104	27,538	12,434

Table – 15. Credit Risk – Restructured Financing Facilities (PD-1.3.23(j))

The following table summarises the aggregate amount of restructured financing facilities during the year as of 31 December 2016:

	Outstanding BD'000	Provision BD'000	Net of Provision BD'000
Total Islamic Financing	726,978	39,971	687,007
Restructured financing facilities	9,643	-	9,643
Percentage	1.33%	0.00%	1.40%

Exposures amounting to BD 10,937 thousand were restructured during the year were excluded from Table 15 and included in Table 13 and 14 above.

Table – 16. Credit Risk Mitigation (PD-1.3.25 (b) and (c))

The following table summarises the exposure as of 31 December 2016 by type of Islamic financing contract covered by eligible collateral:

	Total exposure covered by	
	Eligible collateral BD'000	Guarantees BD'000
Financing assets	12,044	15,900
Ijarah muntahia bittamleek & rental receivables	20,721	831
Total	32,765	16,731

Type of Guarantees	Guarantees BD'000	Risk Weighted BD'000
Tamkeen Guarantee	14,316	8,435
Bank Guarantee	2,415	1,835
Total	16,731	10,270

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.5 Credit Risk (Continued)

4.5.9 Related party transactions (Continued)

Table – 17. Counterparty Credit (PD-1.3.26 (b))

The following table summarises the counterparty credit risk exposure covered by collateral after the application of haircuts as of 31 December 2016:

	Financing assets BD'000	Ijarah muntahia bittamleek and rental receivables BD'000	Total BD'000
Exposures:			
Secured*	96,538	40,243	136,781
Unsecured*	430,099	120,127	550,226
Total	526,637	160,370	687,007
Collateral held:			
- Cash	11,193	797	11,990
- Guarantees	15,900	831	16,731
- Real Estate	851	19,924	20,775
Total	27,944	21,552	49,496
Collateral as a percentage of secured exposure	28.95%	53.55%	36.19%

A haircut of 30% is applied on the Real Estate collateral.

*The financing assets and ijarah muntahia bittamleek exposures are net of provision.

4.6 Market Risk

4.6.1 Introduction

The Group has accepted the definition of market risk as defined by CBB as “the risk of losses in on- and off-balance sheet positions arising from movements in market prices.

4.6.2 Sources of market risk

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. The Group's management believe that the Group is not exposed to material profit rate risk as a result of mismatches of profit rate repricing of assets, liabilities, and equity of investment accountholders as the repricing of assets, liabilities and equity of investment accountholders occur at similar intervals. The profit distribution to equity of investment accountholders is based on profit sharing agreements. Therefore, the Group is not subject to any significant profit rate risk.

Foreign exchange risk is the sensitivity of financial products to changes in spot foreign exchange rates. The value of the Group's portfolio which is denominated in a number of currencies may be exposed to these risks when converted back to the Group's base currency.

Equity price risk is the sensitivity of financial products to the changes in equity prices. Equity risk arises from holding open positions in equities or equity based instruments, thereby creating exposure to a change in the market price of the equity. In addition to Group performance expectations, equity prices are also susceptible to general economic data and sector performance expectations.

Commodity risk is defined as inherent risk in financial product arising from their 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 particular sector and less correlated across sectors.

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.6 Market Risk (Continued)

4.6.3 Market risk strategy

The Group's Board is responsible for approving and reviewing (at least annually) the risk strategy and significant amendments to the risk policies. The Group's senior management is responsible for implementing the risk strategy approved by the Board, and continually enhancing the policies and procedures for identifying, measuring, monitoring, and controlling risks.

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

- 1 The Group will manage its market risk exposure by evaluating each new product / activity with respect to the market risk introduced by it;
- 2 The Group will proactively measure and continually monitor the market risk in its portfolio;
- 3 The Group will at all time hold sufficient capital in line with the CBB Pillar 1 regulatory capital requirements;
- 4 The Group will establish a limit structure to monitor and control the market risk in its portfolio. These limits will include position limits, maximum/stop loss limits, factor sensitivity limits, VaR limits and maturity limits;
- 5 The Group will carry out stress testing periodically using the worst case scenarios to assess the effects of changes in the market value due to changing market conditions;
- 6 The Group will periodically carry out back testing of market risk assessment models in order to evaluate their accuracy and the inherent model risk;
- 7 The Group will match the amount of floating rate assets with floating rate liabilities; and
- 8 The Group will clearly identify the foreign currencies in which it wishes to deal in and actively manage its market risk in all foreign currencies in which it has significant exposure.

4.6.4 Market risk measurement methodology

Market risk measurement techniques include the use of a number of techniques for market risk measurement. The risk measurement techniques mentioned in this section are used for measuring market risk in both trading book as well as banking book.

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

- a. Overnight open positions;
- b. Stop loss limits;
- c. Factor sensitivity limits;
- d. VaR limits; and
- e. Profit rate risk gap analysis.

4.6.5 Market risk monitoring and limits structure

The Asset and Liability Committee (ALCO) proposes through the Executive Committee and Board the tolerance for market risk. Based on these tolerances, Risk and Compliance Unit and Treasury have established appropriate risk limits that maintain the Group's exposure within the strategic risk tolerances over a range of possible changes in market prices and rates.

4.6.6 Limits monitoring

The Treasury Department and Risk and Compliance Unit monitor the risk limits for each transaction, ensure that the limits are well within set parameters, and report periodically to top management.

4.6.7 Breach of limits

In case a limit is breached, an approval from the CEO is required to continue with the transaction. An immediate report is provided to the ALCO after every significant limit breach. This breach is also reported to and approved by the Executive Committee (EXCOM). The limits are revised at least bi-annually or when deemed required.

4.6.8 Portfolio review process

On a monthly basis, Risk and Compliance Unit reviews the Group's assets and liabilities portfolio to evaluate the overall corporate exposure to market risk. As part of the review, Risk and Compliance Unit also monitors the Group's overall market exposure against the risk tolerance limits set by the Board. Risk and Compliance Unit also reviews the adherence to approved limits to control the market risk. Changes, if any, in market risk limits are communicated to business units after review by the GM-C&RM/CEO and approval by the ALCO or EXCOM, as per the delegated authorities approved by the Board. Balance sheet exposure is being reviewed on a quarterly basis by the Board level Audit and Risk committees.

4.6.9 Reporting

Risk and Compliance Unit generates at regular periodic intervals market risk management reports. These reports aim to provide the Group's senior management with an up-to-date view of its market risk exposure.

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.6 Market Risk (Continued)

4.6.10 Stress testing

Stress tests produce information summarising the Group's exposure to extreme, but possible, circumstances and offer a way of measuring and monitoring the portfolio against extreme price movements of this type. The Group's Risk and Compliance Unit employs four stress categories: profit rates, foreign exchange rates, equity prices, and commodity prices. For each stress category, the worst possible stress shocks that might realistically occur in the market are defined.

4.6.11 Foreign subsidiary

The Group does not have any foreign subsidiary.

Table – 18. Market Risk Capital Requirements (PD-1.3.27 (b))

The following table summarises the maximum and minimum capital requirement for foreign exchange risk as of 31 December 2016:

	Foreign exchange risk BD'000
Maximum value capital requirement	1,528
Minimum value capital requirement	975

4.7 Operational Risk

4.7.1 Introduction

Operational risk is the risk of loss arising from system failure, human error, fraud, or external events. When controls fail to perform, operational risks can cause damage to reputation, have legal or regulatory implications, or lead to financial loss. 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.

4.7.2 Sources of operational risk

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

1. People risk which arises due to staffing inadequacy, unattractive remuneration structure, lack in staff development policies, lack in procedures for appointment, unhealthy professional working relationship, and unethical environment;
2. Processes risk which arises due to inadequate general controls, inadequate application controls, improper business and market practices and procedures, inappropriate/inadequate monitoring and reporting; and
3. Systems (Technology) risk which arise due to integrity of information - lacking in timeliness of information, omission and duplication of data, hardware failures due to power surge, obsolescence or low quality.
4. Legal risk which arises due to contractual obligations.

4.7.3 Operational risk management strategy

As a strategy, the Group will identify the sources of operational risks in coordination with each business unit. The Group carried out Risk Control Self-Assessments ("RCSA"), and plans to do a continuous and on-going exercise to identify the operational risks it is exposed to.

The Group on a continuous basis will:

- a. assess the effectiveness of controls associated with identified risks;
- b. regularly monitor operational risk profiles and material exposures to losses / loss events; and
- c. identify stress events and scenarios to which it is vulnerable and assess their potential impact, and the probability of aggregated losses from a single event leading to other risks.

4.7.4 Operational risk monitoring and reporting

The internal monitoring and reporting process ensures a consistent approach for providing pertinent information to senior management 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 Bank has a legal department dedicated to monitor any legal risk arising out of contracts / agreements entered into by the Bank on a day to day basis. The department also liaises with external lawyers for legal cases filed by the bank against delinquent accounts for recovery or any legal cases filed against the Bank.

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.7 Operational Risk (Continued)

4.7.5 Operational risk mitigation and control

The business units, in consultation with Risk and Compliance Units will determine all material operational risks and decide the appropriate procedures to be used to control and/or mitigate the risks.

For those risks that cannot be controlled, the business units in conjunction with Risk and Compliance Unit will decide whether to accept the risks, reduce the level of business activity involved, transfer the risk outside the Group, or withdraw from the associated activity completely. Risk and Compliance Unit facilitates the business units in co-developing the mitigation plans. Bank deals with the pending legal cases through internal and external lawyers depending upon the severity of the cases.

4.7.6 Business Continuity Plan (BCP)

The Group has also developed a comprehensive business continuity plan detailing the steps to be taken in the event of extreme conditions to resume the Group's operations with minimum delay and disturbance. The plan is in implementation stage. Elements of contingency plans and disaster recovery processes include operating systems, physical space, telecommunications, and resources.

Table – 19. Operational Risk Exposure (PD-1.3.30 (a), (b) & (c))

The following table summarises the amount of exposure subject to basic indicator approach of operational risk and related capital requirements:

	Gross income		
	2015 BD'000	2014 BD'000	2013 BD'000
Total Gross Income	40,704	32,290	33,761
Indicators of operational risk			
Average Gross income (BD'000)			35,585
Multiplier			12.5
			444,813
Eligible Portion for the purpose of the calculation			15%
TOTAL OPERATIONAL RISK WEIGHTED EXPOSURE (BD'000)			66,722

Risk and Compliance Unit ensures that the BCP is kept up to date and tested once a year in a simulated environment to ensure that it can be implemented in emergency situations and that the management and staff understand how it is to be executed. Results of this testing conducted by Risk and Compliance Unit is evaluated by the GM-C&RM and presented to the EXCOM/Board for evaluation.

4.8 Equity Position 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 as of 31 December 2016. Equity type instruments carried at fair value through equity and investment properties are kept for capital gain purposes, all other investments including investments in associates are kept for strategic long term holdings.

Table – 20. Equity Position Risk in Banking Book (PD-1.3.31 (b) (c) & (g))

The following table summarises the amount of total and average gross exposure of equity based financing structures by types of financing contracts and investments as of 31 December 2016:

	Total gross exposure BD'000	* Average gross exposure BD'000	Publicly traded BD'000	Privately held BD'000	Risk weighted assets BD'000	Capital Requirements BD'000
Sukuk	113,283	99,527	-	113,283	14,591	1,824
Equity investments	18,280	19,230	688	17,592	13,323	1,665
Funds	14,168	14,167	-	14,168	27,878	3,485
Total	145,731	132,924	688	145,043	55,792	6,974

*Average balances are computed based on quarter end balances.

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.8 Equity Position in the Banking Book (Continued)

Table – 21. Equity Gains or Losses in Banking Book (PD-1.3.31 (d), (e) & (f))

The following table summarises the cumulative realised and unrealised gains or (losses) during the year ended 31 December 2016:

	BD'000
Cumulative realised gain arising from sales or liquidations in the reporting period	(1,792)
Total unrealised losses recognised in the consolidated statement of financial position but not through consolidated statement of income	-
Unrealised gains included in CET 1 Capital	531
Unrealised gains included in Tier 2 Capital	5,363

4.9 Equity of Investment Accountholders ("IAH")

The Group may require to decrease or increase losses or profit on certain IAH accounts for the purpose of income smoothing. Thus the Group is exposed to some of the price risk on assets funded by equity of Investment Accountholders ("IAH"). The CBB requires the Group to maintain capital to cover the price risk arising from 30% of assets funded by IAH on a pro-rata basis.

The Group is authorised by the IAH to invest the account holder's funds on the basis of Mudaraba contract in a manner which the Group deems appropriate without laying down any restrictions as to where, how, and for what purpose the funds should be invested. Under this arrangement the Group can commingle the equity of investment accountholders investment funds with its own funds (owner's equity) or with other funds the Group has the right to use (e.g. current accounts or any other funds which the Group does not receive on the basis of Mudaraba contract). The IAH and the Group generally participate in the returns on the invested funds. In such type of contract, the Group is not liable for any losses incurred on the joint pool other than the loss resulting from gross negligence or wilful misconduct on the part of the Group or due to the Group's violation of the terms and conditions as agreed between the Group and the IAH. During the year the Bank waved 0.7% of profit from mudarabah fees in order maintain competitive profit distribution to IAH.

The amount received from the customer on account of equity of investment accountholders is not invested completely in the portfolio of selected investments as the Group is required to maintain a cash reserve with CBB. In addition, the Group requires to set aside certain amount to meet operational requirements. The income allocated to the equity of investment accountholders deposits being received is in accordance with the utilisation of such funds. The utilisation rate is determined by the ALCO with the approval of Shari'a Supervisory Board.

Proposal for new products is initiated by the business lines within the Group and ALCO review such proposal to ensure that the new product is in line with the Group's business and risk strategy. All new products require the approval of the Shari'a Supervisory Board of the Bank. The business lines of the Group have expertise in creating high end value added products offering a wide range of products, expected return, tenors, and risk profile. Information on new products or any change in the existing products will be placed on the Group's website or published in the media.

The Group has designed special Quality of Service and Complaints Management Unit which reports to GM Retail. The complaints are investigated by personnel not directly related to the subject matter of the complaints.

The Group offers equity of investment accountholders in different currencies for maturity periods ranging from 1 month, 3 months, 6 months, 9 months, 12 months, and 36 months. The customer signs a written contract covering all terms and conditions of the investment, including tenor, basis of profit allocation, and early withdrawal.

Because equity of investment accountholders is a significant funding source for the Group, the Group regularly monitors rate of return offered by competitors to evaluate the expectation of its IAH. The Group's policy provide whole or partial waiver of the Mudarab share of income from investment in order to provide a reasonable return to its investors.

The Group comingles its own funds and equity of investment accountholders funds which are invested together. The equity of investment accountholders funds are invested into assets and income from these assets are allocated to such account.

The Group has already developed written policies and procedures applicable to its portfolio of Equity of investment accountholders. Equity of investment accountholders funds are invested and managed in accordance with Shari'a requirements.

Profits of an investment jointly financed by the Group and the equity of investment accountholders shall be allocated between them according to the contribution of each of the Group and the IAH in the jointly financed investment. Operating expenses incurred by the Group are not charged to investment account. In case of the loss resulting from the transactions in a jointly financed investment, such loss shall first be deducted from undistributed profits, if any. Any excess of such loss shall be deducted from Investment Risk Reserve (IRR). Any remaining of such loss shall be deducted from the total balance of fund available in the Joint pool, as at that date, in the respective ratio of the Group's and IAH's respective contribution to the comingled pool. The Bank temporarily allocates non-performing assets (past due greater than 90 days) from IAH to the equity shareholders and charges the specific impairment provisions to the owners' equity. Amounts recovered from these impaired assets is not subject to allocation between the IAH and owners' equity. The Bank takes remedial action on these non-performing assets and once these assets become performing, the assets and related income are allocated between the IAH and owners' equity.

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.9 Equity of Investment Accountholders ("IAH") (Continued)

In case of early withdrawal of IAH fund before completion of the term, the effective utilisation method will be applied.

In case of term deposits, the IAH account holders can withdraw funds on a premature basis by paying a nominal amount of fees / penalty; such penalties are offered for charity.

Additional disclosures such as the below are disclosed in the Bank's website;

- a) Characteristics of investors for whom investment account may be appropriate
- b) Purchase redemption and distribution procedures
- c) Product information and the manner in which the products are made available to investors

Table – 22. Equity of Investment Accountholders by Type (PD-1.3.33 (a))

The following table summarises the breakdown of equity of investment accountholders accounts as of 31 December 2016:

	BD'000
Individuals and non-financial institutions	654,316
Financial institutions' investment accounts	103,874
Total	758,190

Table – 23. Equity of Investment Accountholders Ratios (PD-1.3.33 (d) & (f))

The following table summarises the return on average assets and mudarib share as a percentage of the total investment profit for the year ended 31 December 2016:

Profit Paid on Average IAH Assets *	1.14
Mudarib Fee to Total IAH Profits	56.88%

* Average assets funded by IAH have been calculated using quarter end balances.

Table – 24. Equity of Investment Accountholders Ratios (PD-1.3.33 (e) & (g))

The following table summarises the profit distributed to IAH and financing ratios to the total of IAH by type of investment for the year ended 31 December 2016:

Account Type	Average declared rate of return	Proportion of profit distributed to total IAH	Proportion of to total IAH
Saving accounts (including VEVO)	0.13%	2.27%	19.51%
Defined accounts - 1 month	0.80%	0.58%	0.70%
Defined accounts - 3 months	0.80%	0.22%	0.27%
Defined accounts - 6 months	0.85%	0.35%	0.43%
Defined accounts - 9 months	0.95%	0.00%	0.00%
Defined accounts - 1 year	1.00%	2.13%	2.18%
Investment certificates	3.50%	0.18%	0.02%
IQRA	1.50%	1.02%	0.71%
Tejoori	0.13%	3.04%	28.42%
Customer special deposits	1.73%	90.21%	47.76%
		100%	100%

The calculation and distribution of profits was based on quarterly average balances.

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.9 Equity of Investment Accountholders ("IAH") (Continued)

Table – 25. Equity of Investment Accountholders to Total Financing (PD-1.3.33 (h) & (i))

The following table summarises the percentage of counterparty type to total financing for each type of Shari'a-compliant contract to total financing as of 31 December 2016:

	Percentage of Counterparty Type to Total Financing					
	Self Financed BD'000	%	IAH BD'000	%	Total BD'000	%
Gross financing assets*						
Murabaha	129,754	30.42%	296,819	69.58%	426,573	100%
Corporate	60,229	27.89%	155,722	72.11%	215,951	100%
Retail	69,525	33.01%	141,097	66.99%	210,622	100%
Musharakah	32,253	29.27%	77,951	70.73%	110,204	100%
Corporate	6,293	29.11%	15,322	70.89%	21,615	100%
Retail	25,960	29.30%	62,629	70.70%	88,589	100%
Total	162,007	30.18%	374,770	69.82%	536,777	100%
Gross Ijarah Muntahia Bittamleek and rental receivables and rental receivables**						
Corporate	6,939	20.58%	26,777	79.42%	33,716	100%
Retail	29,508	22.88%	99,440	77.12%	128,948	100%
Total	36,447	22.41%	126,217	77.59%	162,664	100%
Collective provision	(8,549)	68.76%	(3,885)	31.24%	(12,434)	100%
Total	189,905	27.64%	497,102	72.36%	687,007	100%

*Net of specific provisions of BD 16,560 thousands.

**Net of specific provisions of BD 10,977 thousands.

Table – 26. Equity of Investment Accountholders Share of Profit by account type (PD-1.3.33 (l) (m) & (n))

Account Type	Gross return on equity of IAH BD'000 A	Transfer to equalization Reserve BD'000 B	Average Mudaraba % C	Mudarib fees BD'000 D	Transfer to IRR BD'000 E	Profit paid to IAH BD'000 (A-B-C-D) F
Tejoori	8,108	67	97%	7,531	26	484
Saving	5,107	42	97%	4,731	16	318
Vevo	460	4	97%	428	1	27
IQRA Deposits	227	2	64%	140	7	78
Defined deposit	16,179	135	60%	9,340	480	6,224
	30,081	250		22,170	530	7,131

Table – 27. Equity of Investment Accountholders Share of Profit (PD-1.3.33 (l) (m) & (n))

The following table summarises the share of profits earned by and paid out to profit sharing investment accounts and the Group as Mudarib for the year ended 31 December 2016:

Share of profit allocated by IAH before transfer to/from reserves - BD '000	30,081
Percentage share of profit earned by IAH before transfer to/from reserves	4.60%
Share of profit paid to IAH after transfer to/from reserves - BD '000	7,131
Percentage share of profit paid to IAH after transfer to/from reserves	1.09%
Share of profit paid to Bank as mudarib - BD '000	22,170

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.9 Equity of Investment Accountholders ("IAH") (Continued)

Table – 28. Equity of Investment Accountholders Percentage Return to Profit Rate of Return (PD-1.3.33 (q))

The following table summarises the average distributed rate of return or profit rate on profit sharing investment accounts for the year ended 31 December 2016:

	3 months	6 months	12 months	36 months
Percentage of average distributed rate of return to profit rate of return	0.80%	0.92%	1.09%	3.50%

Table – 29. Equity of Investment Accountholders Type of Assets (PD-1.3.33 (r) & (s))

The following table summarises the types of assets in which the funds are invested and the actual allocation among various types of assets for the year ended 31 December 2016:

	As of 30 June 2016 BD'000	Movement During the Period BD'000	As of 31 December 2016 BD'000
Cash and balances with banks and Central Bank	30,617	744	31,361
Gross financing assets	394,131	(19,361)	374,770
Gross Ijarah Muntahia Bittamleek and rental receivables	92,854	33,363	126,217
Collective impairment	(3,979)	94	(3,885)
Investment securities	94,552	19,198	113,750
Investment in real estate	1,456	1,740	3,196
Other assets	7,240	1,667	8,907
Total	616,871	37,445	654,316

Table – 30. Equity of Investment Accountholders Profit Earned and Paid (PD-1.3.33 (w))

The following table summarises the amount and rate of return of profits earned by the Group and paid out to equity of investment accountholders over the past five years:

	Profit Earned Allocated to IAH		Profit Paid to (IAH)	
	000'BD	%age	000'BD	%age
2016	30,081	3.48%	7,131	0.85%
2015	30,685	4.02%	5,733	0.75%
2014	23,491	3.55%	7,539	1.14%
2013	32,849	4.98%	11,124	1.69%
2012	30,662	5.21%	13,993	2.38%

Table – 31. Treatment of assets financed by IAH (PD-1.3.33 (v))

	Assets BD'000	RWA BD'000	RWA for Capital Adequacy Purposes BD'000	Capital Requirements BD'000
Cash and balances with banks and central Bank	31,361	-	-	-
Financing assets*	374,770	305,205	91,561	11,445
Investment in sukuk	85,524	17,455	5,237	655
Investment Securities	28,226	84,194	25,258	3,157
Ijarah muntahia bittamleek*	126,217	87,946	26,384	3,298
Investment in Real Estate	3,196	6,393	1,918	240
Other Assets	8,907	15,824	4,747	593
	658,201	517,017	155,105	19,388

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.10 Liquidity Risk

4.10.1 Introduction

Liquidity risk is defined as “the risk that the Group will be unable to meet its obligations as they come due because of an inability to obtain adequate funding or to liquidate assets”.

4.10.2 Sources of liquidity risk

The sources of liquidity risk can broadly be categorised in the following:

- a. Funding risk is the risk of not being able to fund net outflows due to unanticipated withdrawal of capital or deposits;
- b. Call risk is the risk of crystallisation of a contingent liability; and
- c. Event risk is the risk of rating downgrades or other negative public news leading to a loss of market confidence in the Group.

4.10.3 Bank's funding strategy

The Board reviews the funding strategy on an annual basis and amends the existing strategy, as deemed necessary. For this purpose, all business units advise the Treasurer of their projected liquidity requirements and contributions at the start of each year as part of annual budgeting process.

The funding strategy highlights any anticipated liquidity shortfalls, the funding requirements to finance these shortfalls and their impact on the statement of financial position. The Group's Risk Charter and Liquidity Policy address liquidity contingency plan to deal with stressed scenarios and outline an action plan that can be taken in the event of liquidity stress situation.

4.10.4 Liquidity risk strategy

The Group monitors the liquidity position by comparing maturing assets and liabilities over different time buckets of up to 1 month, 1-3 months, 3-6 months, 6 months to 1 year, 1-3 years, and over 3 years. The Group carries out stress testing periodically using the worst case scenarios to assess the effects of changes in market conditions on the liquidity of the Group. As a strategy the Group maintains a large customer base and good customer relationships.

The Treasury Department, in conjunction with Risk and Compliance Unit periodically reviews/updates (at least annually) the liquidity risk strategy which is evaluated by ALCO before presenting to the EXCOM and the Board for approval.

4.10.5 Liquidity risk measurement tools

The Group is monitoring the liquidity risk through ALCO

4.10.6 Liquidity risk monitoring

The Group has set the tolerance for liquidity risk which are communicated to the Risk and Compliance Unit and Treasury Department. Based on these tolerances, Risk and Compliance Unit and Treasury have established appropriate risk limits that maintain the Group's exposure within the strategic risk tolerances over a range of possible changes in liquidity situations due to cash flows in current accounts, unrestricted investment accounts and restricted investment accounts.

4.10.7 Liquidity limits structure

The Group uses a combination of different limits to ensure that liquidity is managed and controlled in an optimal manner. The Group has set the following limits for monitoring liquidity risks:

- a. Liquidity Gap limits;
- b. Liquidity Ratio limits; and
- c. Minimum Liquidity Guideline (“MLG”).

4.10.8 Liquidity risk stress testing

To evaluate whether the Group is sufficiently liquid, behavior of the Group's cash flows under different conditions are observed.

4.10.9 Contingency funding plan

The Group does contingency funding exercises which details procedures to be followed by the Group, in the event of a liquidity crisis or a situation where the Group faces stressed liquidity conditions. The contingency funding plan will be an extension of day to day liquidity management and involves maintenance of an adequate amount of liquid assets and management of access to funding resources. The ALCO members discuss and monitor the situation over regular time-intervals to ensure sufficient liquidity in the Group.

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.10 Liquidity Risk (Continued)

Table – 32. Liquidity Ratios (PD-1.3.37)

The following table summarises the liquidity ratios for the past five years:

	2016	2015	2014	2013	2012
Due from banks and financial institutions / Total Assets	6.12%	7.49%	7.83%	20.28%	15.90%
Islamic Financing / Customer Deposits excluding banks	85.13%	80.53%	74.48%	62.49%	64.87%
Customer Deposits / Total Assets	77.43%	77.50%	64.74%	67.83%	68.87%
Short term assets / Short term liabilities	18.53%	22.38%	33.86%	78.41%	60.59%
Liquid Assets / Total Assets	8.95%	10.26%	10.24%	22.27%	17.78%
Growth in Customer Deposits	6.64%	7.48%	(8.24%)	7.66%	8.36%

Short term assets includes cash and balances with banks and placements with FI's

Short term liabilities includes customer current accounts, other liabilities, placements from FI's (maturing within one month) and EIAH (maturing within one month).

Liquid assets includes cash and balances with banks and Central Bank (excluding CBB reserve) and placements with FI's

Customer deposits includes customer current accounts and EIAH.

4.11 Profit Rate Risk

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.

Senior management identifies the sources of profit rate risk exposures based upon the current as well as forecasted balance sheet structure of the Group. The profit rate risk in the Group may arise due to the following transactions:

- Murabaha transactions;
- Wakala transactions;
- Ijarah muntahia bittamleek;
- Sukuk; and
- Musharaka investments.

The Group's management believe that the Group is not exposed to material profit rate risk as a result of mismatches of profit rate repricing of assets, liabilities and equity of investment accountholders as the repricing of assets, liabilities and equity of investment accountholders occur at similar intervals. The profit distribution to equity of investment accountholders is based on profit sharing agreements. Therefore, the Group is not subject to any significant profit rate risk.

4.11.1 Sources of Profit Rate Risk

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

- Re-pricing risk which arises from timing differences in the maturity (for fixed rate) and re-pricing (for floating rate) of assets, liabilities and off balance sheet positions. As profit rates vary, these re-pricing mismatches expose the Group's income and underlying economic value to unanticipated fluctuations;
- Yield curve risk which arises when unanticipated shifts of the yield curve have adverse effects on the Group's income and/or underlying economic value;
- Basis risk which arises from imperfect correlation in the adjustment in the rate earned on products priced and the rate paid on different instruments with otherwise similar re-pricing characteristics. When profit rates change, these differences can give rise to unexpected changes in the cash flows and earnings spread between assets, liabilities, and off balance sheet instruments of similar maturities or re-pricing frequencies; and
- Displaced Commercial Risk 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 competitors rates.

4.11.2 Profit rate risk strategy

The Group is not exposed to interest rate risk on its financial assets as no interest is charged. However, the fair value of financial assets may be affected by current market forces including interest rates. The Group recognises income on certain of its financial assets on a time-apportioned basis. As a strategy the Group:

- has identified the profit rate sensitive products and activities it wishes to engage in;
- has established a limit structure to monitor and control the profit rate risk of the Group;
- measures profit rate risk through establishing maturity/re-pricing schedule that distributes profit rate sensitive assets, liabilities and off-balance sheet items in pre-defined time bands according to their maturity; and
- makes efforts to match the amount of floating rate assets with floating rate liabilities in the banking book.

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.11 Profit Rate Risk (Continued)

4.11.3 Profit rate risk measurement tools

The Group uses the following tools for profit rate risk measurement in the banking book:

- Re-pricing gap analysis which measures the arithmetic difference between the profit-sensitive assets and liabilities of the banking book in absolute terms; and
- Basis Point Value ("BPV") analysis which is the sensitivity measure for all profit rate priced products and positions. The BPV is the change in net present value of a position arising from a 1 basis point shift in the yield curve. This quantifies the sensitivity of the position or portfolio to changes in profit rates.

4.11.4 Profit rate risk monitoring and reporting

The Group has implemented information systems for monitoring, controlling and reporting profit rate risk. Reports are provided on a timely basis to EXCOM and the Board of Directors. The Risk and Compliance Unit monitors these limits regularly. GM-C&RM reviews the results of gap limits and exceptions, if any, and recommends corrective action to be taken which is approved by ALCO or EXCOM, according to authority parameters approved by the Board.

Table – 33. Profit Rate Risk in Banking Book (PD-1.3.40 (b))

The following table summarises the effect on the value of assets, liabilities and economic capital for a benchmark change of 200 bp in profit rates as of 31 December 2016:

	Up to 3 months BD'000	3-6 months BD'000	6-12 months BD'000	1-3 years BD'000	Over 3 years BD'000	Total BD'000
Assets						
Placements with financial institutions	63,805	-	-	-	-	63,805
Financing assets	38,968	23,248	49,452	82,910	332,059	526,637
Ijarah muntahia Bittamleek and rental receivables and rental receivables	13,633	21	63	1,506	145,147	160,370
Investments securities (sukuk and quoted shares)	1,601	3,798	-	39,373	69,200	113,972
Total profit rate sensitive assets	118,007	27,067	49,515	123,789	546,406	864,784
Liabilities and Equity of Investment Accountholders						
Placements from financial institutions	92,297	11,577	-	-	-	103,874
Customers' current accounts	152,647	-	-	-	-	152,647
Equity of investment accountholders	510,925	84,079	50,014	5,003	-	650,021
Total profit rate sensitive liabilities and IAH	755,869	95,656	50,014	5,003	-	906,542
Profit rate gap	(637,862)	(68,589)	(499)	118,786	546,406	(41,758)

	Effect on value of Asset BD'000	Effect on value of Liability BD'000	Effect on value of Economic Capital BD'000
Upward rate shocks:	(2,687)	2,687	-
Downward rate shocks:	15,977	(15,977)	-

Table – 34. Quantitative Indicators of Financial Performance and Position (PD-1.3.9 (b) PD-1.3.33 (d))

The following table summarises the basic quantitative indicators of financial performance for the past 5 years:

	2016	2015	2014	2013	2012
Return on average equity	7.45%	11.88%	11.80%	8.26%	(42.31%)
Return on average assets	0.83%	1.21%	1.00%	0.70%	(4.33%)
Cost to Income Ratio	56.44%	51.68%	55.10%	53.44%	80.14%

Risk and Capital Management Disclosure

31 December 2016

4. Risk Management (Continued)

4.11 Profit Rate Risk (Continued)

4.11.4 Profit rate risk monitoring and reporting (Continued)

Table – 35. The following table summarises the historical data over the past five years in relation to Profit Sharing Investment Accounts (PD-1.3.41):

The details of income distribution to Profit Sharing Investment Accounts (PSIA) for the last five years:

	2016	2015	2014	2013	2012
Allocated income to IAH	29,301	29,961	23,379	32,849	28,496
Distributed profit	7,131	5,187	7,287	10,829	13,931
Mudarib fees	22,170	24,774	16,092	22,021	14,565

As at 31 December 2016:	2016	2015	2014	2013	2012
Balances (BD '000s):					
Profit Equalization Reserve (PER)	250	600	100	295	-
Investment Risk Reserve (IRR)	530	124	40	-	63
PER Movement	(350)	500	(195)	295	-
IRR Movement	406	84	40	(63)	63
Ratios (%):					
Income allocated to IAH / Mudarabah assets %	3.39%	3.85%	3.46%	4.87%	4.71%
Mudarabah fees / Mudarabah assets %	2.57%	3.18%	2.38%	3.26%	2.40%
Distributed profit / Mudarabah assets %	0.83%	0.67%	1.08%	1.61%	2.31%
Rate of Return on IAH %	1.15%	0.86%	1.11%	1.62%	2.15%
Profit Equalization Reserve / IAH %	0.19%	0.17%	0.07%	0.05%	0.00%
Investment Risk Reserve / IAH %	0.12%	0.04%	0.02%	0.01%	0.01%

CBB Penalties (PD 1.3.44)

The CBB penalty imposed upon the Bank amounted to BD 10 thousand during the year regarding teller fraud case.

www.bisb.com