



THE GULF'S OWN MERCHANT BANK

Basel 2, Pillar 3

# Risk Management & Capital Adequacy

30<sup>th</sup> June 2010



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## EXECUTIVE SUMMARY

The Central Bank of Bahrain (CBB) Basel 2 guidelines prescribe the capital adequacy framework for banks incorporated in the Kingdom of Bahrain.

This Risk Management and Capital Adequacy report encompasses the Basel 2 Pillar 3 disclosure requirements prescribed by the CBB based on the Basel Committee's Pillar 3 guidelines. The report contains a description of GIB's risk management and capital adequacy policies and practices, including detailed information on the capital adequacy process.

Since 2006, GIB (the Group) has routinely been monitoring capital adequacy for internal capital management purposes based on both the Basel 2 standardised and the foundation internal ratings based (FIRB) approaches for credit risk, and the basic indicator and standardised approaches for operational risk, in addition to the internal models approach for market risk.

For regulatory purposes, GIB has initially adopted the standardised approach for credit risk. In time and subject to approval by the CBB, GIB plans to adopt the FIRB approach for credit risk, as it is more closely aligned to the Group's internal capital management methodologies. For market risk, GIB uses the internal model approach. GIB has initially adopted the basic indicator approach for determining the capital requirement for operational risk although is in a position to adopt the standardised approach for operational risk when approved by the CBB.

The disclosed tier 1 and total capital adequacy ratios comply with the minimum capital requirements under the CBB's Basel 2 framework.

GIB's total risk-weighted assets at 30<sup>th</sup> June 2010 amounted to US\$11,061.2 million. Credit risk accounted for 94.6 per cent, market risk 0.4 per cent and operational risk 5.0 per cent of the total risk-weighted assets. Tier 1 and total regulatory capital were US\$1,831.4 million and US\$2,543.3 million respectively.

At 30th June 2010, GIB's tier 1 and total capital adequacy ratios were 16.6 per cent and 23.0 per cent respectively. GIB aims to maintain a tier 1 capital ratio above 8 per cent and a total capital ratio in excess of 13 per cent.

GIB views the Basel 2 Pillar 3 disclosures as an important contribution to increased risk transparency within the banking industry, and particularly important during market conditions characterised by high uncertainty. In this regard, GIB has provided more disclosure in this report than is required in accordance with the CBB's Pillar 3 guidelines in order to provide the level of transparency that is believed to be appropriate and relevant to the Group's various stakeholders and market participants.

All figures presented in this report are as at 30th June 2010 unless otherwise stated.

## 1. INTRODUCTION TO THE BASEL 2 FRAMEWORK

The CBB's Basel 2 framework is based on three pillars, consistent with the Basel 2 framework developed by the Basel Committee, as follows:-

- Pillar 1: the calculation of the risk weighted amounts (RWAs) and capital requirement.
- Pillar 2: the supervisory review process, including the Internal Capital Adequacy Assessment Process (ICAAP).
- Pillar 3: the disclosure of risk management and capital adequacy information.

### 1.1 Pillar 1

Pillar 1 prescribes the basis for the calculation of the regulatory capital adequacy ratio. Pillar 1 sets out the definition and calculations of the RWAs, and the derivation of the regulatory capital base. The capital adequacy ratio is calculated by dividing the regulatory capital base by the total RWAs.

The resultant ratio is to be maintained above a predetermined and communicated level. Under the previously applied Basel 1 Capital Accord, the minimum capital adequacy ratio for banks incorporated in Bahrain was 12 per cent compared to the Basel Committee's minimum ratio of 8 per cent.

With the imminent introduction of Pillar 2, the CBB will implement a minimum ratio threshold to be determined for each institution individually, as described in more detail in the Pillar 2 section on page 3 of this report. As at 30th June 2010, and pending the finalisation of the CBB's Pillar 2 guidelines, all banks incorporated in Bahrain were required to maintain a minimum capital adequacy ratio of 12 per cent.

The CBB also requires banks incorporated in Bahrain to maintain a buffer of 0.5 per cent above the minimum capital adequacy ratio. In the event that the capital adequacy ratio falls below 12.5 per cent, additional prudential reporting requirements apply and a formal action plan setting out the measures to be taken to restore the ratio above the target level is to be formulated and submitted to the CBB. Consequently, the CBB requires GIB to maintain an effective minimum capital adequacy ratio of 12.5 per cent. No separate minimum tier 1 ratio is required to be maintained under the CBB's Basel 2 capital adequacy framework. However, the maintenance of a strong tier 1 ratio is nevertheless a focus of GIB's internal capital adequacy assessment process, as it represents the core capital of the bank.

Under the CBB's Basel 2 capital adequacy framework, the RWAs are calculated using more sophisticated and risk sensitive methods than under the previous Basel 1 regulations. Credit risk and market risk are two essential risk types that were included under Basel I, while operational risk has been introduced as a new risk type in the CBB's Basel 2 capital adequacy framework. The table below summarises the approaches available for calculating RWAs for each risk type in accordance with the CBB's Basel 2 capital adequacy framework:-

Approaches for determining regulatory capital requirements		
Credit Risk	Market Risk	Operational Risk
Standardised Approach	Standardised Approach	Basic Indicator Approach
Foundation Internal Ratings Based Approach (FIRB)	Internal Models Approach	Standardised Approach

The approach applied by GIB for each risk type is as follows:-

#### i) Credit Risk

For regulatory reporting purposes, GIB applies the standardised approach for credit risk. The standardised approach is similar to the basis under the previous Basel 1 capital adequacy regulations, except for the use of external ratings to derive RWAs and the ability to use a wider range of financial collateral.

The RWAs are determined by multiplying the credit exposure by a risk weight factor dependent on the type of counterparty and the counterparty's external rating, where available.

Internally, GIB also calculates the capital requirement under the more risk-sensitive and complex FIRB approach, although the resultant ratio is not being used for regulatory compliance purposes at present.

## **1. INTRODUCTION TO THE BASEL 2 FRAMEWORK (continued)**

### **1.1 Pillar 1 (continued)**

#### **ii) Market Risk**

For the regulatory market risk capital requirement, GIB applies the internal models approach based on a Value-at-Risk (VaR) model. The use of the internal models approach for the calculation of regulatory market risk capital has been approved by the CBB.

#### **iii) Operational Risk**

Under the CBB's Basel 2 capital adequacy framework, all banks incorporated in Bahrain are required to apply the basic indicator approach for operational risk unless approval is granted by the CBB to use the standardised approach. The CBB's Basel 2 guidelines do not currently permit the use of the advanced measurement approach (AMA) for operational risk. For regulatory reporting purposes, GIB currently applies the basic indicator approach, although internally the Group also calculates the capital requirement based on the more advanced standardised approach.

Under the basic indicator approach, the regulatory capital requirement is calculated by applying an alpha co-efficient of 15 per cent to the average gross income for the preceding three financial years. Under the standardised approach, the regulatory capital requirement is calculated based on a range of beta coefficients, ranging from 12 to 18 per cent, applied to the average gross income for the preceding three financial years for each of eight predefined business lines.

### **1.2 Pillar 2**

Pillar 2 defines the process of supervisory review of an institution's risk management framework and, ultimately, its capital adequacy.

Under the CBB's Pillar 2 guidelines, each bank is to be individually assessed by the CBB and an individual minimum capital adequacy ratio is to be determined for each bank. The CBB is currently undertaking the assessment exercises, which will allow their setting of minimum capital ratios in excess of 8 per cent, based on the CBB's assessment of the financial strength and risk management practices of the institution. Currently, pending finalisation of the assessment process all banks incorporated in Bahrain are required to continue to maintain a 12 per cent minimum capital adequacy ratio as under the previous Basel 1 framework.

Pillar 2 comprises two processes:

- an Internal Capital Adequacy Assessment Process (ICAAP), and
- a supervisory review and evaluation process.

The ICAAP incorporates a review and evaluation of risk management and capital relative to the risks to which the bank is exposed. GIB is currently developing its ICAAP around its economic capital framework which is designed to ensure that the Group has sufficient capital resources available to meet regulatory and internal capital requirements, even during periods of economic or financial stress. The ICAAP addresses all components of GIB's risk management, from the daily management of more material risks to the strategic capital management of the Group.

The supervisory review and evaluation process represents the CBB's review of the Group's capital management and an assessment of internal controls and corporate governance. The supervisory review and evaluation process is designed to ensure that institutions identify their material risks and allocate adequate capital, and employ sufficient management processes to support such risks.

The supervisory review and evaluation process also encourages institutions to develop and apply enhanced risk management techniques for the measurement and monitoring of risks in addition to the credit, market and operational risks addressed in the core Pillar 1 framework. Other risk types which are not covered by the minimum capital requirements in Pillar 1 include liquidity risk, interest rate risk in the banking book, business risk and concentration risk. These are covered either by capital, or risk management and mitigation processes under Pillar 2.

## **1. INTRODUCTION TO THE BASEL 2 FRAMEWORK (continued)**

### **1.3 Pillar 3**

In the CBB's Basel 2 framework, the third pillar prescribes how, when, and at what level information should be disclosed about an institution's risk management and capital adequacy practices.

The disclosures comprise detailed qualitative and quantitative information. The purpose of the Pillar 3 disclosure requirements is to complement the first two pillars and the associated supervisory review process. The disclosures are designed to enable stakeholders and market participants to assess an institution's risk appetite and risk exposures and to encourage all banks, via market pressures, to move toward more advanced forms of risk management.

Under the current regulations, partial disclosure consisting mainly of quantitative analysis is required during half year reporting, whereas fuller disclosure is required to coincide with the financial year end reporting.

In this report, GIB's disclosures are beyond the minimum regulatory requirements and provide disclosure of the risks to which it is exposed, both on- and off-balance sheet. The disclosures in this report are in addition to the disclosures set out in the consolidated financial statements presented in accordance with International Financial Reporting Standards (IFRS).

## 2. GROUP STRUCTURE AND OVERALL RISK AND CAPITAL MANAGEMENT

This section sets out the consolidation principles and the capital base of GIB as calculated in accordance with the Pillar 1 guidelines, and describes the principles and policies applied in the management and control of risk and capital.

### 2.1 Group structure

The Group's financial statements are prepared and published on a full consolidation basis, with all subsidiaries being consolidated in accordance with IFRS. For capital adequacy purposes, all subsidiaries are included within the Gulf International Bank B.S.C. Group structure. However, the CBB's capital adequacy methodology accommodates both normal and aggregation forms of consolidation.

Under the CBB capital adequacy framework, subsidiaries reporting under a Basel 2 framework in other regulatory jurisdictions may, at the bank's discretion, be consolidated based on that jurisdiction's Basel 2 framework, rather than based on the CBB's guidelines. Under this aggregation consolidation methodology, the risk weighted assets of subsidiaries are consolidated with those of the rest of the Group based on the guidelines of their respective regulator to determine the Group's total risk weighted assets.

GIB's principal subsidiary, GIBUK, is regulated by the Financial Services Authority (FSA) of the United Kingdom, and has calculated its risk weighted assets in accordance with the FSA's guidelines.

The principal subsidiaries and basis of consolidation for capital adequacy purposes are as follows:-

Subsidiary	Domicile	Ownership	Consolidation basis
Gulf International Bank (UK) Limited	United Kingdom	100%	Aggregation
GIB Financial Services LLC	Saudi Arabia	100%	Full Consolidation
GIB Investment SPC	Bahrain	100%	Full Consolidation

No investments in subsidiaries are treated as a deduction from the Group's regulatory capital.

### 2.2 Risk and capital management

GIB maintains a prudent and disciplined approach to risk taking by upholding a comprehensive set of risk management policies, processes and limits, employing professionally qualified people with the appropriate skills, investing in technology and training, and actively promoting a culture of sound risk management at all levels. A key tenet of this culture is the clear segregation of duties and reporting lines between personnel transacting business and personnel processing that business. The Group's risk management is underpinned by its ability to identify, measure, aggregate and manage the different types of risk it faces.

The Board of Directors has created from among its members a Board Risk Policy Committee to review the Group's risk taking activities and report to the Board in this regard. The Board has the ultimate responsibility for setting the overall risk parameters and tolerances within which the Group conducts its activities, including responsibility for setting the capital ratio targets. The Board reviews the Group's overall risk profile and significant risk exposures as well as the Group's major risk policies, processes and controls.

The Management Committee, chaired by the Chief Executive Officer (CEO), has the primary responsibility for sanctioning risk taking policies and activities within the tolerances defined by the Board. The Group Risk Committee assists the Management Committee in performing its risk related functions.

The Group Risk Committee, under the chairmanship of the Head of Risk Management (HoRM) and comprising the Group's most senior risk professionals, provides a forum for the review and approval of new products, risk measurement methodologies and risk control processes. The Group Risk Committee also reviews all risk policies and limits that require approval by the Management Committee. The Assets and Liabilities Committee (ALCO), chaired by the Chief Investment and Treasury Officer (CI&TO), provides a forum for the review of asset and liability activities within GIB. It co-ordinates the asset and liability functions and serves as a link between the funding sources and usage in the different business areas.

## 2. GROUP STRUCTURE AND OVERALL RISK AND CAPITAL MANAGEMENT (continued)

### 2.2 Risk and capital management (continued)

From a control perspective, the process of risk management is facilitated through a set of independent functions, which report directly to senior management. These functions include Credit Risk, Market Risk, Operational Risk, Financial Controls and Internal Audit. This multi-faceted approach aids the effective management of risk by identifying, measuring and monitoring risks from a variety of perspectives.

Internal Audit is responsible for carrying out a risk-based programme of work designed to provide assurance that assets are being safeguarded. This involves ensuring that controls are in place and working effectively in accordance with Group policies and procedures as well as with laws and regulations. The work carried out by Internal Audit includes providing assurance on the effectiveness of the risk management functions as well as that of controls operated by the business units. The Audit Committee approves the annual audit plan and also receives regular reports of the results of audit work.

The Group's policy is to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future business development. The Group manages its capital structure and makes adjustments to the structure taking account of changes in economic conditions and strategic business plans. The capital structure may be adjusted through the dividend payout, and the issue of new shares and subordinated term finance.

The Chief Financial Officer (CFO) is responsible for the capital planning process. Capital planning includes capital adequacy reporting, economic capital and parameter estimation, i.e. probability of default (PD) and loss given default (LGD) estimates, used for the calculation of economic capital. The CFO is also responsible for the balance sheet management framework.

The governance structure for risk and capital management is illustrated in the table below:-

Board of Directors		
Audit Committee	Board Risk Policy Committee	
Chief Executive Officer		
Management Committee (Chairman: CEO)	Group Risk Committee (Chairman: HoRM)	Asset and Liability Committee (Chairman: CI & TO)

The risk, liquidity and capital management responsibilities are illustrated in the table below:-

Chief Executive Officer	
Chief Financial Officer (CFO)	Head of Risk Management (HoRM)
Balance Sheet management framework	Risk management framework and policies
Capital management framework	Group credit control
Operational risk	Credit risk
Liquidity monitoring and reporting	Market risk

### 2.3 Risk types

The major risks associated with the Group's business activities are credit, market, operational and liquidity risk. These risks together with a commentary on the way in which the risks are managed and controlled are set out below, based on the Basel 2 pillar in which the risks are addressed.

### 2.4 Risk in Pillar 1

Pillar 1, which forms the basis for the calculation of the regulatory capital requirement, addresses three specific risk types: credit, market and operational risk.



## 2. GROUP STRUCTURE AND OVERALL RISK AND CAPITAL MANAGEMENT (continued)

### 2.4 Risk in Pillar 1 (continued)

#### i) Credit risk

Credit risk is the risk that a customer, counterparty or an issuer of securities or other financial instruments fails to perform under its contractual payment obligations thus causing the Group to suffer a loss in terms of cash flow or market value. Credit risk is the predominant risk type faced by the Group in its banking, investment and treasury activities, both on- and off-balance sheet. Where appropriate, the Group seeks to minimise its credit exposure using a variety of techniques including, but not limited to, the following:-

- entering netting agreements with counterparties that permit the offsetting of receivables and payables
- obtaining collateral
- seeking third party guarantees of the counterparty's obligations
- imposing restrictions and covenants on borrowers

Credit risk is actively managed and rigorously monitored in accordance with well-defined credit policies and procedures. Prior to the approval of a credit proposal, a detailed credit risk assessment is undertaken which includes an analysis of the obligor's financial condition, market position, business environment and quality of management. The risk assessment generates an internal credit risk rating for each counterparty, which affects the credit approval decision and the terms and conditions of the transaction. For cross-border transactions, an analysis of country risk is also conducted. The credit decision for an individual counterparty is based on the aggregate Group exposure to that counterparty and all its related entities. Groupwide credit limit setting and approval authorisation requirements are conducted within Board approved guidelines, and the measurement, monitoring and control of credit exposures are done on a Groupwide basis in a consistent manner. Overall exposures are evaluated to ensure broad diversification of credit risk. Potential concentration risks by product, industry, single obligor, credit risk rating and geography are regularly assessed with a view to improving overall portfolio diversification. Established limits and actual levels of exposure are regularly reviewed by the HoRM, Chief Credit Officer and other members of senior management. All credit exposures are reviewed at least once a year. Credit policies and procedures are designed to identify, at an early stage, exposures which require more detailed monitoring and review. The credit risk associated with foreign exchange and derivative instruments is assessed in a manner similar to that associated with on-balance sheet activities. The Group principally utilises derivative transactions to facilitate customer transactions and for the management of interest and foreign exchange risks associated with the Group's longer-term lending, borrowing and investment activities. Unlike on-balance sheet products, where the principal amount and interest generally represent the maximum credit exposure, the notional amount relating to a foreign exchange or derivative transaction typically exceeds the credit exposure by a substantial margin. The measure of credit exposure for foreign exchange and derivative instruments is therefore more appropriately considered to be the replacement cost at current market rates plus an add-on amount commensurate with the position's size, volatility and remaining life. Derivative contracts may also carry legal risk; the Group seeks to minimise these risks by the use of standard contract agreements.

#### ii) Market risk

Market risk is the risk of loss of value of a financial instrument or a portfolio of financial instruments as a result of adverse changes in market prices and rates, and market conditions such as liquidity. Market risk arises from the Group's trading, asset and liability management and investment activities.

The categories of market risk to which the Group is exposed are as follows:-

**Interest rate risk** results from exposure to changes in the level, slope, curvature and volatility of interest rates and credit spreads. The credit spread risk is the risk that the interest yield for a security will increase, with a reduction in the security price, relative to benchmark yields as a result of the general market movements for that rating and class of security. Interest rate risk is the principal market risk faced by the Group and arises from the Group's investment activities in debt securities, asset and liability management, and the trading of debt and off-balance sheet derivative instruments.

**Foreign exchange risk** results from exposure to changes in the price and volatility of currency spot and forward rates. The principal foreign exchange risk arises from the Group's foreign exchange forward and derivative trading activities.

## 2. GROUP STRUCTURE AND OVERALL RISK AND CAPITAL MANAGEMENT (continued)

### 2.4 Risk in Pillar 1 (continued)

**Equity risk** arises from exposures to changes in the price and volatility of individual equities or equity indices.

The Group seeks to manage exposure to market risk through the diversification of exposures across dissimilar markets and establishment of hedges in related securities or off-balance sheet derivative instruments. To manage the Group's exposures, in addition to the exercise of business judgment and management experience, the Group utilises limit structures including those relating to positions, portfolios, maturities and maximum allowable losses. A key element in the Group's market risk management framework is the estimation of potential future losses that may arise from adverse market movements. The Group utilises Value-at-Risk (VaR) to estimate such losses. The VaR is derived from quantitative models that use statistical and simulation methods that take account of all market rates and prices that may cause a change in a position's value. These include interest rates, foreign exchange rates and equity prices, their respective volatilities and the correlations between these variables. The Group's VaR is calculated on a Monte Carlo simulation basis using historical volatilities and correlations to generate a profit and loss distribution from several thousand scenarios.

The VaR takes account of potential diversification benefits of different positions both within and across different portfolios. Consistent with general market practice, VaR is computed for all financial instruments for which there are readily available daily prices or suitable proxies. VaR is viewed as an effective risk management tool and a valuable addition to the non-statistically based limit structure. It permits a consistent and uniform measurement of market risk across all applicable products and activities. Exposures are monitored against a range of limits both by risk category and portfolio and are regularly reported to and reviewed by senior management and the Board of Directors.

An inherent limitation of VaR is that past market movements may not provide an accurate prediction of future market losses. Historic analyses of market movements have shown that extreme market movements (i.e. beyond the 99 per cent confidence level) occur more frequently than VaR models predict. Stress tests are regularly conducted to estimate the potential economic losses in such abnormal markets. Stress testing combined with VaR provides a more comprehensive picture of market risk. The Group regularly performs stress tests that are constructed around changes in market rates and prices resulting from pre-defined market stress scenarios, including both historical and hypothetical market events. Historical scenarios include the 1997 Asian crisis, the 1998 Russian crisis, the events of 9/11 and the 2008 credit crisis. In addition, the Group performs stress testing based on internally developed hypothetical market stress scenarios. Stress testing is performed for all material market risk portfolios.

#### iii) Operational risk

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

Whilst operational risk cannot be eliminated in its entirety, the Group endeavours to minimise the risk by ensuring that a strong control infrastructure is in place throughout the organisation. The various procedures and processes used to manage operational risk include effective staff training, appropriate controls to safeguard assets and records, regular reconciliation of accounts and transactions, close monitoring of risk limits, segregation of duties, and financial management and reporting. In addition, other control strategies, including business continuity planning and insurance, are in place to complement the control processes, as applicable.

The Group has an independent operational risk function. As part of the Group's Operational Risk Management Framework (ORMF), comprehensive risk assessments are conducted, which identify operational risks inherent in the Group's activities, processes and systems. The controls in place to mitigate these risks are also reviewed, and enhanced if necessary.

### 2.5 Risk in Pillar 2

Other risk types are measured and assessed in Pillar 2. GIB measures and manages these risk types although they are not included in the calculation of the regulatory capital adequacy ratio. Most of the Pillar 2 risks are included in GIB's calculation of internal economic capital. Pillar 2 risk types include liquidity risk, interest rate risk in the banking book, business risk and concentration risk.

#### i) Liquidity risk

Liquidity risk is the risk that sufficient funds are not available to meet the Group's financial obligations on a punctual basis as they fall due. The risk arises from the timing differences between the maturity profiles of the Group's assets and liabilities. It includes the risk of losses arising from the following:-

- Forced sale of assets at below normal market prices
- Raising of deposits or borrowing funds at excessive rates
- The investment of surplus funds at below market rates

## **2. GROUP STRUCTURE AND OVERALL RISK AND CAPITAL MANAGEMENT (continued)**

### **2.5 Risk in Pillar 2 (continued)**

#### **i) Liquidity risk (continued)**

Liquidity management policies are designed to ensure that funds are available at all times to meet the funding requirements of the Group, even in adverse conditions. In normal conditions, the objective is to ensure that there are sufficient funds available not only to meet current financial commitments but also to facilitate business expansion. These objectives are met through the application of prudent liquidity controls. These controls provide access to funds without undue exposure to increased costs from the liquidation of assets or the aggressive bidding for deposits.

The Group's liquidity controls ensure that, over the short term, the future profile of cash flows from maturing assets is adequately matched to the maturity of liabilities. Liquidity controls also provide for the maintenance of a stock of liquid and readily realisable assets and a diversified deposit base in terms of both maturities and range of depositors.

The management of liquidity and funding is primarily conducted in the Group's individual geographic entities within approved limits. The limits take account of the depth and liquidity of the market in which the entity operates.

It is the Group's general policy that each geographic entity should be self-sufficient in relation to funding its own operations.

The Group's liquidity management policies include the following:-

- the monitoring of (i) future contractual cash flows against approved limits, and (ii) the level of liquid assets available in the event of a stress event
- the monitoring of balance sheet liquidity ratios
- the monitoring of the sources of funding in order to ensure that funding is derived from a diversified range of sources
- the monitoring of depositor concentrations in order to avoid undue reliance on individual depositors
- the maintenance of a satisfactory level of term financing; and
- the maintenance of liquidity and funding contingency plans. These plans identify early indicators of stress conditions and prescribe the actions to be taken in the event of a systemic or other crisis, while minimising adverse long term implications for the Group's business activities.

#### **ii) Interest rate risk in the banking book**

Structural interest rate risk arises in the Group's core balance sheet as a result of mismatches in the repricing of interest rate sensitive financial assets and liabilities. The associated interest rate risk is managed within VaR limits and through the use of models to evaluate the sensitivity of earnings to movements in interest rates.

#### **iii) Business risk**

Business risk represents the earnings volatility inherent in all businesses due to the uncertainty of revenues and costs associated with changes in the economic and competitive environment. Business risk is evaluated based on the observed volatility in historical profits and losses.

#### **iv) Concentration risk**

Concentration risk is the risk related to the degree of diversification in the credit portfolio, i.e. the risk inherent in doing business with large customers or not being equally exposed across industries and regions.

Concentration risk is captured in GIB's economic capital framework through the use of a credit risk portfolio model which considers single-name concentrations in the credit portfolio. Economic capital add-ons are applied where counterparty exposures exceed specified thresholds.

Potential concentration risks by product, industry, single obligor, and geography are regularly assessed with a view to improving overall portfolio diversification. Established limits and actual levels of exposure are regularly reviewed by senior management and the Board of Directors.

### **2.6 Monitoring and reporting**

The monitoring and reporting of risk is conducted on a daily basis for market and liquidity risk, on a monthly or quarterly basis for credit risk, and on a quarterly basis for operational risk.

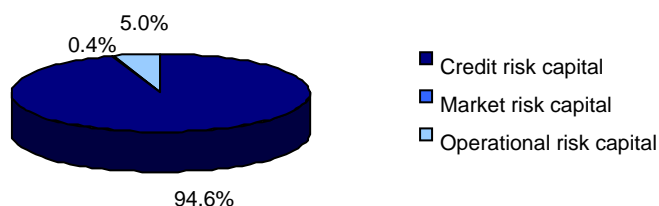
Risk reporting is regularly made to senior management and the Board of Directors. The Board of Directors receives internal risk reports covering market, credit, operational and liquidity risks.

Capital management, including regulatory and internal economic capital ratios, is reported to senior management and the Board of Directors on a monthly basis.

### 3. REGULATORY CAPITAL REQUIREMENTS AND THE CAPITAL BASE

This section describes the Group's regulatory capital requirements and capital base.

The composition of the total regulatory capital requirement was as follows:-



#### 3.1 Capital requirements for credit risk

For regulatory reporting purposes, GIB calculates the capital requirements for credit risk based on the standardised approach. Under the standardised approach on- and off-balance sheet credit exposures are assigned to exposure categories based on the type of counterparty or underlying exposure. The exposure categories are referred to in the CBB's Basel 2 capital adequacy framework as standard portfolios. The primary standard portfolios are claims on sovereigns, claims on banks and claims on corporates. Following the assignment of exposures to the relevant standard portfolios, the RWAs are derived based on prescribed risk weightings. Under the standardised approach, the risk weightings are provided by the CBB and are determined based on the counterparty's external credit rating. The external credit ratings are derived from eligible external rating agencies approved by the CBB. GIB uses ratings assigned by Standard & Poor's, Moody's and Fitch.

An overview of the exposures, RWAs and capital requirements for credit risk analysed by standard portfolio is presented in the table below:-

	Rated exposure	Unrated exposure	Total exposure	Average risk weight	RWA	Capital requirement
	US\$ millions	US\$ millions	US\$ millions	%	US\$ millions	US\$ millions
Sovereigns	2,289.9	-	2,289.9	1%	23.3	2.8
PSEs	-	6.8	6.8	100%	6.8	0.8
Banks	5,757.3	297.4	6,054.7	29%	1,761.4	211.4
Corporates	976.4	7,168.6	8,145.0	93%	7,591.5	911.0
Equities	-	347.5	347.5	124%	430.6	51.7
Past due loans	-	368.9	368.9	131%	482.6	57.9
Other assets	1.8	168.0	169.8	99%	168.0	20.2
<b>Total</b>	<b>9,025.4</b>	<b>8,357.2</b>	<b>17,382.6</b>	<b>60%</b>	<b>10,464.2</b>	<b>1,255.8</b>

Exposures are stated after taking account of credit risk mitigants where applicable. The treatment of credit risk mitigation is explained in more detail in section 4.4(vii) of this report.

The unrated exposure to banks principally represents unrated subordinated loans to rated banks.

The definitions of each standard portfolio and the related RWA requirements are set out in section 4 of this report.

#### 3.2 Capital requirements for market risk

GIB uses a Value-at-Risk (VaR) model to calculate the regulatory capital requirements relating to general market risk.

The VaR calculated by the internal model is subject to a multiplication factor determined by the CBB. GIB's multiplication factor has been set at 3.5 by the CBB. The multiplication factor was increased by the CBB from the regulatory minimum of 3.0 during 2008, based on the number of back testing exceptions recorded in the financial year ended 31st December 2007. The trading-related exposures that gave rise to the back testing exceptions in 2007 were liquidated during the year ended 31st December 2008.

Prescribed additions in respect of specific risk are made to the general market risk. The resultant measure of market risk is multiplied by 12.5, the reciprocal of the theoretical 8 per cent minimum capital ratio, to give market risk-weighted exposure on a basis consistent with credit risk-weighted exposure.

### 3. REGULATORY CAPITAL REQUIREMENTS AND THE CAPITAL BASE (continued)

#### 3.2 Capital requirement for market risk (continued)

The RWAs and capital requirements for market risk are presented in the table below:-

	RWA	Capital requirement
	US\$ millions	US\$ millions
Equity risk	16.4	2.0
Interest rate risk	3.9	0.4
Foreign exchange risk	1.4	0.2
Total general market risk	21.7	2.6
Total specific market risk	24.8	3.0
<b>Total</b>	<b>46.5</b>	<b>5.6</b>

The equity general market risk related to alternative investment funds managed by external managers. The funds have been redeemed and are in the process of liquidation.

#### 3.3 Capital requirements for operational risk

For regulatory reporting purposes, the capital requirement for operational risk is calculated according to the basic indicator approach. Under this approach, the Group's average gross income over the preceding three financial years is multiplied by a fixed alpha coefficient. The alpha coefficient has been set at 15 per cent in the CBB's Basel 2 capital adequacy framework.

The capital requirement for operational risk at 30th June 2010 amounted to US\$66.1 million.

#### 3.4 Capital base

The regulatory capital base is set out in the table below:-

	Tier 1	Tier 2	Total
	US\$ millions	US\$ millions	US\$ millions
Share capital	2,500.0	-	2,500.0
Share premium	7.6	-	7.6
Compulsory reserve	169.2	-	169.2
Voluntary reserve	106.7	-	106.7
Retained earnings	(950.7)	-	(950.7)
Interim retained profits for the period	-	56.3	56.3
Unrealised (losses) / gains on fair valuing AFS equity investments	(1.4)	6.3	4.9
Collective impairment provisions (subject to 1.25% RWA limitation)	-	138.3	138.3
Subordinated term finance	-	511.0	511.0
<b>Tier 1 and tier 2 capital base</b>	<b>1,831.4</b>	<b>711.9</b>	<b>2,543.3</b>

Tier 1 capital is defined as capital of the same or close to the character of paid up capital and comprises share capital, share premium, retained earnings and eligible reserves. Retained losses are included in tier 1 following the external audit. Eligible reserves exclude revaluation gains and losses arising on the remeasurement to fair value of available-for-sale securities and derivative cash flow hedging transactions, with the exception of unrealised gross losses arising on the remeasurement to fair value of equity securities classified as available-for-sale.

Tier 2 capital comprises interim retained profits for the period, qualifying subordinated term finance, collective impairment provisions and 45 per cent of unrealised gross gains arising on the remeasurement to fair value of equity securities classified as available-for-sale.

The subordinated term finance facilities, amounting to US\$511.0 million, represent unsecured obligations of the Group and are subordinated in right of payment to the claims of depositors and other creditors of the Group that are not also subordinated. The subordinated term finance facilities have been approved for inclusion in tier 2 capital for regulatory capital adequacy purposes by the CBB.

### **3. REGULATORY CAPITAL REQUIREMENTS AND THE CAPITAL BASE (continued)**

#### **3.4 Capital base (continued)**

The CBB applies various limits to elements of the regulatory capital base. The amount of innovative tier 1 securities cannot exceed 15 per cent of total tier 1 capital; qualifying tier 2 capital cannot exceed tier 1 capital; and qualifying subordinated term finance cannot exceed 50 per cent of tier 1 capital. There are also restrictions on the amount of collective impairment provisions that may be included as part of tier 2 capital.

In accordance with the CBB's Basel 2 capital adequacy framework, securitisation exposures that are rated below BB- or that are unrated are to be deducted from regulatory capital rather than included in RWAs. At 30th June 2010, the Group had no exposure to securitisations.

There are no impediments on the transfer of funds or regulatory capital within the Group other than restrictions over transfers to ensure minimum regulatory capital requirements are met for subsidiary companies.

#### 4. CREDIT RISK – PILLAR THREE DISCLOSURES

This section describes the Group's exposure to credit risk and provides detailed disclosures on credit risk in accordance with the CBB's Basel 2 framework in relation to Pillar 3 disclosure requirements.

##### 4.1 Definition of exposure classes

GIB has a diversified on- and off-balance sheet credit portfolio, the exposures of which are divided into the counterparty exposure classes defined by the CBB's Basel 2 capital adequacy framework for the standardised approach for credit risk. A high-level description of the counterparty exposure classes, referred to as standard portfolios in the CBB's Basel 2 capital adequacy framework, and the generic treatments, i.e. the risk weights to be used to derive the RWAs, are as follows:-

###### **Sovereigns Portfolio**

The sovereigns portfolio comprises exposures to governments and their respective central banks. The risk weights are 0 per cent for exposures in the relevant domestic currency, or in any currency for exposures to GCC governments. Foreign currency claims on other sovereigns are risk weighted based on their external credit ratings.

Certain multilateral development banks as determined by the CBB may be included in the sovereigns portfolio and treated as exposures with a 0 per cent risk weighting.

###### **PSE Portfolio**

Public sector entities (PSEs) are risk weighted according to their external ratings with the exception of Bahrain PSEs, and domestic currency claims on other PSEs which are assigned a 0 per cent risk weight by their respective country regulator.

###### **Banks Portfolio**

Claims on banks are risk weighted based on their external credit ratings. A preferential risk weight treatment is available for qualifying short term exposures. Short term exposures are defined as exposures with an original tenor of three months or less.

The Banks portfolio also includes claims on investment firms, which are risk weighted based on their external credit ratings although without any option for preferential treatment for short term exposures.

###### **Corporates Portfolio**

Claims on corporates are risk weighted based on their external credit ratings. A 100 per cent risk weight is assigned to exposures to unrated corporates. A preferential risk weight treatment is available for certain corporates owned by the Government of Bahrain, as determined by the CBB, which are assigned a 0 per cent risk weight.

###### **Equities Portfolio**

The equities portfolio comprises equity investments in the banking book, i.e. the investment securities portfolio. The credit (specific) risk for equities in the trading book is included in market risk RWAs for regulatory capital adequacy calculation purposes.

A 100 per cent risk weight is assigned to listed equities and funds. Unlisted equities and funds are risk weighted at 150 per cent. Investments in rated funds are risk weighted according to the external credit rating. Equity investments in securitisations are deducted from the regulatory capital base.

In addition to the standard portfolios, other exposures are assigned to the following exposure classes:-

###### **Past due exposures**

All past due loan exposures, irrespective of the categorisation of the exposure if it were performing, are classified separately under the past due exposures asset class. A risk weighting of either 100 per cent or 150 per cent is applied depending on the level of provision maintained against the loan.

###### **Other assets and holdings of securitisation tranches**

Other assets are risk weighted at 100 per cent.

Securitisation tranches are risk weighted based on their external credit ratings. Risk weightings range from 20 per cent to 350 per cent. Exposures to securitisation tranches that are rated below BB- or are unrated are deducted from regulatory capital rather than subject to a risk weight.

#### 4. CREDIT RISK – PILLAR THREE DISCLOSURES (continued)

##### 4.2 External rating agencies

GIB uses ratings issued by Standard & Poor's, Moody's and Fitch to derive the risk weightings under the CBB's Basel 2 capital adequacy framework. Where ratings vary between rating agencies, the highest rating from the lowest two ratings is used to represent the rating for regulatory capital adequacy purposes.

##### 4.3 Credit risk presentation under Basel 2

The credit risk exposures presented in much of this report differ from the credit risk exposures reported in the consolidated financial statements. Differences arise due to the application of different methodologies, as illustrated below:-

- Under the CBB's Basel 2 framework, off-balance sheet exposures are converted into credit exposure equivalents by applying a credit conversion factor (CCF). The off-balance sheet exposure is multiplied by the relevant CCF applicable to the off-balance sheet exposure category. Subsequently, the exposure is treated in accordance with the standard portfolios referred to in section 4.1 of this report in the same manner as on-balance sheet exposures.
- Credit risk exposure reporting under Pillar 3 is frequently reported by standard portfolios based on the type of counterparty. The financial statement presentation is based on asset class rather than the relevant counterparty. For example, a loan to a bank would be classified in the Banks standard portfolio under the capital adequacy framework although is classified in loans and advances in the consolidated financial statements.
- Certain eligible collateral is applied to reduce exposure under the Basel 2 capital adequacy framework, whereas no such collateral netting is applicable in the consolidated financial statements.
- Based on the CBB's Basel 2 guidelines, certain exposures are either included in, or deducted from, regulatory capital rather than treated as an asset as in the consolidated financial statements.
- Under the CBB's Basel 2 capital adequacy framework, external rating agency ratings are based on the highest rating from the lowest two ratings while for internal credit risk management purposes the Group uses the lowest rating.

##### 4.4 Credit exposure

###### i) Gross credit exposure

The gross and average gross exposure to credit risk before applying collateral, guarantees, and other credit enhancements was as follows:-

	<b>Gross credit exposure</b>	<b>Average gross credit exposure</b>
	<b>US\$ millions</b>	<b>US\$ millions</b>
<b>Balance sheet items:</b>		
Cash and other liquid assets	845.6	553.6
Placements	4,160.9	4,440.0
Trading securities	24.6	39.8
Investment securities	2,319.6	2,494.8
Loans and advances	8,221.1	8,829.9
Other assets, excluding derivative-related items	60.3	61.4
<b>Total on-balance sheet credit exposure</b>	<b>15,632.1</b>	<b>16,419.5</b>
<b>Off-balance sheet items:</b>		
Credit-related contingent items	1,997.6	2,093.8
Derivative and foreign exchange instruments	79.2	68.5
<b>Total off-balance sheet credit exposure</b>	<b>2,076.8</b>	<b>2,162.3</b>
<b>Total credit exposure</b>	<b>17,708.9</b>	<b>18,581.8</b>

The average gross credit exposure is based on daily averages during the six months ended 30th June 2010.

Other assets principally comprise accrued interest, fees and commissions.



#### 4. CREDIT RISK – PILLAR THREE DISCLOSURES (continued)

##### 4.4 Credit exposure (continued)

###### i) Gross credit exposure (continued)

The gross credit exposure for derivative and foreign exchange instruments is the replacement cost (current exposure) representing the cost of replacing the contracts at current market rates should the counterparty default prior to the settlement date. The gross credit exposure reported in the table above does not include potential future exposure. Further details on the counterparty credit risk relating to off-balance sheet exposures are set out in section 7.3(i) of this report.

###### ii) Credit exposure by geography

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

	<b>Placements &amp; other liquid assets</b>	<b>Securities</b>	<b>Loans and advances</b>	<b>Other assets</b>	<b>Off balance sheet items</b>	<b>Total</b>
	<b>US\$ millions</b>	<b>US\$ millions</b>	<b>US\$ millions</b>	<b>US\$ millions</b>	<b>US\$ millions</b>	<b>US\$ millions</b>
GCC	1,581.1	1,571.1	7,842.5	41.0	1,597.2	12,632.9
Other MENA region	-	35.7	188.0	1.4	72.6	297.7
Europe	2,897.8	130.0	185.4	12.4	236.9	3,462.5
North America	310.5	557.5	0.2	5.1	170.1	1,043.4
Asia	217.1	49.9	5.0	0.4	-	272.4
<b>Total exposure</b>	<b>5,006.5</b>	<b>2,344.2</b>	<b>8,221.1</b>	<b>60.3</b>	<b>2,076.8</b>	<b>17,708.9</b>

The MENA region comprises the Middle East and North Africa.

###### iii) Credit exposure by industry

The classification of credit exposures by industry was as follows:-

	<b>Placements &amp; other liquid assets</b>	<b>Securities</b>	<b>Loans and advances</b>	<b>Other assets</b>	<b>Off balance sheet items</b>	<b>Total</b>
	<b>US\$ millions</b>	<b>US\$ millions</b>	<b>US\$ millions</b>	<b>US\$ millions</b>	<b>US\$ millions</b>	<b>US\$ millions</b>
Financial services	3,834.1	1,027.7	1,098.3	18.8	158.6	6,137.5
Energy, oil and petrochemical	-	273.1	2,948.8	11.8	547.8	3,781.5
Government	1,172.4	641.4	280.0	9.8	21.3	2,124.9
Trading and services	-	-	1,105.9	4.5	224.2	1,334.6
Construction	-	-	529.6	1.3	718.4	1,249.3
Transportation	-	13.9	794.1	2.1	50.5	860.6
Manufacturing	-	-	546.3	2.3	245.0	793.6
Real estate	-	-	586.3	6.4	1.5	594.2
Communication	-	16.0	219.2	2.6	17.3	255.1
Equity investments	-	372.1	-	-	4.5	376.6
Other	-	-	112.6	0.7	87.7	201.0
<b>Total exposure</b>	<b>5,006.5</b>	<b>2,344.2</b>	<b>8,221.1</b>	<b>60.3</b>	<b>2,076.8</b>	<b>17,708.9</b>

#### 4. CREDIT RISK – PILLAR THREE DISCLOSURES (continued)

##### 4.4 Credit exposure (continued)

###### iv) Credit exposure by internal rating

The credit risk profile based on internal credit ratings was as follows:-

	Placements & other liquid assets	Securities	Loans and advances	Other assets	Off balance sheet items	Total
	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions
<b>Neither past due nor impaired</b>						
Rating grades 1 to 4-	4,943.0	1,911.2	4,919.0	42.5	1,136.5	12,952.2
Rating grades 5+ to 5-	63.5	33.3	2,088.6	14.5	824.9	3,024.8
Rating grades 6+ to 6-	-	27.6	594.6	2.8	92.3	717.3
Rating grade 7	-	-	138.5	0.3	14.5	153.3
Rating grade 8	-	-	-	-	4.1	4.1
Equity investments	-	349.7	-	-	4.5	354.2
<b>Carrying amount</b>	<b>5,006.5</b>	<b>2,321.8</b>	<b>7,740.7</b>	<b>60.1</b>	<b>2,076.8</b>	<b>17,205.9</b>
<b>Past due but not impaired</b>						
Rating grades 1 to 7	-	-	105.0	-	-	105.0
<b>Carrying amount</b>	<b>-</b>	<b>-</b>	<b>105.0</b>	<b>-</b>	<b>-</b>	<b>105.0</b>
<b>Past due and individually impaired</b>						
Rating grades 1 to 7	-	-	67.5	0.2	-	67.7
Rating grade 8	-	-	89.9	-	-	89.9
Rating grade 9	-	-	127.6	-	-	127.6
<b>Carrying amount</b>	<b>-</b>	<b>-</b>	<b>285.0</b>	<b>0.2</b>	<b>-</b>	<b>285.2</b>
<b>Individually impaired but not past due</b>						
Rating grades 1 to 7	-	-	71.3	-	-	71.3
Rating grade 8	-	-	19.1	-	-	19.1
Equity investments	-	22.4	-	-	-	22.4
<b>Carrying amount</b>	<b>-</b>	<b>22.4</b>	<b>90.4</b>	<b>-</b>	<b>-</b>	<b>112.8</b>
<b>Total</b>	<b>5,006.5</b>	<b>2,344.2</b>	<b>8,221.1</b>	<b>60.3</b>	<b>2,076.8</b>	<b>17,708.9</b>

The analysis is presented prior to the application of any credit risk mitigation techniques.

The Group's internal rating system is commented on in more detail in section 8.1 of this report.

###### v) Credit exposure by maturity

The maturity profile of funded credit exposures based on contractual maturity dates was as follows:-

	Placements & other liquid assets	Securities	Loans and advances	Other assets	Total
	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions
Within 3 months	4,578.9	37.4	1,843.6	42.1	6,502.0
4 months to 1 year	427.6	354.8	1,138.1	15.2	1,935.7
Years 2 to 5	-	1,234.6	2,996.7	3.0	4,234.3
Years 6 to 10	-	323.6	1,408.4	-	1,732.0
Years 11 to 20	-	46.3	641.7	-	688.0
Over 20 years and other	-	347.5	192.6	-	540.1
<b>Total exposure</b>	<b>5,006.5</b>	<b>2,344.2</b>	<b>8,221.1</b>	<b>60.3</b>	<b>15,632.1</b>

An analysis of off-balance sheet exposure is set out in section 7 of this report.

Securities exposure over 20 years comprises equity investments, net of total collective provisions.

#### 4. CREDIT RISK – PILLAR THREE DISCLOSURES (continued)

##### 4.4 Credit exposure (continued)

###### vi) Equities held in the banking book

Equity investments included in investment securities in the consolidated balance sheet are included in the equities standard portfolio in the Pillar 1 credit risk capital adequacy framework. Such equity investments principally comprise investments of a private equity nature, both direct investments and investments in funds managed by external specialist managers and international investment banks.

At 30th June 2010, equity investments held in the banking book amounted to US\$347.5 million, of which US\$56.8 million comprised managed funds. Unlisted equities, which principally represent private equity investments, are stated at cost less provision for impairment. There are no active markets or other appropriate methods from which to derive reliable fair values for these investments. The Group intends to exit these investments principally by means of IPOs or private placements.

During the six months ended 30th June 2010, the total realised gains on equity investments amounted to US\$0.6 million. At 30th June 2010, unrealised gross gains on equity investments amounted to US\$13.9 million. 45 per cent of the unrealised gross gains, or US\$6.3 million, was included in tier 2 capital. Unrealised gross losses on equity investments amounted to US\$1.5 million and were deducted from tier 1 capital in accordance with the CBB's Basel 2 capital adequacy framework.

###### vii) Credit risk mitigation

The credit exposure information presented in section 4 of this report represents gross exposures prior to the application of any credit risk mitigation techniques. Collateral items and guarantees which can be used for credit risk mitigation under the capital adequacy framework are referred to as eligible collateral. Only certain types of collateral and some issuers of guarantees are eligible for preferential risk weights for regulatory capital adequacy purposes. Furthermore, the collateral management process and the terms in the collateral agreements have to fulfil the CBB's prescribed minimum requirements (such as procedures for the monitoring of market values, insurance and legal certainty) set out in their capital adequacy regulations.

The reduction of the capital requirement attributable to credit risk mitigation is calculated in different ways, depending of the type of credit risk mitigation, as follows:-

- Adjusted exposure amount: GIB uses the comprehensive method for financial collateral such as cash, bonds and stocks. The exposure amount is adjusted with regard to the financial collateral. The size of the adjustment depends on the volatility of the collateral and the exposure. GIB uses volatility adjustments specified by the CBB, known as supervisory haircuts, to reduce the benefit of collateral and to increase the magnitude of the exposure.
- Substitution of counterparty: The substitution method is used for guarantees, whereby the rating of the counterparty is substituted with the rating of the guarantor. This means that the credit risk in respect of the customer is substituted by the credit risk of the guarantor and the capital requirement is thereby reduced. Hence, a fully guaranteed exposure will be assigned the same capital treatment as if the loan was initially granted to the guarantor rather than to the customer.

###### Description of the main types of risk mitigation

GIB uses a variety of risk mitigation techniques in several different markets which contribute to risk diversification and credit protection. The different credit risk mitigation techniques such as collateral, guarantees, credit derivatives, netting agreements and covenants are used to reduce credit risk. All credit mitigation activities are not necessarily recognised for capital adequacy purposes since they are not defined as eligible under the CBB's Basel 2 capital adequacy framework, e.g. covenants and non-eligible tangible collateral such as unquoted equities.

Exposures secured by eligible financial collateral, guarantees and credit derivatives, presented by standard portfolio were as follows:-

	Exposure	Of which secured by:	
	before credit risk mitigation	Eligible collateral	Eligible guarantees or credit derivatives
	US\$ millions	US\$ millions	US\$ millions
Sovereigns	438.8	-	438.8
Banks	986.7	516.3	390.1
Corporates	428.4	271.6	8.9

###### Guarantees and credit derivatives

Only eligible providers of guarantees and credit derivatives may be recognised in the standardised approach for credit risk. Guarantees issued by corporate entities may only be taken into account if their rating corresponds to A- or better. The guaranteed exposures receive the risk weight of the guarantor.

#### 4. CREDIT RISK – PILLAR THREE DISCLOSURES (continued)

##### 4.4 Credit exposure (continued)

###### vii) Credit risk mitigation (continued)

GIB uses credit derivatives as credit risk protection only to a very limited extent as the credit portfolio is considered to be well diversified.

###### Collateral and valuation principles

The amount and type of collateral is dependent upon the assessment of the credit risk of the counterparty. The market / fair value of the collateral is actively monitored on a regular basis and requests are made for additional collateral in accordance with the terms of the underlying agreements. In general, lending is based on the customer's repayment capacity rather than the collateral value. However, collateral is considered the secondary alternative if the repayment capacity proves inadequate. Collateral is not usually held against securities or placements.

###### Types of eligible collateral commonly accepted

The Group holds collateral against loans and advances in the form of physical assets, cash deposits, securities and guarantees.

##### 4.5 Impaired credit facilities and provisions for impairment

Individually impaired financial assets represent assets for which there is objective evidence that the Group will not collect all amounts due, including both principal and interest, in accordance with the contractual terms of the obligation. Objective evidence that a financial asset is impaired may include: a breach of contract, such as default or delinquency in interest or principal payments, the granting of a concession that, for economic or legal reasons relating to the borrower's financial difficulties, would not otherwise be considered, indications that it is probable that the borrower will enter bankruptcy or other financial re-organisation, the disappearance of an active market, or other observable data relating to a group of assets such as adverse changes in the payment status of borrowers or issuers in the group, or economic conditions that correlate with defaults in the group. For equity securities classified as available-for-sale, a significant or prolonged decline in fair value below cost is considered in determining whether a security is impaired.

Provisions for impairment are determined based on the difference between the net carrying amount and the recoverable amount of a financial asset. The recoverable amount is measured as the present value of expected future cash flows, including amounts recoverable from guarantees and collateral.

Provisions for impairment are also measured and recognised on a collective basis in respect of impairments that exist at the reporting date but which will only be individually identified in the future. Future cash flows for financial assets that are collectively assessed for impairment are estimated based on contractual cash flows and historical loss experiences for assets with similar credit risk characteristics. Historical loss experience is adjusted, based on current observable data, to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based. Provisions for impairment are recognised in the consolidated statement of income and are reflected in an allowance account against loans and advances and investment securities.

###### i) Impaired loan facilities and related provisions for impairment

Impaired loan facilities and the related provisions for impairment were as follows:-

	<b>Gross exposure</b>	<b>Impairment provisions</b>	<b>Net exposure</b>
	<b>US\$ millions</b>	<b>US\$ millions</b>	<b>US\$ millions</b>
Corporates	610.5	265.8	344.7
Financial institutions	157.8	127.1	30.7
<b>Total</b>	<b>768.3</b>	<b>392.9</b>	<b>375.4</b>

Impaired loan facilities of US\$768.3 million include loans amounting to US\$167.5 million that were not past due but for which specific provisions had been established as a matter of prudence. 21.8 per cent of impaired loan facilities were therefore current in terms of both principal and interest.

The impaired loan facilities were to counterparties in the GCC.

#### 4. CREDIT RISK – PILLAR THREE DISCLOSURES (continued)

##### 4.5 Impaired credit facilities and provisions for impairment (continued)

###### ii) Provisions for impairment – loans and advances

The movements in the provisions for the impairment of loans and advances were as follows:-

	Specific provisions		Total	Collective provisions	Total provisions
	Corporates	Financial institutions			
	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions
At 1st January 2010	270.4	123.7	394.1	240.0	634.1
Exchange rate movements	-	(0.2)	(0.2)	-	(0.2)
Amounts utilised	(0.7)	-	(0.7)	-	(0.7)
(Release) /Charge for the period	(3.9)	3.6	(0.3)	8.3	8.0
<b>At 30<sup>th</sup> June 2010</b>	<b>265.8</b>	<b>127.1</b>	<b>392.9</b>	<b>248.3</b>	<b>641.2</b>

Higher probabilities of default are anticipated to result from the impact of the global recession on the regional economic environment. The probabilities of default applied in the calculation of the collective provisions of impairment at 30th June 2010 equated to a speculative-grade mean default rate of 13.9 per cent, exceeding the previous historical high corporate default levels witnessed in July 1991.

###### iii) Impaired investment securities and related provisions for impairment

Impaired investment securities and related provisions for impairment were as follows:-

	Gross exposure	Impairment provisions	Net exposure
	US\$ millions	US\$ millions	US\$ millions
Equity investments	78.6	64.3	14.3
<b>Total</b>	<b>78.6</b>	<b>64.3</b>	<b>14.3</b>

Total specific impairment provisions of US\$64.3 million represented 81.8 per cent of the gross impaired investment securities exposure.

###### iv) Provisions for impairment – investment securities

The movements in the provisions for the impairment of investment securities were as follows:-

	Specific provisions	Collective provisions	Total provisions
	US\$ millions	US\$ millions	US\$ millions
At 1st January 2010	67.2	30.3	97.5
Exchange rate movements	(1.0)	-	(1.0)
Amounts utilised	(1.9)	-	(1.9)
Release for the period	-	(4.0)	(4.0)
<b>At 30th June 2010</b>	<b>64.3</b>	<b>26.3</b>	<b>90.6</b>

#### 4. CREDIT RISK – PILLAR THREE DISCLOSURES (continued)

##### 4.6 Past due facilities

In accordance with guidelines issued by the CBB, credit facilities are placed on non-accrual status and interest income suspended when either principal or interest is overdue by 90 days whereupon unpaid and accrued interest is reversed from income. Interest on non-accrual facilities is included in income only when received. Credit facilities classified as past due are assessed for impairment in accordance with the IFRS guidelines as set out in section 4.5 of this report. A specific provision is established only where there is objective evidence that a credit facility is impaired.

##### i) Loans

The gross and carrying amount of loans for which either principal or interest was over 90 days past due were as follows:-

	Secured		Unsecured	
	Gross	Carrying amount	Gross	Carrying amount
	US\$ millions	US\$ millions	US\$ millions	US\$ millions
Corporates	44.3	44.3	558.6	327.6
Financial institutions	-	-	132.8	18.1
<b>Total</b>	<b>44.3</b>	<b>44.3</b>	<b>691.4</b>	<b>345.7</b>

Net unsecured past due loans of US\$345.7 million included US\$210.6 million which is subject to restructuring programmes. The restructurings are expected to be finalised before the end of the year following which the loans will revert to performing status. The restructuring programmes are not anticipated to result in an economic loss for the Group.

Non-specific loan provisions of US\$248.3 million represented 1.8 times the net carrying amount of other unsecured past due loans.

The past due loans were to counterparties in the GCC.

The secured past due loan facilities were fully secured by shares listed on recognised stock exchanges.

The overdue status of past due loans based on original contractual maturities was as follows:-

	Less than	2 to 3	Over	Total
	1 year	years	3 years	
	US\$ millions	US\$ millions	US\$ millions	US\$ millions
Corporates	398.8	204.1	-	602.9
Financial institutions	32.5	100.0	0.3	132.8
<b>Total</b>	<b>431.3</b>	<b>304.1</b>	<b>0.3</b>	<b>735.7</b>

##### ii) Investment securities

There were no debt securities for which either principal or interest was over 90 days past due.

##### 4.7 Restructured loan facilities

There were no restructured loan facilities during the six months ended 30th June 2010.

## 5. MARKET RISK – PILLAR THREE DISCLOSURES

### 5.1 Market risk

Market risk is the risk of loss due to adverse changes in interest rates, foreign exchange rates, equity prices and market conditions, such as liquidity. The principal market risks to which the Group is exposed are interest rate risk, foreign exchange risk and equity price risk associated with its trading, investment and asset and liability management activities. The portfolio effects of holding a diversified range of instruments across a variety of businesses and geographic areas contribute to a reduction in the potential negative impact on earnings from market risk factors.

The Group's trading activities principally comprise trading in debt and equity securities, foreign exchange and derivative financial instruments. Derivative financial instruments include futures, forwards, swaps and options in the interest rate, foreign exchange, and equity markets. The Group manages and controls the market risk within its trading portfolios through limit structures of both a VaR and non-VaR nature. Non-VaR based constraints relate, inter alia, to positions, volumes, concentrations, allowable losses and maturities.

### 5.2 VaR model

A key element in the Group's market risk management framework is the estimation of potential future losses that may arise from adverse market movements. Exposure to general market risk is calculated utilising a VaR model. The use of the internal model approach for the calculation of the capital requirement for general market risk has been approved by the CBB. The multiplication factor to be applied to the Value-at-Risk calculated by the internal model has been set at 3.5 by the CBB. The multiplication factor was increased by the CBB from the regulatory minimum of 3.0 during 2008, based on the number of back testing exceptions recorded in the financial year ended 31st December 2007. The trading-related exposures that gave rise to the back testing exceptions in 2007 were liquidated during the year ended 31st December 2008.

An inherent limitation of VaR is that past market movements may not provide an accurate prediction of future market losses. Historic analyses of market movements have shown that extreme market movements (i.e. beyond the 99 per cent confidence level) occur more frequently than VaR models predict. Stress tests are therefore regularly conducted to estimate the potential economic losses in such abnormal markets. Stress testing combined with VaR provides a more comprehensive picture of market risk. The Group regularly performs stress tests that are constructed around changes in market rates and prices resulting from pre-defined market stress scenarios, including both historical and hypothetical market events. Historical scenarios include the 1997 Asian crisis, the 1998 Russian crisis, the events of 9/11 and the 2008 credit crisis. In addition, the Group performs stress testing based on internally developed hypothetical market stress scenarios. Stress testing is performed for all material market risk portfolios.

A key objective of asset and liability management is the maximisation of net interest income through the proactive management of the asset and liability repricing profile based on anticipated movements in interest rates. VaR-based limits are utilised to control fluctuations in interest earnings resulting from changes in interest rates. The asset and liability repricing profile of the various asset and liability categories are set out in section 8 of this report.

For internal risk management purposes, the Group measures losses that are anticipated to occur within a 95 per cent confidence level. Internally, the Group measures VaR utilising a one month assumed holding period for both trading and banking book positions. For regulatory capital adequacy purposes, the figures are calculated using the regulatory VaR basis at a 99 per cent confidence level (2.33 standard deviations) and a ten-day holding period using one-year unweighted historical daily movements in market rates and prices. Correlations across broad risk categories are excluded for regulatory capital adequacy purposes.

The VaR by risk class for the Group's trading positions as calculated in accordance with the regulatory parameters set out above, was as follows:-

	30.6.10	Average	High	Low
	US\$ millions	US\$ millions	US\$ millions	US\$ millions
Equity risk	0.3	0.5	0.7	0.3
Interest rate risk	0.1	0.1	0.1	0.1
Foreign exchange risk	0.1	-	0.1	-
Total diversified risk	0.4	0.5	0.7	0.3

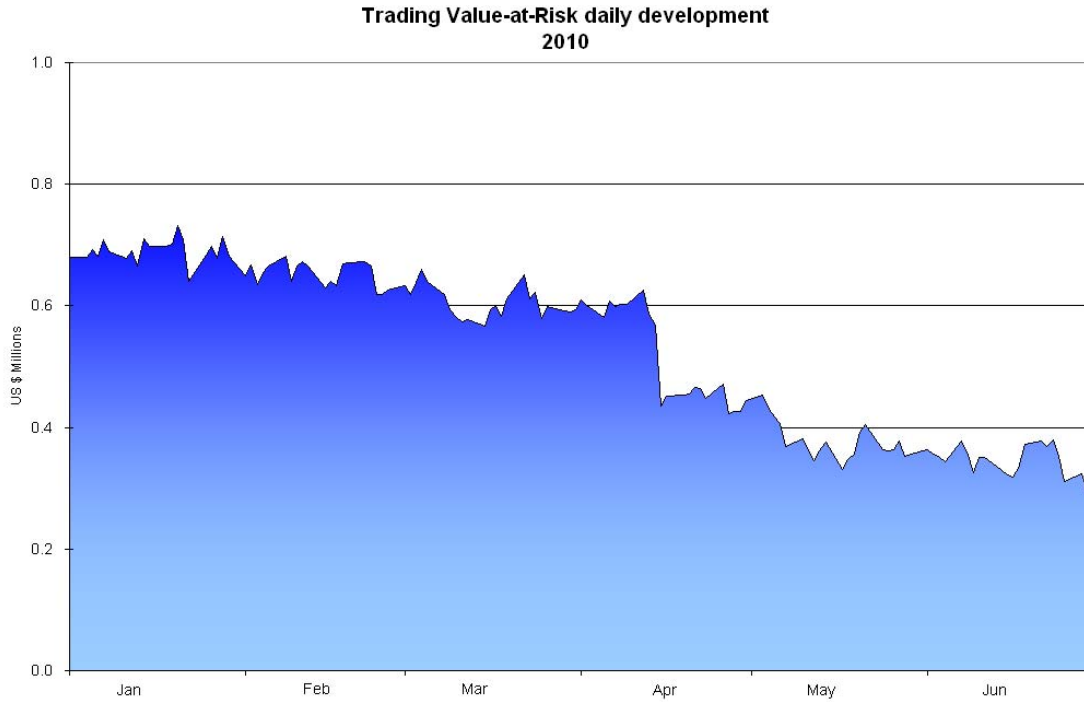
The equity market risk principally related to alternative investment funds managed by external managers. At 30th June 2010, the funds had been redeemed and were in the process of liquidation.

The Group conducts daily VaR back testing both for regulatory compliance purposes and for the internal evaluation of VaR against actual trading profits and losses. During the six months ended 30th June 2010, there were no instances of a daily trading loss exceeding the trading VaR at the close of business on the previous business day.

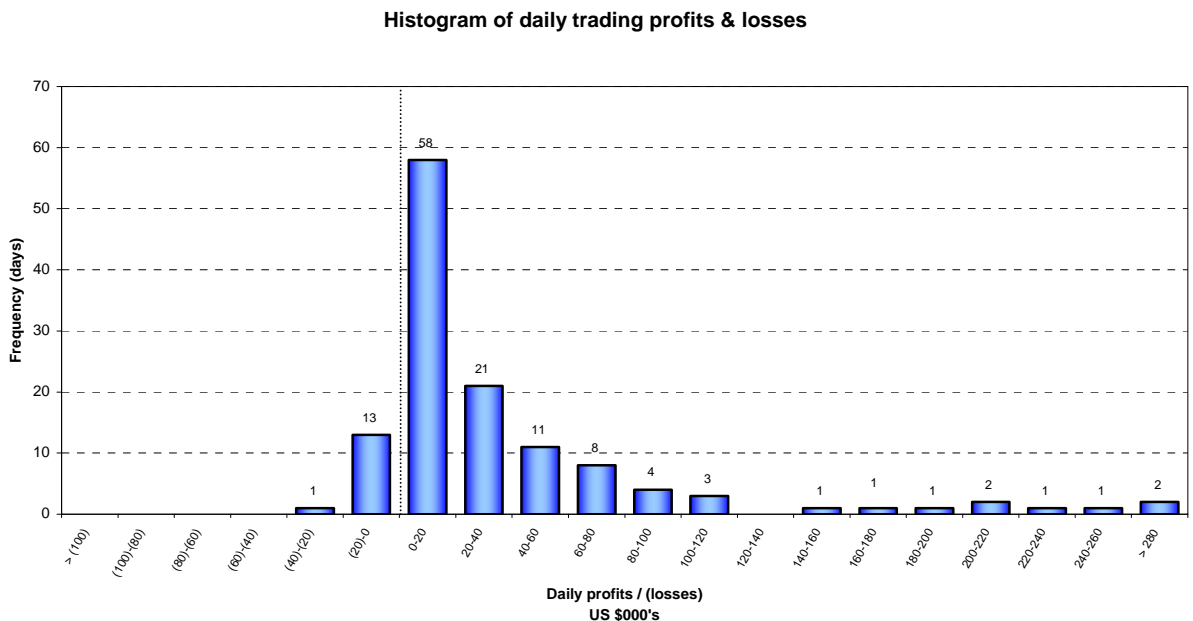
**5. MARKET RISK – PILLAR THREE DISCLOSURE (continued)**

**5.2 VaR model (continued)**

The graph below sets out the total VaR for all the Group's trading activities at the close of each business day throughout the six months ended 30th June 2010:-



The daily trading profits and losses during the six months ended 30th June 2010 are summarised as follows:-



**5.3 Sensitivity analysis**

The sensitivity of the interest rate risk in the banking book to changes in interest rates is set out in section 8.2(iii) of this report.

The Group is also exposed to the impact of changes in credit spreads on the fair value of available-for-sale debt securities. Credit spread risk is managed within VaR limits and through the use of models to evaluate the sensitivity of changes in equity to movements in credit spreads. Based on the available-for-sale debt securities held at 30th June 2010, a one basis point increase in credit spreads would result in a US\$0.6 million decrease in fair value.



## **6. OPERATIONAL RISK – PILLAR THREE DISCLOSURES**

### **6.1 Operational risk**

Whilst operational risk cannot be eliminated in its entirety, the Group endeavours to minimise it by ensuring that a strong control infrastructure is in place throughout the organisation. The various procedures and processes used to manage operational risk include effective staff training, appropriate controls to safeguard assets and records, regular reconciliation of accounts and transactions, close monitoring of risk limits, segregation of duties, and financial management and reporting. In addition, other control strategies, including business continuity planning and insurance, are in place to complement the procedures, as applicable.

As part of the Group's Operational Risk Management Framework (ORMF), comprehensive risk self-assessments are conducted, which identify the operational risks inherent in the Group's activities, processes and systems. The controls in place to mitigate these risks are also reviewed, and enhanced as necessary. A database of measurable operational risk events is maintained, together with a record of key risk indicators, which can provide an early warning of possible operational risk.

The capital requirement for operational risk is calculated for regulatory purposes according to the basic indicator approach, in which the Group's average gross income for the preceding three financial years is multiplied by an alpha coefficient of 15 per cent as prescribed by the CBB.

The operational risk capital requirement is based on gross income from the preceding three financial years. Consequently, the operational risk capital requirement is updated only on an annual basis.

## 7. OFF-BALANCE SHEET EXPOSURE AND SECURITISATIONS

Off-balance sheet exposures are divided into two exposure types in accordance with the calculation of credit risk RWAs in the CBB's Basel 2 capital adequacy framework:-

- Credit-related contingent items: Credit-related contingent items comprise guarantees, credit commitments and unutilised approved credit facilities.
- Derivative and foreign exchange instruments: Derivative and foreign exchange instruments are contracts, the value of which is derived from one or more underlying financial instruments or indices, and include futures, forwards, swaps and options in the interest rate, foreign exchange, equity and credit markets.

In addition to counterparty credit risk measured within the Basel 2 credit risk framework, derivatives also incorporate exposure to market risk and carry a potential market risk capital requirement, as commented on in more detail in section 5 of this report.

For the two off-balance exposure types, there are different possible values for the calculation base of the regulatory capital requirement, as commented on below:-

### 7.1 Credit-related contingent items

For credit-related contingent items, the nominal value is converted to an exposure at default (EAD) through the application of a credit conversion factor (CCF). The CCF factor is 50 per cent or 100 per cent depending on the type of contingent item, and is intended to convert off-balance sheet notional amounts into an equivalent on-balance sheet exposure.

Credit commitments and unutilised approved credit facilities represent commitments that have not been drawdown or utilised at the reporting date. The nominal amount provides the calculation base to which a CCF is applied for calculating the EAD. The CCF ranges between 0 per cent and 100 per cent depending on the approach, product type and whether the unutilised amounts are unconditionally cancellable or irrevocable.

The table below summarises the notional principal amounts, RWAs and capital requirements for each credit-related contingent category:-

	<b>Notional principal amount</b>	<b>RWA</b>	<b>Capital requirement</b>
	<b>US\$ millions</b>	<b>US\$ millions</b>	<b>US\$ millions</b>
Direct credit substitutes	171.4	162.4	19.5
Transaction-related contingent items	918.6	386.1	46.3
Short-term self-liquidating trade-related contingent items	191.6	38.7	4.6
Commitments, including undrawn loan commitments and underwriting commitments under note issuance and revolving facilities	716.0	327.2	39.3
<b>Total</b>	<b>1,997.6</b>	<b>914.4</b>	<b>109.7</b>

Commitments may be drawdown on demand.

The notional principal amounts reported above are stated gross before applying credit risk mitigants, such as cash collateral, guarantees and counter-indemnities. At 30th June 2010, the Group held cash collateral, guarantees, counter-indemnities or other high quality collateral in relation to credit-related contingent items amounting to US\$99.0 million.

### 7.2 Derivative and foreign exchange instruments

The Group utilises derivative and foreign exchange instruments to meet the needs of its customers, to generate trading revenues and as part of its asset and liability management activity to hedge its own exposure to market risk. Derivatives and foreign exchange are subject to the same types of credit and market risk as other financial instruments. The Group has appropriate and comprehensive Board-approved policies and procedures for the control of exposure to both market and credit risk from its derivative and foreign exchange activities.

In the case of derivative transactions, the notional principal typically does not change hands. It is simply a quantity which is used to calculate payments. While notional principal is a volume measure used in the derivative and foreign exchange markets, it is neither a measure of market nor credit risk. The Group's measure of credit exposure is the cost of replacing contracts at current market rates should the counterparty default prior to the settlement date. Credit risk amounts represent the gross unrealised gains on non-margined transactions before taking account of any collateral held or any master netting agreements in place.

## 7. OFF BALANCE SHEET EXPOSURE AND SECURITISATIONS (continued)

### 7.2 Derivative and foreign exchange instruments (continued)

The Group participates in both exchange traded and over-the-counter (OTC) derivative markets. Exchange traded instruments are executed through a recognised exchange as standardised contracts and primarily comprise futures and options. OTC contracts are executed between two counterparties who negotiate specific agreement terms, including the underlying instrument, notional amount, maturity and, where appropriate, exercise price. In general, the terms and conditions of these transactions are tailored to the requirements of the Group's customers although conform to normal market practice. Industry standard documentation is used, most commonly in the form of a master agreement. The existence of a master netting agreement is intended to provide protection to the Group in the event of a counterparty default.

The Group's derivative and foreign exchange activities are predominantly short-term in nature. Transactions with maturities over one year principally represent either fully offset trading transactions or transactions that are designated, and qualify, as fair value and cash flow hedges.

The aggregate notional amounts for derivative and foreign exchange instruments at 30th June 2010 are set out below:

	<b>Trading</b>	<b>Hedging</b>	<b>Total</b>
	<b>US\$ millions</b>	<b>US\$ millions</b>	<b>US\$ millions</b>
Interest rate contracts:-			
Interest rate swaps and swaptions	2,190.9	3,576.8	5,767.7
Options, caps and floors purchased	24.3	-	24.3
Options, caps and floors written	24.3	-	24.3
	<b>2,239.5</b>	<b>3,576.8</b>	<b>5,816.3</b>
Foreign exchange contracts:-			
Unmatured spot, forward and futures contracts	795.1	2,493.7	3,288.8
Credit contracts:-			
Protection sold	39.0	-	39.0
<b>Total</b>	<b>3,073.6</b>	<b>6,070.5</b>	<b>9,144.1</b>

### 7.3 Counterparty credit risk

Counterparty credit risk is the risk that a counterparty to a contract in the interest rate, foreign exchange, equity and credit markets defaults prior to the maturity of the contract. The counterparty credit risk for derivative and foreign exchange instruments is subject to credit limits on the same basis as other credit exposures. Counterparty credit risk arises in both the trading book and the banking book.

#### i) Counterparty credit risk calculation

For regulatory capital adequacy purposes, GIB uses the current exposure method to calculate the exposure for counterparty credit risk for derivative and foreign exchange instruments in accordance with the credit risk framework in the CBB's Basel 2 capital adequacy framework. Credit exposure comprises the sum of current exposure (replacement cost) and potential future exposure. The potential future exposure is an estimate, which reflects possible changes in the market value of the individual contract during the remaining life of the contract, and is measured as the notional principal amount multiplied by a risk weight. The size of the risk weight depends on the risk categorisation of the contract and the contract's remaining life. Netting of potential future exposures on contracts within the same legally enforceable netting agreement is done as a function of the gross potential future exposure.

## 7. OFF BALANCE SHEET EXPOSURE AND SECURITISATIONS (continued)

### 7.3 Counterparty credit risk (continued)

The EAD, RWAs and capital requirements for the counterparty credit risk of derivative and foreign exchange instruments analysed by standard portfolio, is presented in the table below:-

<b>Exposure at Default (EAD)</b>					
	<b>Current exposure</b>	<b>Future exposure</b>	<b>Total exposure</b>	<b>RWA</b>	<b>Capital requirement</b>
	<b>US\$ millions</b>	<b>US\$ millions</b>	<b>US\$ millions</b>	<b>US\$ millions</b>	<b>US\$ millions</b>
Banks	15.7	41.2	56.9	15.8	1.9
Corporates	63.5	0.1	63.6	0.4	-
Sovereigns	-	5.3	5.3	-	-
<b>Total</b>	<b>79.2</b>	<b>46.6</b>	<b>125.8</b>	<b>16.2</b>	<b>1.9</b>

#### ii) Mitigation of counterparty risk exposure

Risk mitigation techniques are widely used to reduce exposure to single counterparties. The most common risk mitigation technique for derivative and foreign exchange-related exposure is the use of master netting agreements, which allow the Group to net positive and negative replacement values of contracts under the agreement in the event of default of the counterparty.

The reduction of counterparty credit risk exposure for derivative and foreign exchange instruments through the use of risk mitigation techniques is demonstrated as follows:-

	<b>Current exposure</b>	<b>Effect of netting agreements</b>	<b>Netted current exposure</b>
	<b>US\$ millions</b>	<b>US\$ millions</b>	<b>US\$ millions</b>
Counterparty credit risk exposure	79.2	(17.6)	61.6

### 7.4 Securitisations

Securitisations are defined as structures where the cash flow from an underlying pool of exposures is used to secure at least two different stratified risk positions or tranches reflecting different degrees of credit risk. Payments to the investors depend upon the performance of the underlying exposures, as opposed to being derived from an obligation of the entity originating those exposures.

At 30th June 2010, the Group had no exposure, net of specific provisions, to securitisation tranches.

The Group provides collateral management services to five collateralised debt obligations (CDOs) issued between 2002 and 2006. The CDOs are intended to extract relative value from a wide range of asset classes across a broad spectrum of credit ratings. The underlying collateral of the CDOs includes leveraged loans, residential and commercial real estate, consumer finance, lending to small and medium sized enterprises, and other receivables. In order to ensure granularity, each CDO holds between 80 and 140 individual investments providing diversification by size, asset class, industry, geography, credit rating and date of issue.

At 30th June 2010 the underlying investments in the CDOs for which the Group acted as collateral manager amounted to US\$1.3 billion. At 30th June 2010, GIB did not hold any exposure to CDOs managed by the Group.

## 8. INTERNAL CAPITAL INCLUDING OTHER RISK TYPES

GIB manages and measures other risk types that are not included under Pillar 1 in the CBB's Basel 2 framework. These are principally covered in the Group's internal economic capital model.

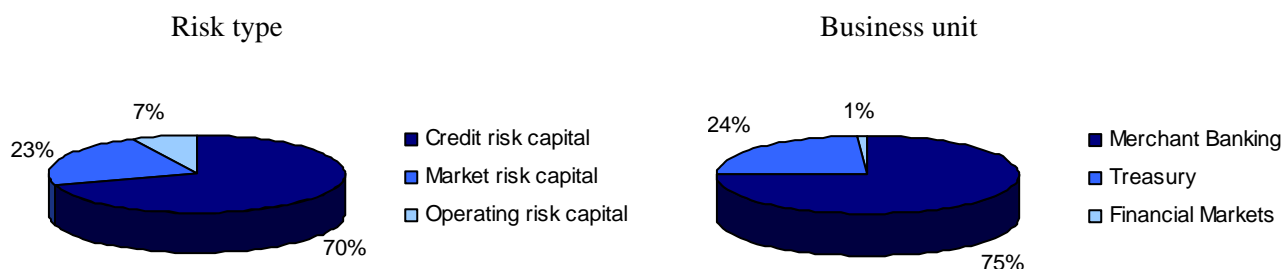
This section describes GIB's economic capital model and discusses the treatment of the other risk types that are not addressed in Pillar 1 of the CBB's Basel 2 framework.

### 8.1 Economic capital model

For many years, GIB has applied economic capital and risk-adjusted return on capital (RAROC) methodologies which are used for both decision making purposes and performance reporting and evaluation.

GIB calculates economic capital for the following major risk types: credit, market and operating risk. Operating risk includes business risk. Additionally, the economic capital model explicitly incorporates concentration risk, interest rate risk in the banking book and business risk.

The composition of economic capital by risk type and business unit was as follows:-



The primary differences between economic capital and regulatory capital under the CBB's Basel 2 framework are summarised as follows:-

- In the economic capital methodology, the confidence level for all risk types is set at 99.88 per cent, compared to 99.0 per cent in the CBB's Basel 2 framework.
- Credit risk is calculated using GIB's estimates of probability of default, loss given default and exposures at default, rather than the regulatory values in the standardised approach.
- The economic capital model utilises GIB's embedded internal rating system, as described in more detail later in this section of the report, to rate counterparties rather than using the ratings of credit rating agencies or the application of a 100 per cent risk weighting for unrated counterparties.
- Concentration risk is captured in the economic capital model through the use of an internal credit risk portfolio model and add-on factors where applicable.
- The economic capital model applies a capital charge for interest rate risk in the banking book.
- The economic capital model applies a business risk capital charge where applicable.

#### Internal rating system

The economic capital model is based on an internal credit rating system. The internal credit rating system is used throughout the organisation and is inherent in all business decisions relating to the extension of credit. A rating is an estimate that exclusively reflects the quantification of the repayment capacity of the customer, i.e. the risk of customer default.

The Group monitors, manages and controls credit risk exposures based on an internal credit rating system that rates individual obligors based on a rating scale from 1 to 10, subject to positive (+) and negative (-) modifiers for rating grades 2 to 6. The internal credit rating is a measure of the credit-worthiness of a single obligor, based on an assessment of the credit risk relating to senior unsecured, medium term, foreign currency credit exposure. The primary objectives of the internal credit rating system are the maintenance of a single uniform standard for credit quality measurement, and to serve as the primary basis for Board-approved risk parameters and delegated credit authority limits. The internal credit rating system also serves as a key input into the Group's RAROC performance measurement system. Ratings are assigned to obligors, rather than facilities, and reflect a medium term time horizon, thereby rating through an economic cycle.

## 8. INTERNAL CAPITAL INCLUDING OTHER RISK TYPES (continued)

### 8.1 Economic capital model (continued)

The internal ratings map directly to the rating grades used by the international credit rating agencies as illustrated below:-

Internal rating grade	Internal classification	Historical default rate range (percentage)	Fitch and Standard & Poor's	Moody's
<b>Investment grade</b>				
Rating grade 1	Standard	0.00 - 0.00	AAA	Aaa
Rating grade 2	Standard	0.00 - 0.04	AA	Aa
Rating grade 3	Standard	0.07 - 0.09	A	A
Rating grade 4	Standard	0.17 - 0.41	BBB	Baa
<b>Sub-investment grade</b>				
Rating grade 5	Standard	0.53 - 1.34	BB	Ba
Rating grade 6	Standard	2.70 - 9.86	B	B
Rating grade 7	Standard	27.98	CCC	Caa
<b>Classified</b>				
Rating grade 8	Substandard	27.98	CC	Ca
Rating grade 9	Doubtful	27.98	C	C
Rating grade 10	Loss	-	D	-

The external rating mapping does not intend to reflect that there is a fixed relationship between GIB's internal rating grades and those of the external agencies as the rating approaches differ.

The historical default rates represent the range of probability of defaults (PDs) between the positive and negative modifiers for each rating grade based on Standard & Poor's one year default rates for the 29 years from 1981 to 2009 for senior unsecured obligations. The default rates represent the averages over the 29 year period and therefore reflect the full range of economic conditions prevailing over that period.

### 8.2 Other risk types

#### i) Liquidity risk

The Group has established approved limits which restrict the volume of liabilities maturing in the short term. An independent risk management function monitors the future cash flow maturity profile against approved limits on a daily basis. The cash flows are monitored against limits applying to both daily and cumulative cash flows occurring over a 14 day period. The cash flow analysis is also monitored on a weekly basis by the Assets and Liabilities Committee (ALCO).

Customer deposits form a significant part of the Group's funding. The Group places considerable importance on maintaining the stability of both its customer and interbank deposits. The stability of deposits depends on maintaining confidence in the Group's financial strength and financial transparency.

The funding base is enhanced through term financing, amounting to US\$3,226.5 million at 30th June 2010. Access to available but uncommitted short-term funding from the Group's established breadth of Middle East and international relationships provides additional comfort. In addition to the stable funding base, the Group maintains a stock of liquid and marketable securities that can be readily sold or repoed.

At 30th June 2010, 53.2 per cent of total assets were contracted to mature within one year. With regard to deposits, retention records demonstrate that there is considerable divergence between their contractual and effective maturities.

US\$6,903.4 million or 74.1 per cent of the Group's deposits at 30th June 2010 were from GCC countries, and a further US\$910.6 million or 9.8 per cent were from other Middle East and North African countries. Total deposits from counterparties in Middle East and North African countries therefore represented 83.9 per cent of total deposits at 30th June 2010. Historical experience has shown that GIB's deposits from counterparties in the Middle East region are more stable than deposits derived from the international interbank market, which at 30th June 2010 were only US\$1,505.4 million, or 16.1 per cent of the Group's deposit base. At 30th June 2010, placements with counterparties in non-MENA countries were 2.3 times the deposits received, demonstrating that the Group is a net lender of funds in the international interbank market.

## 8. INTERNAL CAPITAL INCLUDING OTHER RISK TYPES (continued)

### 8.2 Other risk types (continued)

#### ii) Concentration risk

Concentration risk is the credit risk stemming from not having a well diversified credit portfolio, i.e. the risk inherent in doing business with large customers or being overexposed in particular industries or geographic regions. GIB's internal economic capital methodology for credit risk addresses concentration risk through the application of a single-name concentration add-on.

Under the CBB's single obligor regulations, banks incorporated in Bahrain are required to obtain the CBB's approval for any planned exposure to a single counterparty, or group of connected counterparties, exceeding 15 per cent of the regulatory capital base. At 30th June 2010, the following single obligor exposures exceeded 15 per cent of the Group's regulatory capital base (i.e. exceeded US\$381.5 million):-

	<b>On-balance sheet exposure</b>	<b>Off-balance sheet exposure</b>	<b>Total exposure</b>
	<b>US\$ millions</b>	<b>US\$ millions</b>	<b>US\$ millions</b>
Counterparty A	642.3	44.1	686.4
Counterparty B	319.1	156.5	475.6

This exposure had been approved by the CBB in accordance with the CBB's single obligor regulations. Under the CBB's regulations single obligors include entities in which there is an ownership interest of 20 per cent or more. This is a significantly lower threshold than that used to determine control under IFRS.

#### iii) Interest rate risk in the banking book

Structural interest rate risk arises in the Group's core balance sheet as a result of mismatches in the repricing of interest rate sensitive financial assets and liabilities. The associated interest rate risk is managed within VaR limits and through the use of models to evaluate the sensitivity of earnings to movements in interest rates.

The Group does not maintain material foreign currency exposures or equity exposures in the banking book. Equities held in the banking book are commented in more detail in section 4.4(vi) of this report.

In general, the Group's policy is to match financial assets and liabilities in the same currency or to mitigate currency risk through the use of currency swaps.

## 8. INTERNAL CAPITAL INCLUDING OTHER RISK TYPES (continued)

### 8.2 Other risk types (continued)

#### iii) Interest rate risk in the banking book (continued)

The repricing profile of the Group's financial assets and liabilities are set out in the table below:-

	Within 3 months	Months 4 to 6	Months 7 to 12	Over 1 year	Non-interest bearing items	Total
	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions
Cash and other liquid assets	618.1	1.0	226.5	-	-	845.6
Placements	4,085.9	-	-	75.0	-	4,160.9
Trading securities	-	-	-	-	24.6	24.6
Investment securities:-						
- Fixed rate	-	-	-	534.3	-	534.3
- Floating rate	1,412.1	52.0	-	-	(26.3)	1,437.8
- Equities and equity funds	-	-	-	-	347.5	347.5
Loans and advances	6,292.3	1,775.8	386.8	14.5	(248.3)	8,221.1
Other assets	-	-	-	-	246.7	246.7
<b>Total assets</b>	<b>12,408.4</b>	<b>1,828.8</b>	<b>613.3</b>	<b>623.8</b>	<b>344.2</b>	<b>15,818.5</b>
Deposits	8,464.1	853.5	1.8	-	-	9,319.4
Securities sold under agreements to repurchase	620.7	-	-	-	-	620.7
Other liabilities	0.1	-	-	-	287.1	287.2
Term financing	3,677.5	60.0	-	-	-	3,737.5
Equity	-	-	-	-	1,853.7	1,853.7
<b>Total liabilities &amp; equity</b>	<b>12,762.4</b>	<b>913.5</b>	<b>1.8</b>	<b>-</b>	<b>2,140.8</b>	<b>15,818.5</b>
<b>Interest rate sensitivity gap</b>	<b>(354.0)</b>	<b>915.3</b>	<b>611.5</b>	<b>623.8</b>	<b>(1,796.6)</b>	<b>-</b>
<b>Cumulative interest rate sensitivity gap</b>	<b>(354.0)</b>	<b>561.3</b>	<b>1,172.8</b>	<b>1,796.6</b>	<b>-</b>	<b>-</b>

The repricing profile is based on the remaining period to the next interest repricing date and the balance sheet categories in the consolidated financial statements.

The repricing profile of placements incorporates the effect of interest rate swaps used to lock-in a return on the Group's net free capital funds. Derivative financial instruments that have been used for asset and liability management purposes to hedge exposure to interest rate risk are incorporated in the repricing profiles of the related hedged assets and liabilities. The non-specific investment security and loan provisions are classified in non-interest bearing items.

The substantial majority of assets and liabilities reprice within one year.

Interest rate exposure beyond one year amounted to only US\$623.8 million or 3.9 per cent of total assets. This exposure represented the investment of the net free capital funds in fixed rate government securities and fixed receive interest rate swaps. At 30th June 2010 the modified duration of these fixed rate government securities and interest rate swaps was 2.74. Modified duration represents the approximate percentage change in the portfolio value resulting from a 100 basis point change in yield. More precisely in dollar terms, the price value of a basis point of the fixed rate securities was US\$168,400.



## **8. INTERNAL CAPITAL INCLUDING OTHER RISK TYPES** (continued)

### **8.2 Other risk types** (continued)

#### **iii) Interest rate risk in the banking book** (continued)

Based on the repricing profile at 30th June 2010, and assuming that the financial assets and liabilities were to remain until maturity or settlement with no action taken by the Group to alter the interest rate risk exposure, an immediate and sustained one per cent (100 basis points) increase in interest rates across all maturities would result in a reduction in net income before tax for the following year and in the Group's equity by approximately US\$6.4 million and US\$24.8 million respectively. The impact on the Group's equity represents the cumulative effect of the increase in interest rates over the entire duration of the mismatches in the repricing profile of the interest rate sensitive financial assets and liabilities.

#### **iv) Business risk**

Business risk represents the earnings volatility inherent in all businesses due to the uncertainty of revenues and costs due to changes in the economic and competitive environment.

For economic capital purposes, business risk is calculated based on the annualised cost base of applicable business areas.

## 9. CAPITAL ADEQUACY RATIOS AND OTHER ISSUES

### 9.1 Capital adequacy ratios

The Group's policy is to maintain a strong capital base so as to preserve investor, creditor and market confidence and to sustain the future development of the business. The impact of the level of capital on shareholders' return is also recognised as well as the need to maintain a balance between the higher returns that might be possible with greater gearing and the advantages and security afforded by a sound capital position. The Group manages its capital structure and makes adjustments to the structure taking account of changes in economic conditions and strategic business plans. The capital structure may be adjusted through the dividend payout, and the issue of new shares and subordinated term finance.

The capital adequacy ratios of GIB's principal subsidiary, GIBUK, and the Group were as follows:-

	<b>GIBUK</b>	<b>Group</b>
Total RWAs (US\$ millions)	744.4	11,061.2
Capital base (US\$ millions)	203.6	2,543.3
Tier 1 capital (US\$ millions)	203.6	1,831.4
<b>Tier 1 ratio (per cent)</b>	<b>27.4%</b>	<b>16.6%</b>
<b>Total ratio (per cent)</b>	<b>27.4%</b>	<b>23.0%</b>

GIB aims to maintain a minimum tier 1 ratio in excess of 8 per cent and a total capital adequacy ratio in excess of 12 per cent. The CBB's current minimum total capital adequacy ratio for banks incorporated in Bahrain is set at 12 per cent. The CBB does not prescribe a minimum ratio requirement for tier 1 capital.

#### **Strategies and methods for maintaining a strong capital adequacy ratio**

GIB prepares multi-year strategic projections on a rolling annual basis which include an evaluation of short term capital requirements and a forecast of longer-term capital resources.

The evaluation of the strategic planning projections have historically given rise to capital injections. The capital planning process triggered the raising of additional tier 2 capital through a US\$400 million subordinated debt issue in 2005 to enhance the total regulatory capital adequacy ratio, and a US\$500 million capital increase in March 2007 to provide additional tier 1 capital to support planned medium term asset growth. A further US\$1.0 billion capital increase took place in December 2007 to enhance capital resources and compensate for the impact of provisions relating to exposures impacted by the global credit crisis.

### 9.2 ICAAP considerations

Pillar 2 in the CBB's Basel 2 framework covers two main processes: the ICAAP and the supervisory review and evaluation process. The ICAAP involves an evaluation of the identification, measurement, management and control of material risks in order to assess the adequacy of internal capital resources and to determine an internal capital requirement reflecting the risk appetite of the institution. The purpose of the supervisory review and evaluation process is to ensure that institutions have adequate capital to support the risks to which they are exposed and to encourage institutions to develop and apply enhanced risk management techniques in the monitoring and measurement of risk.

GIB's regulatory capital base exceeded the CBB's minimum requirement of 12 per cent throughout the six months ended 30th June 2010. Based on the results of capital adequacy stress testing and capital forecasting, GIB considers that the buffers held for regulatory capital adequacy purposes are sufficient and that GIB's internal minimum capital targets of 8 per cent for tier 1 capital and 12 per cent for total capital are adequate given its current risk profile and capital position. The Group's regulatory capital adequacy ratios set out in section 9.1 of this report significantly exceeded the minimum capital targets and are high by international comparison.

GIB uses its internal capital models, economic capital, and capital adequacy calculations based on the CBB's FIRB approach for credit risk when considering internal capital requirements both with and without the application of market stress scenarios. As a number of Pillar 2 risk types exist within GIB's economic capital framework (i.e. interest rate risk in the banking book, concentration risk and business risk), GIB uses its existing internal capital measurements as the basis for determining additional capital buffers. GIB considers the results of its capital adequacy stress testing, along with economic capital and RWA forecasts, to determine its internal capital requirement and to ensure that the Group is adequately capitalised in stress scenarios reflecting GIB's risk appetite.

## 10. GLOSSARY OF ABBREVIATIONS

ALCO	Assets and Liabilities Committee
AMA	Advanced Measurement Approach
Basel Committee	Basel Committee for Banking Supervision
CBB	Central Bank of Bahrain
CCF	Credit Conversion Factor
CDO	Collateralised Debt Obligation
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CI & TO	Chief Investment and Treasury Officer
EAD	Exposure at Default
FIRB Approach	Foundation Internal Ratings Based Approach
FSA	Financial Services Authority (of the United Kingdom)
GCC	Gulf Cooperation Council
GIB	Gulf International Bank B.S.C.
GIBUK	Gulf International Bank (U.K.) Limited
The Group	Gulf International Bank B.S.C. and subsidiaries
HoRM	Head of Risk Management
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
LGD	Loss Given Default
MENA	Middle East and North Africa
ORMF	Operational Risk Management Framework
PD	Probability of Default
PSE	Public Sector Entities
RAROC	Risk-adjusted Return on Capital
RWA	Risk Weighted Amount
VaR	Value-at-Risk