

Bahrain Islamic Bank B.S.C.

**Basel II, Pillar III Disclosures
31 December 2012**

(Unaudited)

Bahrain Islamic Bank B.S.C.

Basel II, Pillar III Disclosures

for the year ended 31 December 2012 (Unaudited)

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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 Capital Structure and 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 or issuing 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 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 Measurement 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.

As part of the risk management practice, the Group has already implemented Sunguard system to be Basel II compliant as prescribed by CBB.

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.

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2 Capital Adequacy (continued)

Table – 1. Capital Structure (PD-1.3.12, 1.3.13, 1.3.14 and 1.3.15)

The following table summarises the eligible capital as of 31 December 2012 after deductions for Capital Adequacy Ratio (CAR) calculation;

| | <i>Tier 1</i> <i>BD'000</i> | <i>Tier 2</i> <i>BD'000</i> |
|--|--------------------------------|--------------------------------|
| Components of capital | | |
| Issued and fully paid ordinary shares | 93,404 | - |
| General reserves | 1,000 | - |
| Legal / statutory reserves | 10,267 | - |
| Less: | | |
| Net Losses for the year | (36,195) | - |
| Unrealised gross losses arising from fair valuing equity securities | (638) | - |
| Tier 1 Capital before PCD deductions | 67,838 | - |
| Unrealised gains arising from fair valuing equities (45% only) | | 593 |
| Investment risk reserve | | 63 |
| Other reverse | | 2,688 |
| Tier 2 Capital before PCD deductions | | 3,344 |
| Total available capital | | 71,182 |
| Deductions | | |
| Significant minority investments in banking, securities and other financial entities unless pro-rata consolidated | (2,747) | (2,747) |
| Investment in insurance entity greater than or equal to 20% | (825) | (825) |
| Total Deductions | (3,572) | (3,572) |
| Tier 1 and Tier 2 eligible capital before additional deduction | 64,267 | (228) |
| Additional deduction from Tier 1 to absorb deficiency in Tier 2 | (228) | 228 |
| Tier 1 and Tier 2 eligible capital | 64,039 | - |
| TOTAL ELIGIBLE CAPITAL | 64,039 | - |

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2 Capital Adequacy (continued)

Table – 1. Capital Structure (PD-1.3.12, 1.3.13, 1.3.14 and 1.3.15) (continued)

| | <i>Amount of exposures BD'000</i> |
|--|---|
| Total Credit Risk Weighted Assets | 461,056 |
| Total Market Risk Weighted Assets | 17,063 |
| Total Operational Risk Weighted Assets | 43,497 |
| TOTAL REGULATORY RISK WEIGHTED ASSETS | 521,616 |
| CAPITAL ADEQUACY RATIO | 12.28% |
| Minimum requirement | 12% |

Table – 2. Capital requirements by type of Islamic financing contracts (PD-1.3.17)

The following table summarises the amount of exposures as of 31 December 2012 (gross of deductions) subject to standardised approach of credit risk and related capital requirements by type of Islamic financing contracts;

| Type of Islamic Financing | <i>Risk Weighted Assets BD'000</i> | <i>Capital requirements BD'000</i> |
|---|--|--|
| Murabaha receivables* | 74,291 | 8,915 |
| Due from banks and financial institutions | 12,065 | 1,448 |
| Musharaka investments* | 29,428 | 3,531 |
| Investments | 84,239 | 10,109 |
| Ijarah muntahia bittamleek* | 31,590 | 3,791 |
| Ijarah rental receivables | 4,743 | 569 |
| | 236,356 | 28,363 |
| Other credit exposures | 224,700 | 26,964 |
| | 461,056 | 55,327 |

*The risk weighted assets have been allocated on pro-rata basis due to system limitation.

2 Capital Adequacy (continued)

Table – 3. Capital requirements for market risk (PD-1.3.18)

The following table summarises the amount of exposures as of 31 December 2012 subject to standardised approach of market risk and related capital requirements;

Market Risk - Standardised Approach

| | |
|---|---------------|
| Foreign exchange risk (BD'000) | 1,365 |
| Total of Market Risk - Standardised Approach | 1,365 |
| Multiplier | 12.5 |
| RWE for CAR Calculation (BD'000) | 17,063 |
| Total Market Risk Exposures (BD'000) | 17,063 |
| Total Market Risk Exposures - Capital Requirement (BD'000) | 2,048 |

Table – 4. 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 2012 subject to basic indicator approach of operational risk and related capital requirements;

Indicators of operational risk

| | |
|--|---------------|
| Average Gross income (BD'000) | 23,198 |
| Multiplier | 12.5 |
| | 289,979 |
| Eligible Portion for the purpose of the calculation | 15% |
| Total Operational Risk Exposure (BD'000) | 43,497 |
| Total Operational Risk Exposures - Capital Requirement (BD'000) | 5,220 |

Table – 5. Capital Adequacy Ratios (PD-1.3.20)

The following are Capital Adequacy Ratios as of 31 December 2012 for total capital and Tier 1 capital;

| | <i>Total capital ratio</i> | <i>Tier 1 capital ratio</i> |
|------------------------|--------------------------------|---------------------------------|
| Top consolidated level | 12.28% | 12.28% |

3 Risk Management

3.1 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.

The Group has defined its risk appetite within the parameters of its Risk Strategy. The Group reviews and realigns its risk appetite as per the evolving business plan of the Group with changing economic and market scenarios. The Group also assesses its tolerance for specific risk categories and its strategy to manage these risks.

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 the Basel II. 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.

3.2 Strategies, Processes and Internal Controls

3.2.1 Group's risk strategy

Capital Management policies and Risk Charter define 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 in the Group.

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 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. In addition, the Group is in the process of implementing various risk systems to help quantify not just the regulatory capital but also the economic capital allocated to various portfolios.

The Group is exposed to various types of risk, such as market, credit, profit rate, liquidity and operational, all of which require the comprehensive controls and ongoing oversight. The risk management framework summarises the spirit behind Basel II, 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.

3 Risk Management (continued)

3.2 Strategies, Processes and Internal Controls (continued)

3.2.2 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.

3.2.3 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.

3.2.4 Operational risk

The Group has implemented SunGuard's Operational Risk Management system 'SWORD' for recording the potential risks, controls and events on a continuous basis. As part of implementation, the Group has carried out Risk Control Self Assessment ("RCSA") exercise on a regular basis. The system also measures the Operational risk appetite based on the predefined limits/thresholds.

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.

3.2.5 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.

3.2.6 Profit rate risk

Profit rate risk arises from the possibility that changes in profit rates will affect future profitability or the fair values of financial instruments. The 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 accountholders. The profit distribution to investment accountholders 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 the market rates.

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 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.

3 Risk Management (continued)

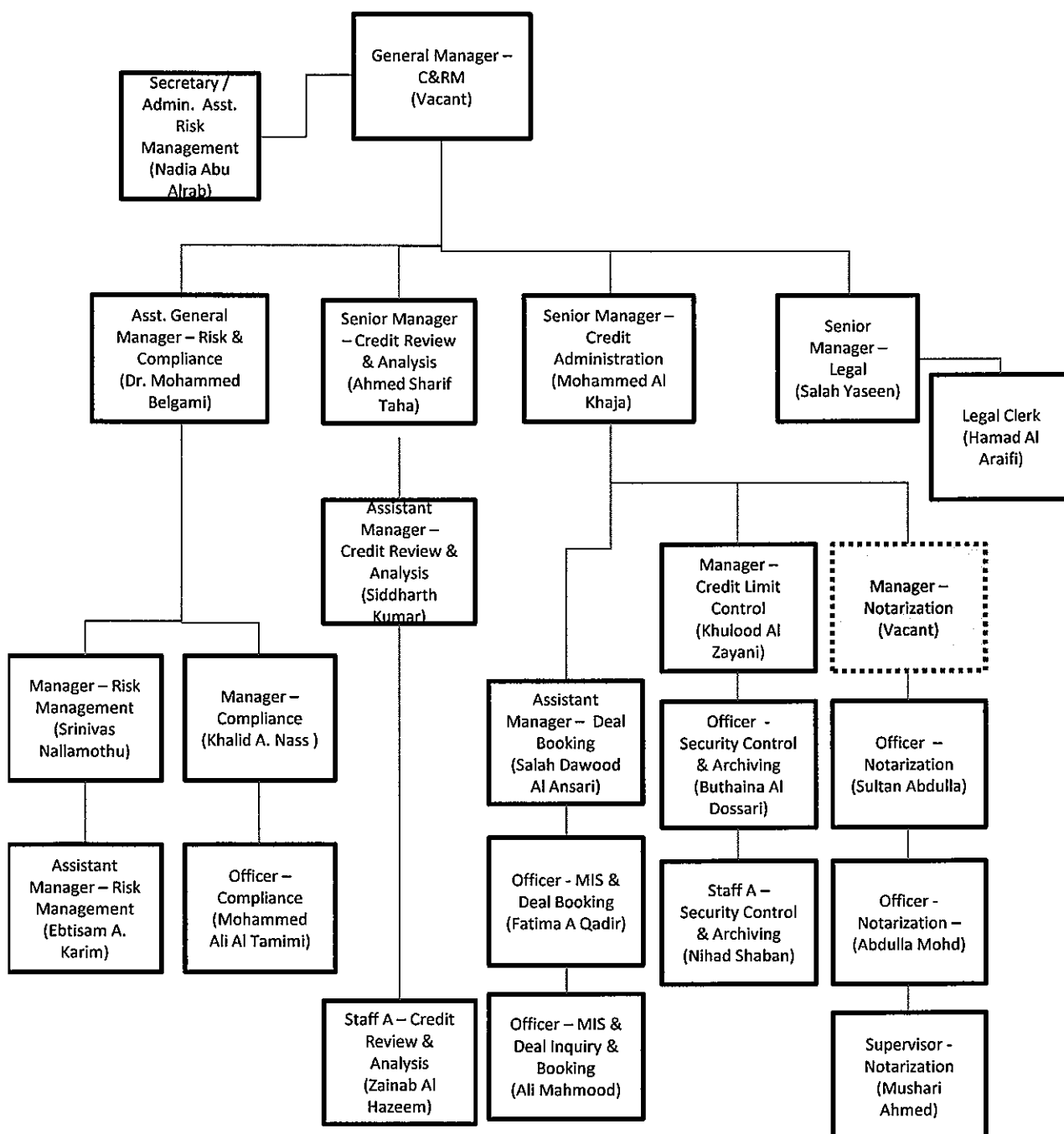
3.3 Structure and Organisation of Risk Management Function

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:

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

CREDIT AND RISK MANAGEMENT ORGANISATION CHART



3 Risk Management (continued)

3.4 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.

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 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 Department ("CR&AD"). Any changes to the Credit Risk Policy will be approved by the Board.

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's 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 an annual basis by CR&AD.

3.5.2 Types of credit risk

Financing contracts mainly comprise 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 resells this commodity to the Murabeh (beneficiary) at a profit. The sale price (cost plus profit margin) is repaid in instalments 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.

3 Risk Management (continued)

3.5 Credit Risk (continued)

3.5.3 Past Due and impaired Islamic financing

The Group defines non-performing facilities as the facilities that are overdue for 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.

3.5.4 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.

3.5.5 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.

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 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.

3.5.7 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. Name lending (i.e. lending without audited financial statements and tangible collateral security) is discouraged and is approved only on an exceptional basis after careful analysis of the quality of the customer, market reputation, approximate personal net worth etc.

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.

3 Risk Management (continued)

3.5 Credit Risk (continued)

3.5.7 Credit risk mitigation (continued)

The market value of tangible collateral security are properly evaluated by the Group approved valuers (for properties) or based on publicly available quotations. Only the Loan-able Value of such security is taken into account while considering 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.

3.5.7.1 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 quantify 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.

International 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 jewellers.

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

3 Risk Management (continued)

3.5 Credit Risk (continued)

3.5.7 Credit risk mitigation (continued)

3.5.7.1 General policy guidelines of collateral management (continued)

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.

3.5.7.2 Guarantees

In cases where a letter of guarantee from parent company or a third party is accepted as credit risk mitigants, 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.

3.5.7.3 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.

3.5.8 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.

3.5.8.1 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.

3.5.8.2 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.

3 Risk Management (continued)

3.5 Credit Risk (continued)

3.5.8 Counterparty credit risk (continued)

3.5.8.3 Group exposure

Group exposure is defined as the total exposure to all counterparties closely related or connected to each other. For this purpose, 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 other(s).

3.5.8.4 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.

3.5.8.5 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).

3.5.8.6 Maximum exposure

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

3.5.8.7 Reporting

The Group reports large counterparty exposures (as defined above) to CBB on 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.

3.5.8.8 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.

3.5.9 Related party transactions

The disclosure relating to related party transactions has been made in the consolidated financial statements as of 31 December 2012. All related party transactions have been made on arm's length basis.

Bahrain Islamic Bank B.S.C.

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3 Risk Management

3.5 Credit Risk

Table – 6. 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 2012 and average gross funded and unfunded exposures over the year ended 31 December 2012 allocated to own capital and current account and profit sharing investment account (PSIA);

| | Own capital and current account | | Profit Sharing Investment Account | |
|--|---|--|---|--|
| | Total gross credit exposure BD'000 | *Average gross credit exposure over the year BD'000 | Total gross credit exposure BD'000 | *Average gross credit exposure over the year BD'000 |
| Funded | | | | |
| Cash and balances with banks and Central Bank | 15,638 | 21,210 | 28,255 | 27,340 |
| Due from banks and financial institutions | 8,419 | 7,733 | 124,005 | 113,882 |
| Murabaha receivables | 14,481 | 13,962 | 213,276 | 205,621 |
| Musharaka investments | 5,736 | 5,975 | 84,484 | 88,003 |
| Investments | 57,850 | 60,123 | 38,438 | 42,296 |
| Investment in associates | 7,143 | 7,028 | - | - |
| Investment in Ijarah assets | 10,599 | 10,553 | - | - |
| Ijarah muntahia bittamleek | 6,158 | 6,356 | 90,688 | 93,606 |
| Investment properties | 106,351 | 111,361 | - | - |
| Ijarah rental receivables | 875 | 514 | 12,891 | 7,571 |
| Other assets | 7,517 | 8,296 | - | - |
| Unfunded | | | | |
| Commitments and contingent liabilities | 9,761 | 10,473 | - | - |
| Total | 250,528 | 263,584 | 592,037 | 578,319 |

*Average balances are computed based on month end balances.

Bahrain Islamic Bank B.S.C.

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for the year ended 31 December 2012 (Unaudited)

3 Risk Management (continued)

3.5 Credit Risk (continued)

Table -- 7. Credit Risk -- Geographic Breakdown (PD-1.3.23(b))

The following table summarises the geographic distribution of exposures as of 31 December 2012, broken down into significant areas by major types of credit exposure;

| | Own capital and current account | | | | | Profit Sharing Investment Account | | | | |
|--|---------------------------------|------------------|--------------------------|---------------------------|-----------------|-----------------------------------|------------------|--------------------------|---------------------------|-----------------|
| | * Geographic area | | | | | * Geographic area | | | | |
| | North America BD'000 | Europe BD'000 | Middle East BD'000 | Rest of Asia BD'000 | Total BD'000 | North America BD'000 | Europe BD'000 | Middle East BD'000 | Rest of Asia BD'000 | Total BD'000 |
| Cash and balances with banks and Central Bank | 1,435 | 280 | 13,822 | 101 | 15,638 | - | - | 28,255 | - | 28,255 |
| Due from banks and financial institutions | - | 395 | 8,024 | - | 8,419 | - | 5,814 | 118,191 | - | 124,005 |
| Murabaha receivables | - | 449 | 14,032 | - | 14,481 | - | 6,613 | 206,663 | - | 213,276 |
| Musharaka investments | - | - | 5,736 | - | 5,736 | - | - | 84,484 | - | 84,484 |
| Investment in associates | 854 | 4,848 | 51,242 | 906 | 57,850 | - | - | 38,438 | - | 38,438 |
| Investment in ijarah assets | - | - | 7,143 | - | 7,143 | - | - | - | - | - |
| Ijarah muntahia bittamleek | - | - | 10,599 | - | 10,599 | - | - | - | - | - |
| Investment properties | - | - | 6,158 | - | 6,158 | - | - | 90,688 | - | 90,688 |
| Ijarah rental receivables | - | - | 106,351 | - | 106,351 | - | - | - | - | - |
| Other assets | - | - | 875 | - | 875 | - | - | 12,891 | - | 12,891 |
| | - | - | 7,517 | - | 7,517 | - | - | - | - | - |
| Total | 2,289 | 5,972 | 231,499 | 1,007 | 240,767 | - | 12,427 | 579,610 | - | 592,037 |

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

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3 Risk Management (continued)

3.5 Credit Risk (continued)

Table – 8. 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 2012 by industry, broken down into major types of credit exposure;

| | Own Capital and Current Account | | | | | | | | | |
|---|----------------------------------|---|--------------------|-----------------|-------------------------|----------------------------------|---------------|----------------|--|--|
| | Industry Sector | | | | | Personal & | | | | |
| | Trading and Manufacturing BD'000 | Banks and Financial Institutions BD'000 | Real Estate BD'000 | Aviation BD'000 | Consumer Finance BD'000 | Governmental Organisation BD'000 | Others BD'000 | Total BD'000 | | |
| Funded | | | | | | | | | | |
| Cash and balances with banks and Central Bank | - | 8,481 | - | - | - | - | 7,157 | 15,638 | | |
| Due from banks and financial institutions | - | 8,419 | - | - | - | - | - | 8,419 | | |
| Murabaha receivables | 1,351 | 1,750 | 1,731 | 740 | 8,138 | - | 771 | 14,481 | | |
| Musharaka investments | 204 | - | 1,492 | - | 3,386 | 166 | 488 | 5,736 | | |
| Investments | 4,774 | 10,066 | 13,840 | - | - | 1,636 | 27,534 | 57,850 | | |
| Investment in associates | - | 7,143 | - | - | - | - | - | 7,143 | | |
| Investment in Ijarah assets | - | - | 10,599 | - | - | - | - | 10,599 | | |
| Ijarah muntahia bittamleek | 628 | 8 | 2,411 | 573 | 2,523 | - | 15 | 6,158 | | |
| Investment properties | - | - | 106,351 | - | - | - | - | 106,351 | | |
| Ijarah rental receivables | 98 | 8 | 246 | 136 | 373 | - | 14 | 875 | | |
| Other assets | - | 200 | - | - | 798 | - | 6,519 | 7,517 | | |
| Unfunded | | | | | | | | | | |
| Commitments and contingent liabilities | 3,437 | 2,277 | 1,356 | 957 | 274 | - | 1,460 | 9,761 | | |
| Total | 10,492 | 38,352 | 138,026 | 2,406 | 15,492 | 1,802 | 43,958 | 250,528 | | |

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3 Risk Management (continued)

3.5 Credit Risk (continued)

Table – 8. Credit Risk – Industry Sector Breakdown (PD-1.3.23(c)) (continued)

The following table summarises the distribution of funded and unfunded exposures as of 31 December 2012 by industry, broken down into major types of credit exposure;

| | Profit Sharing Investment Account | | | | | | | | | |
|---|-----------------------------------|---|--------------------|-----------------|-------------------------|----------------------------------|---------------|----------------|--|--|
| | Industry Sector | | | | | Personal & | | | | |
| | Trading and Manufacturing BD'000 | Banks and Financial Institutions BD'000 | Real Estate BD'000 | Aviation BD'000 | Consumer Finance BD'000 | Governmental Organisation BD'000 | Others BD'000 | Total BD'000 | | |
| Funded | | | | | | | | | | |
| Cash and balances with banks and Central Bank | - | 28,255 | - | - | - | - | - | 28,255 | | |
| Due from banks and financial institutions | - | 124,005 | - | - | - | - | - | 124,005 | | |
| Murabaha receivables | 19,896 | 25,777 | 25,495 | 10,901 | 119,858 | - | 11,349 | 213,276 | | |
| Musharaka investments | 2,999 | - | 21,972 | - | 49,872 | 2,439 | 7,202 | 84,484 | | |
| Investments | - | 1,629 | 12,708 | - | - | 24,101 | - | 38,438 | | |
| Investment in associates | - | - | - | - | - | - | - | - | | |
| Investment in Ijarah assets | - | - | - | - | - | - | - | - | | |
| Ijarah muntahia bittamleek | 9,243 | 118 | 35,510 | 8,439 | 37,151 | - | 227 | 90,688 | | |
| Investment properties | - | - | - | - | - | - | - | - | | |
| Ijarah rental receivables | 1,444 | 114 | 3,624 | 2,008 | 5,498 | - | 203 | 12,891 | | |
| Other assets | - | - | - | - | - | - | - | - | | |
| Unfunded | | | | | | | | | | |
| Commitments and contingent liabilities | - | - | - | - | - | - | - | - | | |
| Total | 33,582 | 179,898 | 99,309 | 21,348 | 212,379 | 26,540 | 18,981 | 592,037 | | |

3 Risk Management (continued)

3.5 Credit Risk (continued)

Table – 9. Credit Risk – Intra-group transactions (PD-1.3.23(d))

The balances and transactions with the related parties are disclosed in the consolidated financial statements as of 31 December 2012 and all related party transactions have been made on an arms' length basis.

The balances of major transactions with the subsidiaries are as follows:

| | Own Capital and Current Account BD'000 | Profit Sharing Investment Account BD'000 | Total BD'000 |
|-----------------------------|---|--|-----------------|
| Customers' current accounts | 151 | - | 151 |
| Other liabilities | 5,242 | - | 5,242 |
| Other assets | 66 | - | 66 |
| Investment in subsidiaries | 25,001 | - | 25,001 |

The income and expenses arising from dealing with the subsidiaries which we eliminated in the consolidated statement of income are as follows:

| | Own Capital and Current Account BD'000 | Profit Sharing Investment Account BD'000 | Total BD'000 |
|---------------------------|---|--|-----------------|
| Income from Ijarah assets | 414 | - | 414 |

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3 Risk Management (continued)

3.5 Credit Risk (continued)

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

The following balances representing the financing facilities to highly leveraged or other high risk counterparties as of 31 December 2012;

| Counterparties | Own Capital and Current Account BD'000 | Profit Sharing Investment Account BD'000 | Total BD'000 |
|------------------|---|--|-----------------|
| Counterparty # 1 | 717 | - | 717 |
| | 717 | - | 717 |

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

Following balances representing the concentration of risk to individual counterparties as of 31 December 2012;

| Counterparties | Own capital and current account BD'000 | Profit Sharing Investment Account BD'000 | Total BD'000 |
|------------------|---|--|-----------------|
| Counterparty # 1 | 1,101 | 16,209 | 17,310 |
| Counterparty # 2 | 14,200 | - | 14,200 |
| Counterparty # 3 | 813 | 11,968 | 12,780 |
| Counterparty # 4 | 10,825 | - | 10,825 |
| Counterparty # 5 | 677 | 9,974 | 10,651 |
| Counterparty # 6 | 10,436 | - | 10,436 |
| Counterparty # 7 | 638 | 9,391 | 10,029 |
| | 38,690 | 47,542 | 86,230 |

* The exposures are in excess of the 15% individual obligor limit and exempted from deduction from eligible capital.

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3 Risk Management (continued)

3.5 Credit Risk (continued)

Table – 12. Credit Risk – Residual Contractual Maturity Breakdown (Own Capital and Current Account) (PD-1.3.23(g) PD-1.3.38)

The following table summarises the residual contractual maturity of own capital and current account breakdown of the whole credit portfolio as of 31 December 2012, broken down by major types of credit exposure:

| | Own capital and current account | | | | | | | | | | No fixed maturity BD'000 | Total BD'000 |
|---|---------------------------------|----------------------|----------------------|-----------------------|---------------------|---------------------|----------------------|-----------------------|--------------------------|----------------|-----------------------------|-----------------|
| | Up to One months 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 | | | |
| Assets | | | | | | | | | | | | |
| Cash and balances with banks and Central Bank | 15,638 | - | - | - | - | - | - | - | - | - | - | 15,638 |
| Due from banks and financial in: | 7,628 | 564 | 58 | 169 | - | - | - | - | - | - | - | 8,419 |
| Murabaha receivables | 131 | 947 | 261 | 842 | 1,297 | 3,111 | 4,788 | 25 | 3,079 | - | - | 14,481 |
| Musharaka investments | 258 | 167 | 16 | 48 | 722 | 570 | 1,308 | 807 | 1,840 | - | - | 5,736 |
| Investments | 340 | 20,289 | - | - | 3,632 | 23,597 | 1,320 | - | 242 | 8,430 | 8,430 | 57,850 |
| Investment in associates | - | - | - | - | - | - | - | - | - | 7,143 | 7,143 | 7,143 |
| Investment in Ijarah assets | - | - | - | - | - | - | - | - | - | 10,599 | 10,599 | 10,599 |
| Ijarah muntahia bittamleek | - | - | 13 | 119 | 277 | 858 | 654 | 1,106 | 3,131 | - | - | 6,158 |
| Investment properties | - | - | - | - | - | - | - | - | - | 106,351 | 106,351 | 106,351 |
| Ijarah rental receivables | - | - | 875 | - | - | - | - | - | - | - | - | 875 |
| Other assets | 209 | 655 | 528 | - | - | - | - | - | 502 | 5,623 | 5,623 | 7,517 |
| Total Assets | 24,204 | 22,622 | 1,751 | 1,178 | 5,928 | 28,136 | 8,070 | 1,938 | 8,794 | 138,146 | 138,146 | 240,767 |

* All non performing facilities have been classified as over 20 years.

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3 Risk Management (continued)

3.5 Credit Risk (continued)

Table – 13. Credit Risk – Residual Contractual Maturity Breakdown (Profit Sharing Investment Account) (PD-1.3.23(g) PD-1.3.38)

The following table summarises the residual contractual maturity of profit sharing investment account breakdown of the whole credit portfolio as of 31 December 2012, broken down by major types of credit exposure:

| | Profit Sharing Investment Account | | | | | | | | No fixed maturity BD'000 | Over 20 years* BD'000 | Total BD'000 |
|---|-----------------------------------|----------------------|----------------------|-----------------------|---------------------|---------------------|----------------------|-----------------------|-----------------------------|--------------------------|-----------------|
| | Up to One months 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 | | | |
| Assets | | | | | | | | | | | |
| Cash and balances with banks and Central Bank | - | - | - | - | - | - | - | - | 28,255 | - | 28,255 |
| Due from banks and financial in: | 112,364 | 8,299 | 854 | 2,488 | - | - | - | - | - | - | 124,005 |
| Murabaha receivables | 1,923 | 13,945 | 3,841 | 12,412 | 19,097 | 45,825 | 70,523 | 366 | 45,344 | - | 213,276 |
| Musharaka investments | 3,788 | 2,452 | 237 | 720 | 10,626 | 8,389 | 19,261 | 11,884 | 27,127 | - | 84,484 |
| Investments | 5,016 | 864 | - | - | 5,429 | 4,128 | 19,443 | - | 3,558 | - | 38,438 |
| Ijarah muntahia bittamleek | - | - | 192 | 1,765 | 4,074 | 12,646 | 9,634 | 16,295 | 46,082 | - | 90,688 |
| Ijarah rental receivables | - | - | 12,891 | - | - | - | - | - | - | - | 12,891 |
| Total Assets | 123,091 | 25,560 | 18,015 | 17,385 | 39,226 | 70,988 | 118,861 | 28,545 | 122,111 | 28,255 | 592,037 |

* All non performing facilities have been classified as over 20 years.

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3.5 Credit Risk (continued)

Table – 14. Credit Risk – Impaired Exposures, Past Due Exposures and Allowances (Own capital and current account by industry sector) (PD-1.3.23(h) PD-1.3.24(b) PD-1.3.24(d))

Own capital and current account

****** 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.

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3 Risk Management (continued)

3.5 Credit Risk (continued)

Table – 15. Credit Risk – Impaired Exposures, Past Due Exposures and Allowances (profit sharing investment account by industry sector) (PD-1.3.23(h))

The following table summarises the impaired facilities, past due facilities and allowances financed by profit sharing investment account disclosed by major industry sector as of 31 December 2012;

| Profit Sharing Investment Account | | | | | | | | | | | | | |
|--|---|--------------------|--------------|--------|--------|---------------------|--------------------------------------|-------------------------|-----------------------------|--------------------------------|--------------------------------------|-----------------------------|-----------------------------------|
| Non-performing or past due or impaired | Aging of non-performing or past due or impaired | | | | | Specific allowances | | | | * General allowances | | | |
| | Islamic financing contacts | | | | | Over 3 years | Balance at the beginning of the year | Charges during the year | Charge-offs during the year | Balance at the end of the year | General allowances beginning balance | General allowances movement | General allowances ending balance |
| | Less than 3 months | 3 months to 1 year | 1 to 3 years | | | | | | | | | | |
| Islamic financing contracts | BD'000 | BD'000 | BD'000 | BD'000 | BD'000 | BD'000 | BD'000 | BD'000 | BD'000 | BD'000 | BD'000 | BD'000 | BD'000 |
| Trading and Manufacturing | 2,986 | 2,560 | 184 | 58 | 184 | 36,083 | 1,699 | (36,590) | 1,192 | - | - | - | - |
| Real Estate | 69,404 | 32,827 | 3,682 | 25,472 | 7,423 | 2,542 | 9,442 | - | 11,984 | - | - | - | - |
| Banks and Financial Institutions | 17,964 | 16,112 | 65 | 1,774 | 13 | 3,194 | 1,339 | - | 4,533 | - | - | - | - |
| Personal / Consumer Finance | 35,095 | 19,744 | 3,475 | 11,208 | 668 | 3,966 | 7,537 | (2,345) | 9,158 | - | - | - | - |
| Others | 520 | 377 | 66 | 77 | - | - | 905 | - | 905 | - | - | - | - |
| No specific sector | - | - | - | - | - | - | - | - | - | 5,163 | (2,645) | 2,518 | 2,518 |
| Total | 125,969 | 71,620 | 7,472 | 38,589 | 8,288 | 45,785 | 20,922 | (38,935) | 27,772 | 5,163 | (2,645) | 2,518 | 2,518 |

* 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.

Although the above table shows the portion of impairment provision related to PSIA, the Group has taken all the provision to their own capital. Hence the PSIA were not charged for any of the impairment provision.

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3 Risk Management (continued)

3.5 Credit Risk (continued)

Table – 16. Credit Risk – Impaired Exposures, Past Due Exposures and Allowances (own capital and current account and profit sharing investment account 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 2012;

| | Own capital and current account | | | Profit Sharing Investment Account | | |
|--------------|---|--------------------------------------|--|---|--------------------------------------|--|
| | Non-performing or past due or impaired Islamic financing contracts BD'000 | Specific Impairment provision BD'000 | Collective Impairment provision BD'000 | Non-performing or past due or impaired Islamic financing contracts BD'000 | Specific Impairment provision BD'000 | Collective Impairment provision BD'000 |
| Middle East | 8,552 | 1,885 | 170 | 125,969 | 27,772 | 2,518 |
| Total | 8,552 | 1,885 | 170 | 125,969 | 27,772 | 2,518 |

Table – 17. Credit Risk – Restructured Financing Facilities (PD-1.3.23(j))

The following table summarises the aggregate amount of restructured financing facilities during the year financed by own capital and current account and profit sharing investment account as of 31 December 2012;

| | Own capital and current account | | Profit Sharing Investment Account | |
|-----------------------------------|---------------------------------|-------------------------|-----------------------------------|-------------------------|
| | Aggregate amount BD'000 | Aggregate amount BD'000 | Aggregate amount BD'000 | Aggregate amount BD'000 |
| Restructured financing facilities | 2,228 | | 32,829 | |
| Total | 2,228 | | 32,829 | |

The provision on restructured facilities is BD 6,161 thousand and the impact on present and future earnings is not significant.

3 Risk Management (continued)**3.5 Credit Risk (continued)****Table – 18. Credit Risk Mitigation (PD-1.3.25 (b) and (c))**

The following table summarises the exposure as of 31 December 2012 by type of Islamic financing contract covered by eligible collateral;

| | <i>Total exposure covered by</i> | |
|----------------------------|----------------------------------|-------------------|
| | <i>Eligible collateral</i> | <i>Guarantees</i> |
| | <i>BD'000</i> | <i>BD'000</i> |
| Murabaha receivables | 25,800 | 9,188 |
| Musharaka investments | 200 | 125 |
| Ijarah muntahia bittamleek | 5,537 | 1,125 |
| Total | 31,537 | 10,438 |

Table – 19. 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 2012;

| | <i>BD'000</i> |
|--|----------------|
| Gross positive fair value of contracts | 832,804 |
| Netting Benefits | - |
| Netted current credit exposure | 832,804 |
| Collateral held: | |
| -Cash | 31,537 |
| -Shares | 5,720 |
| -Real Estate | 217,918 |
| Total | 255,175 |

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

3.6 Market Risk**3.6.1 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."

3 Risk Management (continued)

3.6 Market Risk (continued)

3.6.2 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; 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 particular sector and less correlated across sectors.

3.6.3 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 market risk appetite which will be quantified in terms of a market risk limit structure;
- 5 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;
- 6 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;
- 7 The Group will periodically carry out back testing of market risk assessment models in order to evaluate their accuracy and the inherent model risk;
- 8 The Group will match the amount of floating rate assets with floating rate liabilities; and
- 9 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.

3 Risk Management (continued)

3.6 Market Risk (continued)

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 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.

3.6.5 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.

3.6.6 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.

3.6.7 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.

3.6.8 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.

3.6.9 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.

3.6.10 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.

3 Risk Management (continued)**3.6 Market Risk (continued)****3.6.11 Foreign subsidiary**

The Group does not have any foreign subsidiary.

Table – 20. Market Risk Capital Requirements (PD-1.3.27 (b))

The following table summarises the capital requirement for foreign exchange risk as of 31 December 2012;

| | <i>Foreign exchange risk BD'000</i> |
|---|---|
| Foreign exchange risk | 17,063 |
| Foreign exchange risk capital requirement | 2,048 |
| Maximum value capital requirement | 2,048 |
| Minimum value capital requirement | 1,365 |

3.7 Operational Risk**3.7.1 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.

3.7.2 Sources of operational risk

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

People risk which 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;

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

Systems (Technology) risk which arise due to integrity of information - lacking in timelines of information, omission and duplication of data; hardware failures due to power surge, obsolescence or low quality.

3.7.3 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.

3 Risk Management (continued)**3.7 Operational Risk (continued)****3.7.3 Operational risk management strategy (continued)**

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; 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.

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 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

The business units, in consultation with Risk and Compliance Unit 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.

3.7.6 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.

3.7 Operational Risk

Table - 21. 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:

| | <i>Gross income</i> | | |
|--|---------------------|---------------|---------------|
| | <i>2011</i> | <i>2010</i> | <i>2009</i> |
| | <i>BD'000</i> | <i>BD'000</i> | <i>BD'000</i> |
| Total Gross Income | 24,856 | 18,777 | 25,962 |
| Indicators of operational risk | | | |
| Average Gross income (BD'000) | | | 23,198 |
| Multiplier | | | 12.5 |
| | | | 289,979 |
| Eligible Portion for the purpose of the calculation | | | 15% |
| TOTAL OPERATIONAL RISK WEIGHTED EXPOSURE (BD'000) | | | 43,497 |

3 Risk Management (continued)**3.7 Operational Risk (continued)**

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.

3.8 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 2012. 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 – 22. Equity Position Risk in Banking Book (PD-1.3.31 (b) (c) & (f))

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 2012;

| | <i>Total gross exposure BD'000</i> | <i>* Average gross exposure BD'000</i> | <i>Publicly traded BD'000</i> | <i>Privately held BD'000</i> | <i>Risk weighted assets BD'000</i> | <i>Capital Requirements BD'000</i> |
|--------------------|--|--|---------------------------------------|--------------------------------------|--|--|
| Sukuk | 41,049 | 45,168 | - | 41,049 | 4,270 | 512 |
| Equity investments | 28,660 | 29,519 | 20,230 | 8,430 | 35,562 | 4,267 |
| Funds | 26,579 | 27,732 | - | 26,580 | 44,407 | 5,329 |
| Total | 96,288 | 102,419 | 20,230 | 76,059 | 84,239 | 10,109 |

*Average balances are computed based on month end balances.

Table – 23. Equity Gains or Losses in Banking Book (PD-1.3.31 (d) & (e))

The following table summarises the cumulative realised and unrealised gains or (losses) during the year ended 31 December 2012;

| | <i>BD'000</i> |
|---|---------------|
| Cumulative realised gain arising from sales or liquidations in the reporting period | 654 |
| Total unrealised losses recognised in the consolidated statement of financial position but not through consolidated statement of income | 377 |
| Unrealised losses included in Tier 1 Capital | 638 |
| Unrealised gains included in Tier 2 Capital* | 1,318 |

* This unrealised gain is discounted by 55% before including it in Tier 2 Capital

3 Risk Management (continued)

3.9 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.

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 deposits. The utilisation rate is determined by the ALCO with the approval of Shari'a Supervisory Board.

If at any point of time in a particular pool the funds of IAH exceed the assets, the excess amount shall be treated to be invested in commodity Murabaha and earn the average rate of profit on Commodity Murabaha earned during the excess period. There should be no inter-pool financing at any point of time. The Group should establish a control to avoid excess fund in any pool to be used in other pool.

Proposal for new products is initiated by the business lines within the Group, 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 assurance units whom reports complaints directly to the CEO. 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 month, 6 month, 9 month, 12 month and 36 month. The customer signs 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 commingles its own funds and equity of investment accountholders funds which are invested together. The Group has identified two pools of assets where the equity of investment accountholders funds are invested and income from which is allocated to such is account.

3 Risk Management (continued)

3.9 Equity of Investment Accountholders ("IAH") (continued)

The Group has already developed a 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.

- Pool A: Low risk assets or generating low yield.
- Pool B: High risk assets or generating high yield.

Profits of an investment jointly financed by the Group and the equity of investment accountholders holders shall be allocated between them according to the contribution of each of the Group and the IAH in the jointly financed investment separately for each Joint pool A and B. 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 joint fund. Impairment provisions shall only be allocated to Pool B in the ratio of capital contribution by Bank and IAH of Pool B. The reversal of this provision in future year shall be allocated between Bank and IAH of Pool B in the ratio of capital contribution at the time the reversal is made. The loss can be entirely borne by the shareholders of the Group subject to the approval of the Board. Equity of investment accountholders deposits are measured at their book value.

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

Table – 24. 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 2012;

| | <i>BD'000</i> |
|---|----------------|
| Customers | 573,570 |
| Financial institutions' investment accounts | 87,690 |
| Total | 661,260 |

Table – 25. 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 2012;

| | |
|-------------------------------------|---------------|
| Profit Paid on Average IAH Assets * | 2.34% |
| Mudarib Fee to Total IAH Profits | 45.00% |

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

3 Risk Management (continued)**3.9 Equity of Investment Accountholders ("IAH") (continued)****Table – 26. 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 account holder for the year ended 31 December 2012;

| <i>Account Type</i> | <i>Profit distributed to total IAH</i> | <i>Percentage to total IAH</i> |
|----------------------------------|--|--------------------------------|
| Saving accounts (including VEVO) | 2.62% | 13.68% |
| Defined accounts - 1 month | 1.36% | 1.39% |
| Defined accounts - 3 months | 0.38% | 0.46% |
| Defined accounts - 6 months | 0.52% | 0.59% |
| Defined accounts - 9 months | 0.00% | 0.00% |
| Defined accounts - 1 year | 2.66% | 2.72% |
| Investment certificates | 0.61% | 0.32% |
| IQRA Deposits | 0.44% | 0.39% |
| Tejoori Deposit | 2.80% | 14.99% |
| Customer's deposits | 84.97% | 52.25% |
| Bank's deposits | 3.64% | 13.21% |
| | 100% | 100% |

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

Table – 27. 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 2012;

| | <i>Percentage Financing to Total Financing</i> |
|---|--|
| Due from banks and financial institutions | 22.00% |
| Murabaha receivables | 37.81% |
| Musharaka investments | 14.99% |
| Investment in Sukuk | 6.82% |
| Ijarah muntahia bittamleek | 16.09% |
| Ijarah rental receivables | 2.29% |

| | <i>Percentage of Counterparty Type to Total Financing</i> | | | | | |
|---|---|---|--------------------|-----------------|--|---|
| | <i>Trading and Manufacturing</i> | <i>Banks and Financial Institutions</i> | <i>Real Estate</i> | <i>Aviation</i> | <i>Personal & Consumer Finance</i> | <i>Governmental Organisation Others</i> |
| Due from banks and financial institutions | - | 22.00% | - | - | - | - |
| Murabaha receivables | 3.53% | 4.57% | 4.52% | 1.93% | 21.25% | 2.01% |
| Musharaka investments | 0.53% | - | 3.90% | - | 8.85% | 1.28% |
| Investment in Sukuk | - | 0.29% | 2.25% | - | - | - |
| Ijarah muntahia bittamleek | 1.64% | 0.02% | 6.30% | 1.50% | 6.59% | 0.04% |
| Ijarah rental receivables | 0.26% | 0.02% | 0.64% | 0.36% | 0.97% | 0.04% |
| | 5.96% | 26.90% | 17.61% | 3.79% | 37.66% | 3.37% |

3 Risk Management (continued)**3.9 Equity of Investment Accountholders ("IAH") (continued)****Table – 28. 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 2012;

| | |
|---|--------|
| Share of profit earned by IAH before transfer to/from reserves - BD '000 | 14,056 |
| Percentage share of profit earned by IAH before transfer to/from reserves | 49.33% |
| Share of profit paid to IAH after transfer to/from reserves - BD '000 | 13,993 |
| Percentage share of profit paid to IAH after transfer to/from reserves | 49.33% |
| Share of profit paid to Bank as mudarib - BD '000 | 14,503 |

Table – 29. 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 2012;

| | 3 month | 6 month | 12 month | 36 month |
|---|----------------|----------------|-----------------|-----------------|
| Percentage of average distributed rate of return to profit rate of return | 2.25% | 3.47% | 3.49% | 3.89% |

Table – 30. 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 2012;

| | Opening Actual Allocation BD'000 | Movement During the Period BD'000 | Closing Actual Allocation BD'000 |
|---|---|--|---|
| Cash and balances with banks and Central Bank | 27,009 | 1,246 | 28,255 |
| Due from banks and financial institutions | 90,244 | 33,761 | 124,005 |
| Murabaha receivables | 232,950 | (19,674) | 213,276 |
| Musharaka investments | 80,273 | 4,211 | 84,484 |
| Investment in sukuk | 53,553 | (15,115) | 38,438 |
| Ijarah muntahia bittamleek | 95,094 | (4,406) | 90,688 |
| Ijarah rental receivables | 6,815 | 6,076 | 12,891 |
| Total | 585,938 | 6,099 | 592,037 |

3 Risk Management (continued)**3.9 Equity of Investment Accountholders ("IAH") (continued)****Table – 31. 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;

| | <i>Profit Earned (jointly financed)</i> | | <i>Profit Paid to (IAH)</i> | |
|-------------|---|--------------|---------------------------------|--------------|
| | <i>BD'000</i> | <i>%age</i> | <i>BD'000</i> | <i>%age</i> |
| 2012 | 30,662 | 5.21% | 13,993 | 2.38% |
| 2011 | 33,029 | 5.53% | 14,742 | 2.31% |
| 2010 | 33,083 | 4.46% | 17,721 | 2.39% |
| 2009 | 35,694 | 5.27% | 17,638 | 2.61% |
| 2008 | 36,934 | 5.87% | 17,702 | 2.81% |
| 2007 | 31,463 | 7.80% | 15,609 | 3.87% |

Table – 32 Treatment of assets financed by IAH (PD-1.3.33 (v))

| | <i>Assets</i> | <i>RWA</i> | <i>RWA for Capital Adequacy Purposes</i> | <i>Capital Requirements</i> |
|--|----------------|----------------|--|---------------------------------|
| | <i>BD'000</i> | <i>BD'000</i> | <i>BD'000</i> | <i>BD'000</i> |
| Cash and balances with banks and Central Bank | 28,255 | - | - | - |
| Murabaha receivables* | 213,276 | 201,932 | 60,580 | 7,270 |
| Due from banks and financial institutions | 124,005 | 32,794 | 9,838 | 1,181 |
| Musharaka investments* | 84,484 | 79,990 | 23,997 | 2,880 |
| Investment in sukuk | 38,438 | 11,605 | 3,482 | 418 |
| Ijarah muntahia bittamleek* | 90,688 | 85,865 | 25,760 | 3,091 |
| Ijarah rental receivables | 12,891 | 12,891 | 3,867 | 464 |
| | 592,037 | 425,077 | 127,524 | 15,304 |

*The amounts have been allocated on pro-rata basis due to system limitation.

3.10 Liquidity Risk**3.10.1 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".

3.10.2 Sources of liquidity risk

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

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

3 Risk Management (continued)

3.10 Liquidity Risk (continued)

3.10.3 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.

3.10.4 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.

3.10.5 Liquidity risk measurement tools

The Group uses a combination of techniques for measurement of its liquidity risk. These include liquidity gap analysis, liquidity ratio limits and minimum liquidity guidelines.

3.10.6 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.

3.10.7 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").

3.10.8 Liquidity risk stress testing

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

3.10.9 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.

3 Risk Management (continued)**3.10 Liquidity Risk (continued)****Table – 33. Liquidity Ratios (PD-1.3.37)**

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

| | 2012 | 2011 | 2010 | 2009 | 2008 | 2007 |
|--|--------|----------|---------|---------|---------|---------|
| Due from banks and financial institutions / Total Assets | 15.90% | 17.73% | 22.27% | 12.10% | 17.58% | 29.62% |
| Islamic Financing / Customer Deposits excluding banks | 72.32% | 114.41% | 115.46% | 123.01% | 144.62% | 171.72% |
| Customer Deposits / Total Assets | 68.87% | 63.08% | 64.13% | 57.28% | 48.71% | 36.04% |
| Liquid Assets / Total Assets | 21.17% | 22.70% | 27.02% | 16.06% | 23.25% | 46.29% |
| Growth in Customer Deposits | 8.36% | (11.71%) | 14.86% | 21.98% | 79.24% | 55.50% |

3.11 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.

3.11.1 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.

3 Risk Management (continued)**3.11 Profit Rate Risk (continued)****3.11.2 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:

- a. has identified the profit rate sensitive products and activities it wishes to engage in;
- b. has established a limit structure to monitor and control the profit rate risk of the Group;
- c. 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
- d. makes efforts to match the amount of floating rate assets with floating rate liabilities in the banking book.

3.11.3 Profit rate risk measurement tools

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

- a. Re-pricing gap analysis which measures the arithmetic difference between the profit-sensitive assets and liabilities of the banking book in absolute terms; and
- b. 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.

3.11.4 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 – 34. 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 200bp in profit rates as of 31 December 2012;

| | <i>Effect on value of Asset BD'000</i> | <i>Effect on value of Liability BD'000</i> | <i>Effect on value of Economic Capital BD'000</i> |
|-----------------------|--|--|---|
| Upward rate shocks: | (3,958) | 9,814 | 5,856 |
| Downward rate shocks: | 3,958 | (9,814) | (5,856) |

Table – 35. 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;

| | 2012 | 2011 | 2010 | 2009 | 2008 | 2007 |
|--------------------------|-----------------|-------------|-------------|-------------|-------------|-------------|
| Return on average equity | (42.31%) | (17.23%) | (33.02%) | (12.64%) | 12.62% | 19.10% |
| Return on average assets | (4.33%) | (1.96%) | (4.30%) | (2.17%) | 2.91% | 4.57% |
| Cost to Income Ratio | 80.14% | 74.89% | 107.73% | 70.66% | 31.32% | 32.41% |

4 Glossary of Terms

| | |
|--------------|--|
| ALCO | Assets and Liabilities Committee |
| BCP | Business Continuity Plan |
| BisB | Bahrain Islamic Bank B.S.C. |
| BPV | Basis Point Value |
| CA Module | Capital Adequacy Module |
| CAR | Capital Adequacy Ratio |
| CBB | Central Bank of Bahrain |
| CRMD | Credit and Risk Management Department |
| CR & AD | Credit Review and Analysis Department |
| C&IC | Credit and Investment Committee |
| DCR | Displaced Commercial Risk |
| Excom | Executive Committee |
| CBB | Central Bank of Bahrain |
| FX | Foreign Exchange |
| GM-C&RM | General Manager-Credit and Risk Management |
| Group | Bahraini Islamic Bank B.S.C. and its subsidiaries |
| HR Committee | Human Resource Committee |
| IAH | Investment Account Holder |
| ICAAP | Internal Capital Adequacy Assessment Process |
| IFRS | International Financial Reporting Standards |
| IT Committee | Information Technology Committee |
| IRR | investment Risk Reserve |
| MLG | Minimum Liquidity Guidelines |
| PCD | Prudential Consolidation and Deduction Requirements Module |
| PD | Public Disclosure |
| PER | Profit Equalisation Reserve |
| PSIA | Profit Sharing Investment Account |
| RCSA | Risk and Control Self-Assessment |
| RMC | Risk Management Committee |
| RWE | Risk Weighted Exposures |
| VaR | Value-at-Risk |
| L/C | Letter of Credit |
| L/G | Letter of Guarantee |

بنك البحرين الإسلامي



BisB Corporate Governance Report 2012

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Introduction to BisB's Corporate Governance

Corporate Governance:

BisB is committed to upholding the highest standards of corporate governance. The Bank seeks to balance entrepreneurship, compliance, and industry best practices, while creating value for all stakeholders. This includes, but is not limited to, conducting the policy and affairs of BisB in compliance with regulatory requirements. It also involves having the right checks and balances in place throughout the organization to ensure that the right things are always done in the right way.

Responsibilities:

The Board of Directors is accountable to the shareholders for the creation and delivery of strong sustainable financial performance and long-term shareholder value through strategic initiatives. The Chairman is responsible for leading the Board, ensuring its effectiveness, monitoring the performance of the Executive Management, and maintaining a dialogue with the Bank's shareholders. The Board has appointed two Committees to assist it in carrying out its responsibilities. The Internal Audit function reports directly to the Board through the Audit Committee. The Board delegates the authority for management of the business to the Chief Executive.

Framework:

BisB's corporate governance framework comprises a code of business conduct; operational policies and procedures; internal controls and risk management systems; internal and external audit and compliance procedures; effective communications and transparent disclosure; and measurement and accountability.

Code of Business Conduct:

BisB conducts itself in accordance with the highest standards of ethical behavior. A Code of Business Conduct has been developed to govern the personal and professional conduct of all stakeholders.

Compliance:

BisB has in place comprehensive policies and procedures to ensure full compliance with the relevant rules and regulations of the Central Bank of Bahrain, including appropriate anti-money laundering procedures.

Communications:

BisB conducts all communications with its stakeholders in a professional, honest, transparent, understandable, accurate and timely manner. Main communications channels include an annual report, corporate brochure and website, and regular announcements in the appropriate local media.

Bahrain Islamic Bank's Board of Directors

Board member's Profile

Khalid Abdulla Al-Bassam

Chairman

Holds a Bachelors degree in Business Administration. Currently Chairman of Al Bassam Investment Company and of Capital Management House. Also a Board Member of Gulf Investment Corporation, Kuwait and the Islamic Bank of Asia, Singapore. Previously was the Deputy Governor of Bahrain Monetary Agency (now Central Bank of Bahrain) and Vice Chairman of the Bahrain Bourse.

Nabil Ahmed Ameen

Vice Chairman

Holds a Bachelors degree in International Business Administration. Currently Chairman & Managing Director of Almadar Finance and Investment Company, Kuwait. Also Vice Chairman of Al Wethaq Takaful Insurance Company, Kuwait. Has also held senior executive positions in Kuwait Finance House in Kuwait and Turkey and at The International Investor in Kuwait.

Khalid Mohammed Najibi

Board Member

Mr. Najibi is the Managing Director & CEO of Capital Management House. He is also the Founding Member and Executive Director of Bahrain-based Najibi Investment Company. Also a Board Member and Chairman of the Executive Committee of Bahrain Islamic Bank, Board Member of First Energy Bank BSC and Arbah Capital (Saudi Arabia), founding Member of Young Arab Leaders (YAL) Bahrain Chapter.

Mr. Najibi has over 21 years experience in the fields of finance and investment. He holds a B.A. in Business Administration with a major in Finance from Schiller International, UK, which he gained in 1990. He passed his US Certified Public Accountant's Exams in California, USA in 1993.

Ali Mohammed Al Olaimi

Board Member

Holds a Bachelors degree in Accounting and is currently the General Manager of Kuwait's Public Authority for Minors' Affairs. Currently a Board Member for Al Reem Real Estate Services and was a Board Member of National Real Estate Company, Kuwait.

Mohammed Alzarooq Rajab

Board Member

Holds a Bachelors degree in Accountancy and is a Fellow member of the Institute of Chartered Accountants in England & Wales. Has held senior posts in Libya including the Auditor General, the Minister of Treasury, Head of Libyan Peoples' Congress, the Prime Minister from 1983 to 1985, Convener of Libyan Central Bank, and has been with Libyan Foreign Investment since 2007.

Ghassan Hamad Al-Baraheem

Board Member

Holds a Masters in Business Administration Degree. Currently is a Deputy Secretary – General of Kuwait Awqaf Public Foundation. Previously held senior positions in Kuwait Investment Authority, Kuwait Investment Office – London, Morgan Stanley & Co and J. P. Morgan.

Abdulla Meshari Al-Homaidhi

Board Member

Mr. Abdullah M. Al-Homaidhi is currently the Chief Executive Officer in the Investment Dar Company since 2005. With past professional experience in full supervising all administration affairs activities, training and engineering department services – in Kuwait Airways Corporation –KAC from 1977 to 2005. Mr. Al-Homaidhi is also chairman of Credit Rating & Collection crc, Vice Chairman of Wethaq Takaful Insurance Company and Investment Dar Bank B.S.C.(c), General Manager of Al-Dar Al-Aula Real Estate Co. Ltd., Board member in Bahrain Islamic Bank, Wethaq Takaful Insurance Company- Egypt, Stehwaz Holding, and supervisory Board Member of Al Dar Fund of Funds.

Adnan Al Nisif

Board Member

Holds a Business degree from AZUSA Pacific University, USA. Mr. Adnan Al-Nisif is started his career in Kuwait Stock Exchange from 1987 to 2007. Currently he is the Chairman and General Manager of Manazel Real Estate Development (Kuwait). Additionally, Mr. Al-Nisif is a Board Member in The Investment Dar and Al-Dar Asset Management.

Ismaeel Amin

Board Member

With over 40 years of professional accounting and business consulting experience, Mr. Amin joined Ernest & Young in 1967 and served in Bahrain, London, KSA, UAE and Qatar. Elected Partner in 1976, Chairman and Chief Executive of Ernest & Young from 1985 to 1999. Mr. Amin is currently a Board Member and Chairman of the Audit Committees in SKAB Group, Najran Cement Company and Masane Al Khobar Mining Company.

Number and names of independent board members

1. Khalid Al-Bassam
2. Khalid Najibi
3. Ghassan Al-Baraheem
4. Ali Al-Olaimi
5. Ismaeel Amin

All the Board members are non-executive and no Board member has more than one Directorship of Retail Bank and Wholesale Bank.

Board start date for each term for each director

1. Khalid Al-Bassam (Start date: 08-02-2011)
2. Nabeel Amin (Start date: 08-02-2011)
3. Khalid Najibi (Start date: 08-02-2011)
4. Ali Al-Olaimi (Start date: 08-02-2011)
5. Mohammed Rajab (Start date: 08-02-2011)
6. Ghassan Al-Baraheem (Start date: 08-02-2011)

7. Abdulla Al-Humadhi (Start date: 01-12-2011)
8. Ismaeel Amin (Start date: 02-04-2012)
9. Adnan Al-Nisif (Start date: 02-04-2012)
10. Abdulrahman Al-Dawood (Resigned: 02-04-2012)

Code of Conduct

The Bank will adopt a Code of Conduct and other internal policies and guidelines to comply with the laws, rules and regulations that govern the Bank's business operations. The Code of Conduct will apply to all employees of the Bank and its subsidiaries, as well as to Directors, temporary workers and other independent contractors and consultants whether engaged by or otherwise representing the Bank and its interests.

The Directors have adopted the following Code of Conduct in respect of their behavior.

- To act with honesty, integrity and in good faith, with due diligence and care, with a view to the best interest of the Bank and its stakeholders;
- To meet regularly with senior management and Internal Audit to establish and approve policies;
- To act only within the scope of their responsibilities;
- To have a proper understanding of the affairs of the Bank and to devote sufficient time to their responsibilities;
- To understand, identify and measure the significant risks to which the Bank is exposed in its business activities;
- To independently assess and question the policies, processes and procedures of the Bank with the intent to identify and initiate management action on issues requiring improvement;
- To keep confidential board discussions and deliberations;
- To refrain from making improper use of information gained through the position as a Director;
- To refrain from taking improper advantage of the position of Director;
- To ensure his / her personal financial affairs will never cast doubt on the integrity of the Bank
- To maintain sufficient detailed knowledge of the Bank's business and performance to make informed decisions;
- To be independent in judgment and actions and to take all reasonable steps to be satisfied as to the soundness of all decisions of the Board;
- To refrain from agreeing to the business of the Bank being carried out or cause or allow the business to be carried on, in a manner likely to create a substantial risk of serious loss to the Bank's creditors and other key stakeholders;
- To refrain from agreeing to the Bank incurring an obligation unless he / she believes at the time, on reasonable grounds, that the Bank will be able to perform the obligations when it is required to do so;

- To treat fairly and with respect all of the Bank's employees and customers with whom they interact;
- To refrain from entering into competition with the Bank;
- To refrain from demanding or accepting substantial gifts from the Bank for himself or his associates;
- To refrain from taking advantage of business opportunities to which the Bank is entitled for himself or his associates;
- To report to the Board any potential conflict of interest;
- To declare interests in the Register of Interest; and
- To absent themselves from any discussions or decision-making that involves a subject in which they are incapable of providing objective advice or which involves a subject or proposed conflict of interest.
- To commit to follow the applicable regulations and follow the best industry practices
- To handle disputes and complaints from the clients to their entire satisfaction and at the same time safeguarding the interest of the Bank

The Director's adherence to this Code will be periodically reviewed. Additionally, this Code of Conduct may be published in the Annual Report with copies also available on request.

New product information, Banks new announcement and information related to stakeholders are made available in timely manner through various channels of communication which may include publications, website, direct mailers, electronic mail and local media. In addition, the Consolidated Financial Statements of at least past 3 years are available in the Bank's website.

The Group has a Quality Assurance Department which is responsible for managing customer complaints. After receiving a complaint, the department routes the complaint to the concerned department for their response. After analyzing the responses of the concerned department the customer is contacted accordingly. The customers may use the Group's website or the call centre for lodging a complaint.

Board and Directors' Responsibilities

The primary responsibility of the Board of Directors is to provide effective governance over the Bank's affairs for the benefit of its stakeholders, and to balance the interests of its diverse constituencies, including associated concerns, employees and other stakeholders. In all actions taken by the Board, the Directors are expected to exercise their business judgment in what they reasonably believe to be the best interests of the Bank.

The Board will approve and oversee the implementation of the Bank's strategies and will review and approve the Bank's strategic plan. As part of its strategic review process the Board will review major plans of action and business plans, set performance objectives and oversee major investments, divestitures and acquisitions. Every year, at an annual Board strategy session, the Board will formally reassess the Bank's objectives, strategies and plans.

One of the Board's most important responsibilities is identifying, evaluating and selecting candidates for the Board of Directors. The Board will seek members from diverse professional backgrounds who combine a broad spectrum of experience and expertise with a reputation for integrity. Directors should have had experience in positions with a high degree of responsibility, be leaders in the companies or institutions with which they are affiliated and be selected based upon the contributions they can make to the Board.

The factors to be considered by the Board in its review of potential candidates include:

- Whether the candidate has exhibited behavior that indicates he or she is committed to the highest ethical standards and the values adhered to by the Bank.
- Whether the candidate has had broad business, governmental, non-profit or professional experience that indicates that the candidate will be able to make a significant and immediate contribution to the Board's discussion and decision-making in an array of complex issues.
- Whether the candidate has special skills, expertise and background that add to and complement the range of skills, expertise and background of the existing directors.
- Whether the candidate has had a successful career that demonstrates the ability to make the kind of important and sensitive judgments that the Board is called upon to make.
- Whether the candidate will effectively, consistently and appropriately take into account and balance the legitimate interests and concerns of all of the Bank's shareholders and our other stakeholders in reaching decisions.
- Whether the candidate will be able to devote sufficient time and energy to the performance of his or her duties as a director.
- The application of these factors involves the exercise of judgment and cannot be measured in any mathematical or routine way.

Responsibilities

The following are the detailed responsibilities of the Board and Directors. The Board of Directors may not necessarily carry out all these responsibilities but should ensure that these have been delegated to various board committees or executive management committees to act on their behalf and communicate periodic reports to the Board for their review:

- Ensure that senior managements adequately manages the Bank's capital adequacy on a regular basis and periodic reports showing the adequacy of capital to support the business risks of the bank are prepared and submitted to the Board
- Establish policies for appointing senior managers, and ensuring that they have the necessary integrity, technical and managerial competence, and experience
- Oversee succession planning and replacing key executives when necessary, and ensuring appropriate resources are available, and minimizing reliance on key individuals
- Monitor and make formal (annual) evaluations of senior management's performance in implementing agreed strategy and business plans
- Approve budgets and review performance against those budgets and key performance indicators
- Approval of Financial Statements
- Manage the bank's compliance risk
- Submit organizational structure or changes to the structure approved by the Board of Directors to the CBB for final approval
- Develop policy to review the systems and controls framework, and to identify any significant issues related to the bank's adopted governance framework, processes and practices
- Ensure to obtain the CBB's approval on the following positions prior to their appointment:
 - Director
 - Member of Sharia'a Supervisory Board
 - Chief Executive or General Manager
 - Senior Manager
 - Compliance Officer
 - Money Laundering Reporting Officer and
 - Financial Instrument Trader

Responsibilities relating to Risk Management Function

- Approve the Bank's strategies and policies with respect to risk management i.e. credit, operational, market, liquidity, profit rate risk, strategic and legal, E-banking.
- Define the committee responsible for managing the risk which responsibility includes the following:
 - Ensure risk management personnel are adequately qualified to investigate and resolve issues relating to potential risks
 - Determine acceptable limits of exposure to various types of risks
 - Ensure that the risk management function is subject to independent review at least annually and results are communicated to the Board
 - Review the Bank's strategy and significant policies at least annually with respect to Risk Management Function
 - Ensure that the senior management is adequately carrying out the delegated responsibilities with respect to the Risk Management Function
 - Approve disclosure policy in line with applicable regulations
- Define responsibility of the individuals managing the risk
- Ensure that the Risk Management manual should clearly define reports to be used for monitoring risk, frequency at which these reports should be prepared and appropriate management levels to whom these should be submitted for review.

Responsibilities relating to Compliance Function

- The Board should appoint a senior member with responsibility for the management of compliance risk as their Compliance Officer/ Manager (CM).
- The Compliance Function should be independent and CM should report directly to the Board of Directors or to the Audit Committee. The CM should have direct access to senior management and all confidential information of the Bank.
- Prior to appointment of the CM, the Board should obtain the CBB's prior approval and ensure he has the necessary qualification and experience necessary for the proposed position.
- The Compliance Function is typically responsible for the following:
 - Independent assessment of compliance requirements in relation to the operating activities
 - Provide guidance on the applicable laws and regulations
 - Check and evaluate internal policies and limits
 - Evaluate practices adopted to disseminate information to respective business units
 - Develop programmes for training staff on laws, regulations and internal policies
 - Carryout compliance monitoring activities

- Reporting exceptions to the senior management and the Board or its committee

Board of Directors Membership Terms and Termination

The Board of Directors membership term is three years subject to renewal. Shareholders owning 10% or more of the share capital must nominate a representative on the Board of Directors in proportion to the number of Board members. A secret ballot is held at the General Meeting for the remaining Board members. The Board of Directors elect, by a secret ballot, a Chairman and Vice Chairman for a renewable term of three years.

Membership of the Board of Directors shall be terminated in the following cases:

- If a member fails to attend four consecutive meetings without a reasonable excuse.
- If he tenders his resignation in writing.
- If he fails to fulfill any of the conditions referred to in Article 26 of Bahrain Islamic Bank's Memorandum of Association.
- If he is appointed or elected in violation of the provisions of the law.
- If he abuses his membership for carrying on other business that competes with or is detrimental to the company's business.
- If the shareholder who nominates him applied for his removal.

Board Meetings and Attendance in 2012

| Members | 1 Feb | 14 Mar | 25 Apr | 18 Jun | 23 Sep | 11 Nov |
|--|-------|--------|--------|--------|--------|--------|
| Mr. Khalid Al-Bassam | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Mr. Nabeel Amin | ✓ | ✓ | ✓ | | ✓ | |
| Mr. Khalid Najeebi | | ✓ | ✓ | ✓ | ✓ | ✓ |
| Mr. Ali Al Olaimi | ✓ | ✓ | | ✓ | ✓ | ✓ |
| Mr. Moh'd Rajab | ✓ | ✓ | ✓ | | ✓ | ✓ |
| Mr. Ghassan Al-Baraheem | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Mr. Abdulla Al-Homaidhi | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Mr. A. Rahman Al Dawood (resigned 2 nd April 2012) | ✓ | ✓ | | | | |
| Mr. Adnan Al-Nisif (Joined 2 nd April 2012) | | | ✓ | ✓ | | ✓ |
| Mr. Ismaeel Amin (Joined 2 nd April 2012) | | | ✓ | ✓ | ✓ | ✓ |

Board Committees, Members and Objectives

| Board Committee | Members | Objectives |
|--|---|--|
| Executive Committee | <p>Khalid Najibi Chairman</p> <p>Members</p> <ul style="list-style-type: none"> • Nabeel Amin • Ghassan Al-Baraheem • Mohammed Ebrahim | <p>Review of strategy and performance</p> <p>Review of new investment proposals, credit proposals, and exit strategies</p> <p>Review of risk, provision and impairment</p> <p>The committee meets six times per year</p> |
| Audit Committee (including Corporate Governance Committee responsibilities) | <p>Mohammed Rajab Chairman</p> <p>Members</p> <ul style="list-style-type: none"> • Ali Al-Olaimi • Abdulla Al-Homaidhi (Joined the committee on 16th March 2012) • Ismaeel Amin (Joined the committee on 2nd April 2012) | <p>Oversight of integrity and reporting of the Bank's quarterly and annual financial statements</p> <p>Compliance with legal and regulatory requirements</p> <p>The committee meets four times per year</p> |
| Nomination and Remuneration Committee | <p>Khalid Al-Bassam Chairman</p> <p>Members</p> <ul style="list-style-type: none"> • Khalid Najibi • Nabil Ameen | <p>Oversight of the compensation and bonus policy</p> <p>Oversight of recruitment & promotion of key personnel</p> <p>The committee meets two times per year</p> |
| Risk Management Committee | <p>Khalid Al Bassam Chairman</p> <p>Members</p> <ul style="list-style-type: none"> • Abdulla Al-Homaidhi • Adnan Al-Nisif | <p>Monitoring the enterprise-wide risk profile independently Risk Guidance to the Board and Management periodically</p> <p>The committee meets four times per year</p> |

Executive Committee Meetings and Attendance

| Members | 8 Feb | 19 Feb | 29 Mar | 23 Apr | 17 May | 6 Jun | 31 Jul | 4 Sep | 7 Nov |
|---------------------|-------|--------|--------|--------|--------|-------|--------|-------|-------|
| Khalid Najibi | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Nabeel Amin | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Ghassan Al-Baraheem | ✓ | ✓ | ✓ | ✓ | | ✓ | ✓ | ✓ | ✓ |
| Mohammed Ebrahim | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |

Audit Committee Meetings and Attendance

| Members | 18 Jan | 31 Jan | 13 Mar | 24 Apr | 17 June | 16 July | 16 Sep | 11 Nov |
|---|--------|--------|--------|--------|---------|---------|--------|--------|
| Mohammed Rajab | ✓ | ✓ | ✓ | ✓ | | ✓ | ✓ | ✓ |
| Ali Al-Olaimi | ✓ | ✓ | ✓ | | ✓ | | ✓ | ✓ |
| Abdulla Al-Homaidhi (Joined the committee on 13 th March 2012) | | | ✓ | | ✓ | ✓ | ✓ | ✓ |
| Ismaeel Amin (Joined the committee on 2 nd April 2012) | | | | ✓ | ✓ | | ✓ | ✓ |

Risk Committee Meetings and Attendance

| Members | 24 Apr | 23 Sep |
|---------------------|--------|--------|
| Khalid Al-Bassam | ✓ | ✓ |
| Abdulla Al-Homaidhi | ✓ | ✓ |
| Adnan Al-Nisif | | ✓ |

Nomination & Remuneration Committee Meetings and Attendance

| Members | 17 Jan | 13 Mar | 23 Sep |
|------------------|--------|--------|--------|
| Khalid Al-Bassam | ✓ | ✓ | ✓ |
| Khalid Najibi | ✓ | ✓ | ✓ |
| Nabil Amin | ✓ | ✓ | ✓ |

Evaluation of the Board and Each Committee

The Nomination and Remuneration committee carried out the evaluations through questionnaires to each board member followed by an assessment of the committees and members, and expresses its satisfaction with the positive results.

Sharia'a Supervisory Board

Sharia'a Supervisory Board Report

To the shareholders of Bahrain Islamic Bank B.S.C.

Assalam Alaykum Wa Rahmatu Allah Wa Barakatoh

Pursuant to the powers entrusted to the Sharia'a Supervisory Board to supervise the Bank's activities, we hereby submit the following report.

The Sharia'a Supervisory Board monitored the operations, related to the Bank throughout the year ended 31 December 2012 to express opinion on the Bank's adherence to the provisions and principles of Islamic Sharia'a in its activities by following the guidelines and decisions issued by the Sharia'a Supervisory Board. The Sharia'a Supervisory Board believes that ensuring the conformity of its activities and investments with the provisions of Islamic Sharia'a is the sole responsibility of the Bank's Management while the Sharia'a Supervisory Board is only responsible for expressing an independent opinion and preparing a report thereabout.

The Sharia'a Supervisory Board's monitoring function included the checking of documents and procedures to scrutinize each operation carried out by the Bank, whether directly or through the Sharia'a Internal Audit department. We planned with the Sharia'a Internal Audit department to carry out monitoring functions by obtaining all the information and clarifications that were deemed necessary to confirm that the Bank did not violate the principles and provisions of Islamic Sharia'a. The Sharia'a Internal Audit department audited the Bank's transactions and submitted a report to the Sharia'a Supervisory Board. The report confirmed the Bank's commitment and conformity to the Sharia'a Supervisory Board's opinions.

The Sharia'a Supervisory Board obtained data and clarifications it deemed necessary to confirm that the Bank did not violate the principles and provisions of Islamic Sharia'a. It held several meetings throughout the year ended 31 December 2012 and replied to inquiries, in addition to approving a number of new products presented by the Management. The Sharia'a Supervisory Board discussed with the Bank's officials all transactions carried out by the Management throughout the year and reviewed the Bank's conformity with the provisions and principles of Islamic Sharia'a as well as the resolutions and guidelines of the Sharia'a Supervisory Board.

The Sharia'a Supervisory Board believes that:

1. Contracts, operations and transactions conducted by the Bank throughout the year ended 31 December 2012 were in accordance with the standard contracts pre-approved by the Sharia'a Supervisory Board.
2. The distribution of profit on investment accounts was in line with the basis and principles approved by the Sharia'a Supervisory Board.
3. Any gains resulted from sources or means prohibited by the provisions and principles of Islamic Sharia'a, have been directed to the Charity and Donations Account according to SSB's resolution.
4. Zakah was calculated according to the provisions and principles of Islamic Sharia'a. And the shareholders should pay their portion of Zakah on their shares as stated in the financial report.

The Bank was committed to the Sharia'a standards issued by the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI).

Zakah

Zakah is calculated on the Zakah base of the Group in accordance with the "FAS" issued by the "AAOIFI" using the net invested funds method. Zakah is paid by the Group based on the consolidated figures of statutory reserve, general reserve and retained earning balances at the beginning of the year. The remaining Zakah is payable by individual shareholders. Payment of Zakah on unrestricted investment and other accounts is the responsibility of investment account holders.

Earnings prohibited by Sharia'a

The Group is committed to avoid recognizing any income generated from non-Islamic sources. Accordingly, all non-Islamic income is credited to a charity fund where the Group uses these funds for social welfare activities.

Sharia'a Board members' Profiles

Rev. Shaikh Dr. Abdul Latif Mahmood Al Mahmood

Sharia'a Supervisory Board's Chairman and Sharia'a Supervisory Executive Committee Chairman

-
- Head of Arabic Language and Islamic Studies Department at the University of Bahrain.
 - Member of the Sharia'a Supervisory Board of Takaful International, Kingdom of Bahrain.
 - Member of the Sharia'a Supervisory Board of ABC Islamic Bank, Kingdom of Bahrain.
 - Member of the Sharia'a Supervisory Board of ABC Islamic Bank, London.
 - Preacher at a number of Bahrain's mosques since 1973.
 - He gives lessons in Koran interpretation, jurisprudence, principles of jurisprudence and preaching.
 - Member of the Joint Sharia'a Supervisory Board of Albaraka Group.
 - He participated in a number of jurisprudence, educational, economic, intellectual, social and cultural conferences and seminars.

Rev. Shaikh Mohammed Jaffar Aljuffairi

Sharia'a Supervisory Board Member and Vice Chairman

-
- Judge of the High Sharia'a Court of Appeal and seconded as President of the High Sharia'a Court, Ministry of Justice, Kingdom of Bahrain.
 - Former Member of the Zakat Committee, Ministry of Justice.

Rev. Shaikh Adnan Abdulla Al Qattan

Sharia'a Supervisory Board Member

-
- Judge of the High Sharia'a, Ministry of Justice, Kingdom of Bahrain.
 - Member of the Board of Directors of Sanabil for Orphan Care.
 - Chairman of the Orphans and Widows Care Committee, of the Royal Court.
 - Chairman of the Pilgrimage Mission, of the Kingdom of Bahrain.
 - Puisne Justice of the High Sharia'a Court.
 - Preacher of Ahmed Al Fateh Islamic Mosque.
 - He participated in a number of Islamic committees, courses, seminars and conferences.
 - He worked as Notary Public at the Ministry of Justice and Islamic Affairs from 1981 to 1983.
 - He worked as a teacher at the Islamic Studies Department, University of Bahrain.

Rev. Shaikh Nedham Mohamed Saleh Yacoubi

Sharia'a Supervisory Board Member

-
- Member of the Sharia'a Supervisory Board at:
 - Bahrain Islamic Bank – Bahrain.
 - Abu Dhabi Islamic Bank, UAE.
 - Sharjah Islamic Bank, UAE.
 - Ithmaar Bank, Kingdom of Bahrain.

- Gulf Finance House, Kingdom of Bahrain.
- ABC Islamic Bank, Kingdom of Bahrain.
- ABC Islamic Bank, London.
- Islamic Accounting Standards Organisation, Kingdom of Bahrain.
- Businessman.

Rev. Shaikh Dr. Essam Khalaf AlEnizi

Sharia'a Supervisory Board Member

-
- University of Kuwait Faculty – Sharia'a and Islamic Studies
 - Member of Sharia'a Supervisory Committee at:
 - Bahrain Islamic Bank
 - Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)
 - Bobyan Bank
 - Alsham Bank
 - Investment Dar and others

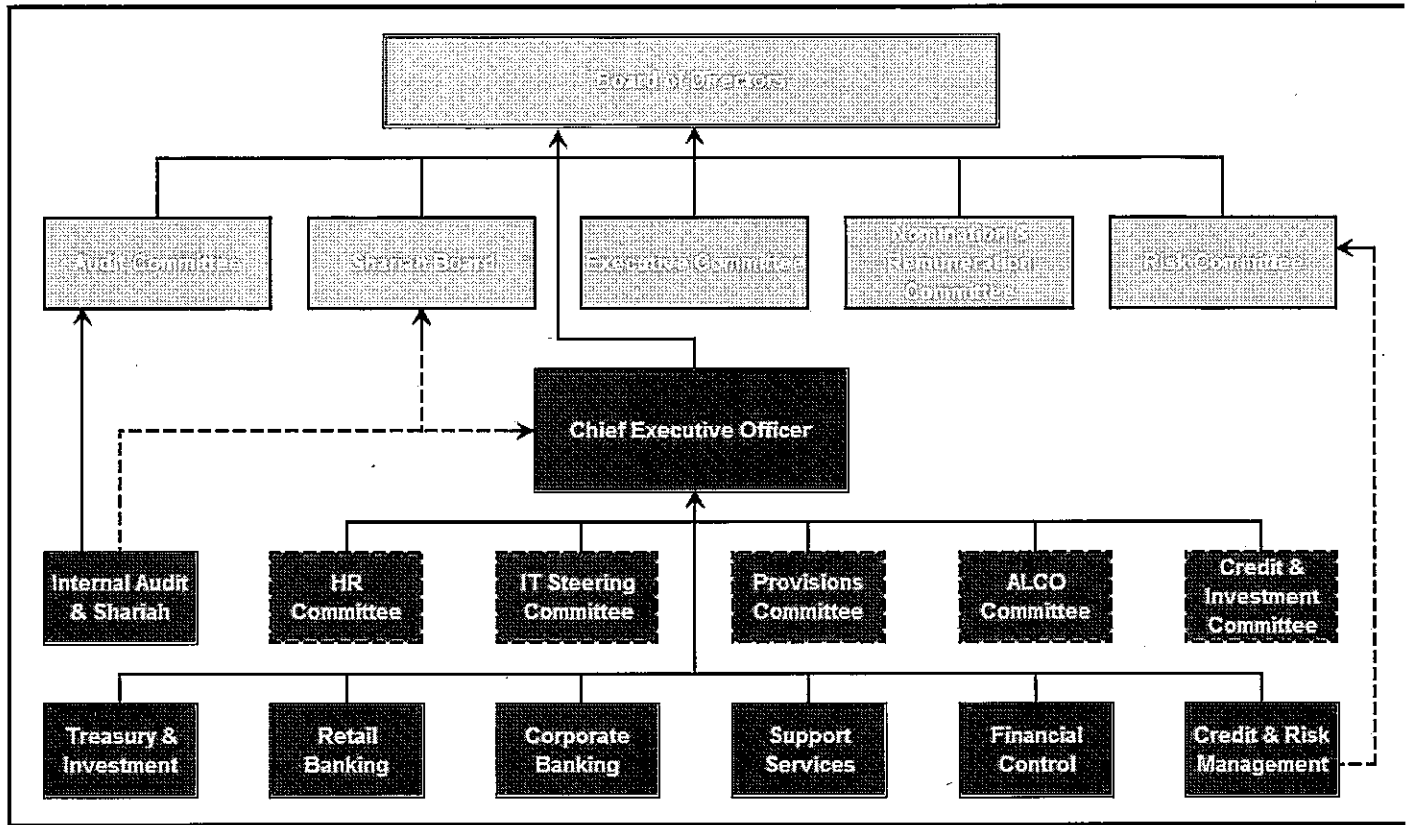
Sharia'a Committee Members and its Objective

| Members | Objectives |
|--|---|
| <p>Abdullatif Al-Mahmood Chairman</p> <p>Members</p> <ul style="list-style-type: none"> • Mohammed Al Juffairi • Adnan Al-Qattan • Nedham Yacoubi • Essam Al Enizi | <p>The main objective of Sharia'a Committee is to advise the business units on any Sharia'a matter and to ensure compliance with the sharia'a tenets and requirements in their operations. The Sharia'a Committee is entrusted with the duty of directing, reviewing and supervising the activities of the Bank in order to ensure that the Bank is in compliance with Sharia'a rules and AAOIFI.</p> |

Sharia'a Board Meetings

| Members | 15 Mar | 20 Jun | 24 Sep | 2 Dec |
|--------------------------|--------|--------|--------|-------|
| Sh. Abdulatif Al-Mahmood | ✓ | ✓ | ✓ | ✓ |
| Sh. Moh'd Al-Jufairi | ✓ | ✓ | ✓ | |
| Sh. Adnan Al-Qattan | ✓ | ✓ | ✓ | ✓ |
| Sh. Nidham Yacoubi | ✓ | ✓ | ✓ | ✓ |
| Sh. Dr. Esam Al-Enizi | ✓ | ✓ | ✓ | ✓ |

Management Structure



Executive Management, business title, experience in years and the qualifications of each Executive member

| Name of Executive Member | Designation | Profession | Experience in years | Qualification |
|---|---------------------|------------|---------------------|---|
| Mohammed Ebrahim Mohammed | CEO | Banker | 35 | Master degree in Business Administration from University of Glamorgan- Wales |
| Abdul Rahman Mohammed Turki | GM – Retail Banking | Banker | 40 | Master Degree in Business Administration from University of Strathclyde, Scotland |
| Dr. Salah Addeen Saeed (resigned 31 st Dec 2012) | GM – Credit & Risk | Banker | 35 | Doctor of Business Administration MBA with Distinction B.Sc. Honors in Mechanical |

| | | | | |
|---|---------------------------------|------------|----|--|
| | | | | Engineering |
| Mohammed Fikree (Resigned 19 th Nov 2012) | GM – Treasury & Investment | Banker | 30 | B.Sc (Honors) in Mechanical Engineering from the UK |
| Nader Ebrahim (Resigned 19 th Nov 2012) | GM – Corporate Banking | Banker | 30 | Executive Management & Leadership from University of Virginia, USA |
| Mohammed Ahmed Hassan | GM – Support Services | Banker | 44 | Advance Management for Senior Decision Makers |
| Khalid Mohammed Al Dosari | Chief Financial Officer | Accountant | 29 | CPA from American Institute of Certified Public Accountants |
| Khalid Mahmood Abdulla | AGM – Internal Audit & Sharea'a | Accountant | 19 | CPA from American Institute of Certified Public Accountants |

Management Committees

| Board Committee | Members | Objectives |
|--------------------------------------|---|---|
| Asset & Liability Committee (ALCO) | <p>Mohammed Ebrahim Chairman</p> <p>Members</p> <ul style="list-style-type: none"> A. Rahman Turki Salah' Addeen A. Qader (resigned 31st Dec 2012) Nader Ebrahim (Resigned 19th Nov 2012) Mohammed Fikree (Resigned 19th Nov 2012) Yousif A.Kareem (Joined the committee on 13th Dec 2012) Nader Al Bastaki (Joined the committee on 13th Dec 2012) <p>Secretary to the Committee:</p> <ul style="list-style-type: none"> Khalid Al Dosari <p>Permanent Invitee:</p> <ul style="list-style-type: none"> Mohammed Belgami | The main objective of ALCO is to manage and monitor the liquidity risk of the Bank on a coordinated and consistent basis. |
| Credit & Investment Committee (C&IC) | Mohammed Ebrahim Chairman | The main objectives of C&IC is to exercise due care, diligence and skill to oversee, direct and review the |

| | | |
|---|---|--|
| | <p>Members</p> <ul style="list-style-type: none"> • A. Rahman Turki • Salah Addeen A. Qader (resigned 31st Dec 2012) • Nader Ebrahim (Resigned 19th Nov 2012) • Mohammed Fikree (Resigned 19th Nov 2012) • Yousif A.Kareem (Joined the committee on 13th Dec 2012) • Nader Al Bastaki (Joined the committee on 13th Dec 2012) <p>Secretary to the Committee:</p> <ul style="list-style-type: none"> • Ahmed Sharif Taha <p>Permanent Invitee:</p> <ul style="list-style-type: none"> • Mohammed Belgami | management of credit risk within the financing portfolio of the Bank and reviewing policies and strategies for achieving investment objectives. |
| Information Technology Steering Committee | <p>Mohammed Ebrahim Chairman</p> <p>Members</p> <ul style="list-style-type: none"> • Mohammed Hassan • Salah Addeen A. Qader • Khalid Al Dossari • Khalid Mahmood • Nader Ebrahim (Resigned 19th Nov 2012) • A. Rahman Turki <p>Secretary to the Committee:</p> <ul style="list-style-type: none"> • Hassan Abuhassan | The main objective of the IT Committee is to plan, prepare, coordinate, implement, support and follow-up on all issues related to the IT and new projects implementation issue. |
| Human Resource Committee (HR) | <p>Mohammed Ebrahim Chairman</p> <p>Members</p> <ul style="list-style-type: none"> • A. Rahman Turki • Mohammed Hassan • Salah Adden A. Qader (resigned 31st Dec 2012) • Khalid Al Dossari • Khalid Mahmood • Nader Ebrahim (Resigned 19th Nov 2012) • Yousif A.Kareem (Joined the committee on 13th Dec 2012) <p>Secretary to the Committee:</p> <ul style="list-style-type: none"> • Mohammed Khalifa Al Mulla | The main objectives of HR Committee is to monitor and assess the employer workforce regarding human resources issues and monitor, review and analyze legislative and/or administrative changes related to human resources. |
| Qarth Al Hassan, Donation & | Mohammed Hassan | The main objective of Qard Al Hassan |

| | | |
|------------------------|---|--|
| Zakah Committee | Chairman Members <ul style="list-style-type: none"> • Saleh Isa Al Mehri • Ali Hassan Duaij Secretary to the Committee: <ul style="list-style-type: none"> • Hamad Farooq Al Shaikh | and Zakah Committee is to discharge the Group's social responsibilities toward its society through distributing zakah, charity funds, donations & good faith Qard for marriage, medical treatments, etc. |
| Provisioning Committee | Mohammed Ebrahim Chairman Members <ul style="list-style-type: none"> • Salah Adden A. Qader (resigned 31st Dec 2012) • Khalid Al Dossari • Mohammed Belgami • Khalid Mahmood Secretary to the Committee: <ul style="list-style-type: none"> • Mohammed Al Khaja | The main objective of Provisioning Committee, on behalf of the Chief Executive Officer, is to assist the CEO in reviewing the bank's provisions. In addition, the Committee would be responsible in formulating provision policies with a view to maintain the strategic risk levels objectives of the bank. |

Performance-linked incentive structure

The Remuneration of all Directors is governed and comply with the provision of the Commercial Companies law no 21 for the year 2001 and CBB Law promulgated by decree no. (64) of 2006.

The Bank remunerates Directors in a manner consistent with the prevailing best practice within banking industry. The current entitlement comprise of setting fees paid per meeting on an annual basis. Non-resident directors are also entitled to full travel expenses.

In addition, the performance of all Board members is evaluated annually by the Nomination & Remuneration Committee based on their contribution in the board meetings and Permanent Committees.

Board of Directors and Senior Management Aggregate Remuneration and Sitting Fees

Board of Directors Sitting Fees

The aggregate Board sitting fees was BD 210 thousand including travel expenses for the year 2012.

Senior Management Aggregate Remuneration

The aggregate Senior Management remuneration was BD 1,070 thousand including basic salaries, fixed allowances and bonus distribution for the year 2012.

Approval Process for Related Party Transactions

The bank monitors these exposures carefully on a periodic basis. Exposures to these obligors are subject to normal credit review and approval process (in line with Credit Policy) on an arm's length basis. These are also specially whetted for all regulatory compliance purposes.

Shareholders Ownership (5% and above)

| Shareholder | Nationality | Number of Shares | Percentage |
|-----------------------------------|--------------|------------------|------------|
| Investment Dar | Kuwait | 372,632,690 | 39.66% |
| Islamic Development Bank | Saudi Arabia | 165,804,485 | 17.64% |
| Kuwait Investment Company | Kuwait | 110,962,471 | 11.81% |
| General Council of Kuwaiti Awaqaf | Kuwait | 67,946,033 | 7.23% |

Distribution of Ownership of Shares by Nationality

| Country | Percentage | Number of Shares |
|-------------------------|----------------|--------------------|
| Kuwait | 60.59% | 569,354,751 |
| Kingdom of Saudi Arabia | 18.54% | 174,171,789 |
| Kingdom of Bahrain | 17.10% | 160,710,145 |
| United Arab Emirates | 3.64% | 34,234,559 |
| Qatar | 0.11% | 1,019,303 |
| Oman | 0.02% | 182,952 |
| Total | 100.00% | 939,673,499 |

Distribution of Ownership shares of Directors, Sharea'a Members and Senior Management (As of December 2012)

| Directors | Shares as of 31 st Dec 2011 | Shares as of 31 st Dec 2012 |
|--------------------------|--|--|
| Khalid Al-Bassam | 1,957,639 | 1,957,639 |
| Khalid Najibi | 851,709 | 851,709 |
| Mohammed Al-Zarroq Rajab | 152,460 | 152,460 |
| Ali Mohammed Al-Olaimi | 402,293 | 402,293 |

| | | |
|---|---|---------|
| Nabeel Ahmed Amin | 244,750 | 244,750 |
| Abdulrahman Al-Dawood | 110,000 | 0 |
| Ghassan Al-Baraheem | No Shares Transferred As of December 2011 | 100,000 |
| Abdulla Al-Homaidhi | No Shares Transferred As of December 2011 | 123,750 |
| Adnan Al-Nisif | 0 | 110,000 |
| Ismaeel Amin | 0 | 100,000 |
| Shareholders Members | | |
| Shaikh Dr. Abdul Latif Mahmood Al Mahmood | 191,405 | 191,405 |
| Shaikh Nedham Mohamed Saleh Yacoubi | 14,320 | 14,320 |
| Senior Management | | |
| Mohammed Ebrahim Mohammed | 100,000 | 100,000 |

Corporate Social Responsibility

Since inception, BisB has been committed to supporting the social and economic development of the Kingdom of Bahrain. As a concerned corporate citizen, we have put in place a comprehensive corporate social responsibility programme that provides financial assistance to various charitable, educational, medical, cultural and sporting organizations and events, and deserving causes; and also supports the development of Bahrain's financial services industry. In line with the Bank's business philosophy, we are particularly keen to support initiatives that foster entrepreneurship and that encourage the development of tomorrow's leaders.