

BMB Middle East Bank B.S.C

Basel II Pillar 3 Disclosures

The Year ended 31 December 2012



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1. INTRODUCTION

Beginning June 2008, the Central Bank of Bahrain (CBB) requires licensed banking institutions to publish risk disclosures in addition to the normal financial statement disclosures on a half yearly basis and an annual basis as part of the Basel II Pillar 3 disclosures. This report contains the BMB Group's Basel II Pillar 3 Disclosures for the year ended 31 December 2012 in conformity with the requirements of the CBB's Rulebook Number 1 – Module PD as well as certain other additional information which the Bank believes will be useful to readers in interpreting this material and in understanding BMB's approach to risk management. The Basel II Pillar 3 Disclosures must be read in conjunction with the Bank's 2012 annual financial statement disclosures.

The Disclosures are part of Basel II Pillar 3 and are based on paragraph numbers 820 through to number 826 of the Basel Committee on Banking Supervision's (BCBS) "International Convergence of Capital Measurement and Capital Standards" (June 2006 edition) (the "Basel II Framework"). The Central Bank of Bahrain's Rulebook is available at www.cbb.gov.bh and the BCBS Basel II Framework is available at www.bis.org.

This document discusses BMB's risk management strategies, processes, structures, risk mitigation strategies and their effectiveness. Risks covered include those related to Basel II Pillar 3 (credit risk, market risk, and operational risks) and to Pillar 2 risks (Interest Rate Risk in the Banking Book (IRRBB), liquidity risk, legal and other related risks). The Bank considers this report and the information it contains a critical part of its efforts in fostering transparency and disclosure of the performance and condition of the Bank.

The Bank's previous Basel II Pillar 3 Disclosures report was for the six months ended 30 June 2012 and is available at its website, www.bmb.com.bh.

2. GENERAL INFORMATION

2.1. Incorporation And Principal Activity

Bahrain Middle East Bank (B.S.C.) (the “Bank”, “BMB” or “BMB Investment Bank”) is a Bahraini Shareholding Company with limited liabilities and is incorporated in the Kingdom of Bahrain as well as being listed on the Bahrain Stock Exchange (“BSE”).

The registered office of the Bank is:

**BMB Centre, Building 135,
Road 1702, Block 317,
Diplomatic Area,
Manama,
Kingdom of Bahrain.**

The Bank operates under a Wholesale Banking License issued by the Central Bank of Bahrain (“CBB”) and is regulated by the CBB. The Bank is part of a group that comprises the Bank and its subsidiaries. The principal subsidiaries of the Bank at 31 December 2012 were as follows:

<u>Subsidiaries</u>	<u>Ownership interest</u>	<u>Country of incorporation</u>	<u>Nature of business</u>
	<u>31</u>		
	<u>December</u>		
	<u>2012</u>		
BMB Investment Company (Jersey) Limited	100%	Jersey	Investment holding
Adhari Limited	100%	Cayman Islands	Investment holding
BMB Property Services	100%	Bahrain	Building Management
BMB Trade Finance	100%	Cayman Islands	Investment holding
Universal Merchant Holdings NV	100%	Netherlands Antilles	Investment holding
BMB Netherlands Antilles NV	100%	Netherlands Antilles	Investment holding
BMB Curacao Netherlands NV	100%	Netherlands Antilles	Investment holding
Universal Finance Holding NV	100%	Netherlands	Investment holding
European Universal Finance NV	100%	Netherlands	Investment holding
Qassari Limited – LDC	100%	Cayman Islands	Investment holding
Umm Shoum Limited – LDC	100%	Cayman Islands	Investment holding
Bu Zaidan Limited – LDC	100%	Cayman Islands	Investment holding
BMB New Era Ventures – I LDC	100%	Cayman Islands	Investment holding
BMB New Era Ventures – II LDC	100%	Cayman Islands	Investment holding
BMB New Era Ventures – III LDC	100%	Cayman Islands	Investment holding
BMB New Era Ventures – IV LDC	100%	Cayman Islands	Investment holding
BMB New Era Ventures – V LDC	100%	Cayman Islands	Investment holding

- At 31 December all subsidiary companies were consolidated in the financial statements.
- *Beverages Limited was liquidated during the year 2012.
- Except for BMB Property Services, the Bank’s all other subsidiaries are used for the exclusive purposes of holding investments.

3. SCOPE OF APPLICATION

3.1. Legal Entity

The name of the principal entity in the Group to which these Disclosures apply is Bahrain Middle East Bank (B.S.C.). The bank operates under a Wholesale banking license issued by the Central Bank of Bahrain. The Group comprises the bank and its subsidiaries.

The principal activities of the group are the provision of investment banking, private banking and treasury services, trading and investment, asset management and fund distribution.

3.2. Consolidation

All of BMB's subsidiaries are fully consolidated in the preparation of the Bank's financial statements. There is no material difference between the basis of consolidation used for financial statement and regulatory purposes, except for the calculation of the regulatory Capital Adequacy Ratio ("CAR") where certain elements of equity are assigned to different capital tiers and assets are risk-weighted using certain risk factors as specified in the Basel II Framework.

3.3. Restrictions on transfer of capital

Since none of the Bank's subsidiaries are regulated financial institutions, there is no regulatory impediment to the transfer of retained earnings to the Bank. However, as separate legally incorporated entities, the transfer of paid in capital and mandatory reserves would require shareholder action. As the sole shareholder (either direct or indirect) in these entities, the Bank has the power to undertake the legal processes for the transfer of such capital. None of the Bank's subsidiaries are registered and domiciled in jurisdictions which impose exchange controls or other restrictions on the cross border transfer of funds.

3.4. Aggregate Regulatory Surplus Capital of Insurance Subsidiaries

BMB does not have any subsidiary engaged in the insurance business.

3.5. Aggregate Regulatory and other Capital Deficiencies and Deductions

Since none of the Bank's subsidiaries are regulated financial institutions, they are not subject to standalone capital requirements in excess of their paid in capital. On a legal and accounting basis, none of the Bank's subsidiaries has a deficit in its legal or accounting capital. For the purposes of the Bank's implementation of Basel II under CBB regulations, none of the capital of any of the Group's subsidiaries is required to be deducted from regulatory capital.

4. CAPITAL STRUCTURE

4.1. Capital instruments

All of the Bank's equity capital consists of one class of common equity. The Bank has not issued any innovative, complex or hybrid capital instruments in the year under review, nor does it have any such capital instruments outstanding.

4.2. Tier 1 Capital

Tier 1 Capital is the nominal value of paid in capital, audited retained earnings and accumulated reserves arising from the appropriation of current and past years' income and/or retained earnings less any treasury stock, or negative fair value reserves. Local regulations require that certain investments or exposures be deducted from Tier 1 capital. The aggregate amount of Tier 1 Capital as at 31 December 2012 was US\$ 25.5 million.

4.3. Tier 2 Capital

Tier 2 Capital consists of the qualifying portion of subordinated loans and unrealised gains arising on changes in the fair value of assets and liabilities. Under Central Bank of Bahrain regulations, the aggregate amount of Tier 2 Capital eligible for inclusion in the CAR is limited to no more than 100% of Tier 1 Capital. The aggregate amount of Tier 2 Capital as at 31 December 2012 was US\$ 2.0 million.

4.4. Tier 3 Capital

The Bank had no Tier 3 Capital as at 31 December 2012.

4.5. Deductions from regulatory capital

As at 31 December 2012, there were no deductions from eligible Tier 1 Capital. Since BMB uses the Standardised Approach for both Credit and Market Risk, there are no IRB model based deductions.

4.6. Total eligible capital

As at 31 December 2012, the aggregate amount of regulatory capital (Tier 1 and Tier 2) was US\$ 27.5 million.

5. DESCRIPTION OF BUSINESS ACTIVITIES

BMB's main activities are:

- investment banking which forms the core of our activities
- asset management and funds distribution, and
- trading and investment

These activities are conducted through dedicated specialist business units.

5.1. Investment banking

This activity consists of originating and structuring investments. It is conducted by our Investment Department. Our Investment Department engages in limited, selective investments in equities, funds and equity derivatives. Additionally, the Investment Department manages the Bank's portfolio of listed equities, which primarily consist of IPOs or listed shares resulting from the realization of private equity investments.

5.2. Private equity

Since 1988, the Bank has developed strong relationships with premier unquoted equity fund managers, both directly and through private equity fund distributors. Drawing on our own fundamental macro trend analysis, we seek out unquoted equity funds and direct investments which meet our stringent investment criteria. These investments are both for the Bank's own account and for clients. Our primary focus is on fund managers who pursue a strategy of taking a controlling interest in high quality investments with a solid financial history. The fund managers selected by BMB must be able to demonstrate both a proven track record over a number of years and economic cycles, as well as strong institutional backing. They must have a strict pricing discipline, make investments with a pre-determined exit strategy and for the most part must not merely be sourcing transactions through the auction process.

5.3. Private placements

BMB raises equity on a private placement basis for mid-size companies. Our Investment Department and executive management originate transactions drawing on BMB's network of contacts. After a satisfactory internal review and structuring, the Bank places the transactions with its customers.

5.4. Funds distribution

This activity consists of marketing investment products to BMB's individual and institutional clients and the management of BMB proprietary funds. Our Investor Marketing Department has responsibility for the former, while our Investment Department handles funds' management.

5.5. Investor marketing

Our Investor Marketing Department distributes structured products and private equity transactions to our investor base. This group also markets other specially developed products, including private equity funds, listed funds and hedge funds which are designed to meet our clients' needs. For our proprietary funds, we provide a full range of accounting, reporting and support services. Investor marketing is based upon our knowledge of each client's investment objectives and risk parameters. This detailed understanding enables us to focus product development and marketing efforts to more effectively meet our clients' needs. It also facilitates the cross-selling of other products and establishment of long-term client relationships.

5.6. Funds management

The Bank manages BMB's first fund of private equity funds, BMB Technology & Telecommunications Company, a US\$ 70 million fund.

5.7. Treasury Activities

Our Treasury Department trades in bonds, foreign exchange, capital markets and related derivative instruments.

6. CORPORATE GOVERNANCE

BMB conducts its business activities under a written corporate governance framework which sets forth the roles and responsibilities of members of the Board of Directors and Bank management.

The Bank's corporate governance framework comprises the following which are available on the Bank's website at <http://www.bmb.com.bh/corporate/more.asp>

- Code of Ethics and Code of Conduct
- Corporate Governance Policies and Procedures
- Charter of the Board of Directors
- Directors' Roles and Responsibilities
- Charter of the Executive Committee of the Board of Directors
- Charter of the Audit Committee of the Board of Directors
- Charter of the Chairman of the Board of Directors
- Charter of the Chief Executive
- Disclosure Policy and Procedures

7. CAPITAL MANAGEMENT

The primary purpose of the Bank's capital management program is to ensure that the Bank complies with externally imposed capital requirements and that the Bank maintains strong credit ratings and healthy capital ratios in order to support its business and to maximize shareholders' value. As a further step in mitigating risks, the Bank follows a policy of diversification in its activities and seeks to minimise the risk exposure to particular geographical regions, counterparties and instruments and types of business. To manage its capital, BMB employs a risk adjusted measure of capital adequacy (a Capital Adequacy Ratio or "CAR") based on the local regulatory regime as implemented by the CBB in line with the Basel Committee on Banking Supervision's International Convergence of Capital Measurement and Capital Standards: A Revised Framework" guideline. Beginning January 2008, CBB required all Bahrain banking institutions to implement Pillar 1 of Basel II, which involves calculation of capital charges for market, credit and operational risks. BMB uses the Basic Indicator Approach of Operational Risks and the Standardised Approach for market and credit risk.

BMB manages its capital with the following objectives:

1. To comply at all times with the capital adequacy ratio set by the Group's regulator, the Central Bank of Bahrain,
2. To ensure that the Bank has sufficient capital to enable it to absorb diminutions in the value of its assets or unexpected losses while continuing to function as a "going concern",
3. To maintain a sound capital base that allows the Bank to take advantage of opportunities to develop and grow its business,
4. To assess the utilization of capital by the Bank's business units

Reports on the Bank's capital adequacy are filed quarterly with the CBB. As the Bank has no operating branches outside the Kingdom of Bahrain, it is subject only to the capital requirements of the CBB, which currently requires all financial institutions in Bahrain to maintain a 12.0% CAR. In determining its CAR, the Bank calculates risk adjusted assets which are then divided by regulatory capital rather than the equity capital appearing in the Bank's statement of financial position. Regulatory equity capital is composed of two elements:

(a) Tier 1 Capital is the nominal value of paid in capital, audited retained earnings and accumulated reserves arising from the appropriation of current and past years' income and/or retained earnings less any treasury stock, or negative fair value reserves. Local regulations require that certain investments or exposures be deducted from Tier 1 capital.

(b) Tier 2 Capital consists of the qualifying portion of subordinated loans and unrealised gains arising on fair valuation. Under Central Bank of Bahrain regulations, the aggregate amount of Tier 2 capital eligible for inclusion in the CAR is limited to no more than 100% of Tier 1 Capital.

The Bank's Capital Adequacy Ratio as at 31 December 2012 was as follows:

Table 1: Capital Composition

	US\$000
<u>Tier 1 capital</u>	
Share capital	60,501
Legal reserves	17,545
Retained earnings (accumulated losses)	(49,045)
Unrealized gross losses arising from fair valuing equity securities	(3,122)
Excess amount over maximum permitted large exposure limit *	<u>(360)</u>
Total qualifying Tier 1 capital	<u>25,519</u>
<u>Tier 2 capital</u>	
Revaluation reserves – available-for-sale investments	<u>2,055</u>
Total qualifying Tier 2 capital	<u>2,055</u>
Total regulatory capital	<u>27,574</u>
Risk weighted assets	
On-balance sheet	78,494
Off-balance sheet	<u>2,671</u>
Total risk weighted assets	<u>81,165</u>
Capital Adequacy Ratio (CAR)	<u>34.0%</u>
Core Capital Ratio	<u>31.4%</u>

*The excess' exposure over permitted limit relates to the Iraqi Sovereign Bond of US\$ 4.388 million.

The table below summarises the capital requirement for credit risk using the Standardised Approach as at 31 December 2012:

Table 2: Credit Risk Capital Requirement

	<u>Net exposure</u> US\$000	Risk weighted <u>amount</u> US\$000	Capital <u>requirement</u> US\$000
Sovereigns	4,388	4,388	527
Banks	6,318	1,264	152
Corporate	23,863	17,284	2,074
Securities	21,981	32,750	3,930
Others	1,320	1,320	<u>158</u>
Total			<u>6,841</u>

8. OPERATIONAL RISK CAPITAL CHARGE

The capital requirement for operational risk using the Basic Indicator Approach as at 31 December 2012 amounted to US\$ 9.8 million.

9. MARKET RISK CAPITAL CHARGE

The Bank uses the Standardised Approach for calculating market risk capital charges for the following market risk components:

- Equity exposure risk
- Interest rate exposure risk
- Foreign currency exposure risk

The Bank's market risk capital charge is largely composed of foreign currency risk arising from the Bank's foreign exchange exposure on private equity investments denominated mainly in sterling and euros, interest rate risk arising on the bond portfolio, currency and bond futures. The capital requirement for market risk using the Standardised Approach as at 31 December 2012 was as follows:

Table 3: Market Risk Capital

	<u>Capital requirement US\$000 31 December 2012</u>	<u>Capital requirement US\$000 Maximum</u>	<u>Capital requirement US\$000 Minimum</u>	<u>Capital requirement US\$000 Average</u>
Equity risk capital	70	956	(1,075)	5
Foreign exchange risk capital	1,073	330	(320)	(9)
Interest rate risk capital	-	<u>145</u>	<u>(96)</u>	<u>3</u>
Total	<u>1,143</u>			

10. FINANCIAL RISK MANAGEMENT

10.1. Risk Governance Structure

In the normal course of its business, the Bank is exposed to various risks, related to the nature of the activities in which it engages and these risks include:

- Private equity investment risk
- Market risk
- Credit risk
- Interest rate risk
- Currency risk
- Liquidity risk
- Operational risk
- Strategic risk and
- Legal risks

At BMB, the management of financial and other risks is based on the establishment of an appropriate risk governance structure, comprising:

1. Procedures for the identification and quantification of risks
2. Criteria for risk acceptance based on risk and return as well as other factors
3. Clearly defined exposure and risk limits

4. Robust operating policies and procedures, including those for specific allocation of risk limits to individual obligors and/or transactions
5. The use of quantitative models and qualitative approaches to assess and manage risks
6. Portfolio diversification and, where possible, other risk mitigation techniques
7. Ongoing review of exposures and risks by an independent department, including stress testing and frequent reporting
8. Periodic internal audits of the control environment,
9. Risk Management Committee authorization and approval for certain activities and transactions.

10.2. Risk limits

Risk limits are at the heart of risk management processes at BMB. The Bank begins by setting maximum exposure limits as a percentage of capital for major lines of business. Within these macro limits, sub-limits are set by geography, obligor type/credit grade, instrument, tenor, etc.

Despite the existence of various risk limits, overall risk discipline is maintained by the requirement that the Bank:

- (a) Maintains Basel II capital adequacy ratio in excess of the regulatory required minimum, and
- (b) Considers the impact on the Bank's liquidity position of any major transaction(s) or new business initiative.

10.3. Role of the Board

Risk management at BMB begins at the Board of Directors level. The Board of Directors exercises oversight and final approval of the risk management process at BMB. It operates through two Board Committees, the Executive Committee and the Audit Committee. With input provided by the Bank's Risk Management Committee, the Executive Committee proposes the overall risk management strategy of the Bank. Based on the recommendations of the Executive Committee, the Board of Directors approves the aggregate levels of risk the Bank can assume as well as reviewing and approving the Bank's risk management policies, risk limits and risk control framework.

Among its duties, the Audit Committee is charged with reviewing and approving the Bank's policies and procedures as well as overseeing both the internal and external audits of the Bank, including matters related to the Bank's compliance with CBB anti-money laundering regulations. The Board delegates certain authority to the Executive Committee and the executive management of the Bank to implement the risk control decisions of the Board. To carry out these responsibilities, executive management operates through a Risk Management Committee (the "RMC"). The RMC is chaired by the Chief Executive and comprises members of senior management. It serves as the Bank's credit committee, asset/liability management committee, and investment approval committee. In addition, it prepares and submits to the Board detailed risk control policies and procedures as well as country, asset class and individual counterparty limits for Board approval. On an ongoing basis, the RMC monitors the environment in which the Bank operates and the risks to which it is exposed and recommends adjustments, as appropriate.

10.4. Risk Management Department

The Risk Management Department ("RMD") plays a key role in the Bank's risk management process. The RMD is independent of the Bank's trading and business areas and reports directly to the Chief Executive. It is responsible for identifying and quantifying risk exposures, recommending appropriate limits and monitoring usage of them. As part of its duties, the RMD prepares daily risk reports, including stress tests, for senior management and the RMC. In addition, the RMD manages problem or past-due assets. In identifying and monitoring risk exposures, BMB uses a variety of quantitative tools (including Value at Risk) as well as qualitative approaches to measure risks at the "macro" level. The Bank seeks to judiciously balance the use of these two approaches rather than rely on a single approach.

10.5. Independent Review

Internal Audit, which is independent of both operations and the Bank's business units, also assists in the risk management process. In particular, Internal Audit is charged with a periodic review of the effectiveness of BMB's policies and internal controls - a review which is independent of the Bank's executive management.

10.6. CREDIT RISK MANAGEMENT

BMB's principal line of business is placement of private equity investments, and, as such, the Bank is not involved in the granting of credit facilities. Further, BMB is not engaged in retail business and therefore does not use credit "scoring" models. However, the Bank is exposed to counterparty credit risk through its money market trading activities. In this respect credit risk is the risk of loss arising from the inability or unwillingness of a counterparty to meet its obligations to the Bank.

The Risk Management Department, under the oversight of RMC, has the responsibility for establishing credit risk standards and implementing the Bank's credit risk management process. BMB uses the Standardised Approach under the Basel II framework for measuring and managing its credit risk.

10.7. Internal Risk Grading

All obligors and countries are risk graded. All lines of credit, counterparty, country and trading limits are subject to periodic review and some on a specific case by case basis. The limits are also reviewed more frequently as necessary to ensure consistency with the Bank's trading and investment strategies or to take into account the latest market developments. The Bank seeks to mitigate its exposure to losses through a variety of techniques such as investing in senior instruments (those with legal priority), transaction structuring and collateral or other security. Given the nature of the Bank's business, the Bank uses nominal balance sheet amounts including accrued interest and other receivables as its measure of Credit Risk exposure.

Credit risks for a given economic entity (including its subsidiaries and affiliates) are aggregated as the measure of exposure and are managed at that level. For internal credit risk management the Bank estimates the probability of default through its risk grading system which employs a ten-grade scale, with "1" representing a risk which has the least probability of default (equivalent to AAA rating) and "10" representing a defaulted obligation (equivalent to rating below CCC-). Risk grading is based on (a) quantitative factors (historical and prospective such as cash flow, profitability, asset quality and tenor of risk), (b) qualitative factors (such as management quality, market share and competitive position) and other factors, including country risk, the type of transaction, tenor, and credit mitigation. Where ratings from an External Credit Assessment Institution, recognized by the CBB, are available, BMB considers these as part of its internal rating process.

Table 4 : BMB Rating Translation Methodology

Fitch	Moody's	S&P	CI	BMB Rating
AAA	Aaa	AAA	AAA	1
AA+	Aa1	AA+	AA+	2
AA	Aa2	AA	AA	3
AA-	Aa3	AA-	AA-	
A+	A1	A+	A+	4
A	A2	A	A	
A-	A3	A-	A-	
BBB+	Baa1	BBB+	BBB+	5
BBB	Baa2	BBB	BBB	

BBB-	Baa3	BBB-	BBB-	6
BB+	Ba1	BB+	BB+	7
BB	Ba2	BB	BB	
BB-	Ba3	BB-	BB-	
B+	B1	B+	B+	8
B	B2	B	B	
B-	B3	B-	B-	
CCC+	Caa1	CCC+	CCC+	9
CCC	Caa2	CCC	CCC	
CCC-	Caa3	CCC-	CCC-	
Below;				10
CCC-	Caa3/NP	CCC-	CCC-	

The process by which BMB transfers External Credit Assessment Institutions (ECAI) public issuer ratings onto comparable assets in its Banking Book is described in the table above. Where an obligor or counterparty is rated by two ECAIs, BMB uses the higher risk weight (more adverse rating) to determine the applicable risk weighting. Where an obligor or counterparty is rated by three or more ECAIs, BMB uses the two lowest (most favourable ratings) and selects the higher risk weight (more adverse rating) of the two to determine the applicable risk weighting.

10.8. External Credit Assessment Institutions

In its Credit Risk Management process, the Bank uses the following ECAIs: Capital Intelligence (CI), Fitch Ratings, Moody's and Standard and Poor's. The Bank currently does not hold any financial assets subject to an ECA guarantee or insurance. ECAI ratings are used to determine applicable credit grades for money market placements, foreign exchange trading limits, country exposure limits and rated bonds.

10.9. Collateral and Netting

The Group attempts to manage its credit risk exposure through diversification of its equity investments, capital markets and trading activities. Where possible, collateral agreements and master netting agreements are obtained to further control risks. In order to ensure a common approach to risk control, the Bank uses the same credit procedures when entering into trading activities, including foreign exchange and derivatives, as it does for traditional lending products.

10.10. Credit Related Contingent items

The Bank's off-balance sheet items consist primarily of commitments to various private equity funds representing the undrawn portion of the Bank's commitment for future investments which may be made by these funds. Undrawn investment commitments comprise contractual commitments to make investments in quoted equities and in other equities and funds as amounts are called by fund managers. The Bank's commitments for its private equity investments and other funds are generally for a period of between four and six years.

The Bank has USD 1,400 thousands contingent exposure related to the issuance of letters of credit, standby letters of credit/guarantees or loans. Credit-related financial instruments include commitments to extend credit, standby letters of credit, guarantees and acceptances which are designed to meet the requirements of the Bank's customers. Commitments to extend credit represent contractual commitments to make loans and revolving credits. Commitments generally have fixed dates or other termination clauses and require the payment of a fee. Since commitments may expire without being drawn upon, the total contract amounts do not necessarily represent future cash requirements. Standby letters of credit, guarantees and acceptances commit the Bank to make payments on behalf of customers contingent upon the failure of the customer to perform under the terms of the contract.

Other commitments represent unclaimed dividend amounts written back by the Bank in 2011. However, as per regulatory requirement, these amounts have been carried as a contingent item.

10.11. Securitisation

The Bank does not participate in Securitisation activities in relation to credit synthesis; acting as sponsor, liquidity facility provider, credit enhancement facility provider, swap provider and during the year ended 31 December 2012 has not securitised any of its assets and therefore has no recourse obligations under such transactions. In addition the Bank does not have any exposure to “Highly Leveraged Institutions” (“HLI”) as defined by the Financial Stability Task Force.

10.12. Concentration Credit Risk

Concentration of credit risk arises when a number of obligors or counterparties are engaged in similar business activities or activities in the same geographic region or have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions. Accordingly, such concentrations indicate the relative sensitivity of the Group’s performance to developments affecting a particular industry or region. The Bank sets limits based on geographic regions, types of investment, risks involved. The Bank’s Large Exposure Policy details the Bank’s exposure limits and the policy is in compliance with CBB restrictions on concentration limits.

The table below summarizes the Group’s gross and average gross credit exposures as at the year ended 31 December 2012:

Table 5: Gross and average credit exposures

	<u>Gross exposure</u> <u>31 December 2012</u> <u>US\$000</u>	<u>average</u> <u>31 December 2012</u> <u>US\$000</u>
Cash and cash equivalents	2,318	4,294
Placement with financial institutions	4,000	4,600
Trading securities	3	480
Held-to-maturity investments	4,624	4,621
Loans and advances	20,956	21,000
Other assets	<u>858</u>	<u>1,425</u>
Total	32,759	36,420
Off-balance sheet credit and investment instruments	<u>10,491</u>	<u>11,656</u>

The gross average credit exposures are based on quarter end prudential return reporting.

The following tables summarize the Group’s geographical and industry sector exposures, and any potential risk concentrations arising there from. Maximum credit risk exposures are detailed without considering the effects, if any, of collateral or other credit mitigation techniques on the Group’s assets, liabilities and off-balance sheet items.

Table 6: Geographical Sector Exposures

	<u>North America</u> US\$000	<u>Europe</u> US\$000	<u>Rest of the world</u> US\$000	<u>Total</u> US\$000
Assets				
Cash and cash equivalents	729	763	826	2,318
Placement with financial institutions	-	-	4,000	4,000
Trading securities	-	-	3	3
Held-to-maturity investments	-	236	4,388	4,624
Loans and advances	-	13,159	7,797	20,956
Other assets	-	<u>169</u>	<u>689</u>	<u>858</u>
Total assets subject to credit risk	<u>729</u>	<u>14,327</u>	<u>17,703</u>	<u>32,759</u>
Credit Related Contingent items	<u>2,642</u>	<u>2,433</u>	<u>5,416</u>	<u>10,491</u>

Table 7: Industry sector exposure

	<u>Banking/ Finance</u> US\$000	<u>Government</u> US\$000	<u>Technology/ Telecoms</u> US\$000	<u>Diversified</u> US\$000	<u>Others</u> US\$000	<u>Total</u> US\$000
Assets						
Cash and cash equivalents	2,318	-	-	-	-	2,318
Placement with financial institutions	4,000	-	-	-	-	4,000
Trading securities	3	-	-	-	-	3
Held-to-maturity investments	-	4,388	-	-	236	4,624
Loans and advances	13,159	-	-	-	7,797	20,956
Other assets	149	118	-	-	591	858
Total assets subject to credit risk	<u>19,629</u>	<u>4,506</u>	-	-	<u>8,624</u>	<u>32,759</u>
Credit Related Contingent	<u>1,453</u>	<u>-</u>	<u>4,817</u>	<u>1,485</u>	<u>2,736</u>	<u>10,491</u>

10.13. Provisions for impairment

A provision is made in respect of a financial asset that is impaired if its carrying amount is greater than its estimated recoverable amount. Provisions for assets carried at amortised cost are calculated as the difference between the asset's carrying amount and the present value of expected future cash flows discounted at the financial instrument's original effective interest rate. By comparison, the recoverable amount of an instrument measured at fair value is the present value of expected future cash flows discounted at the current market rates of interest for similar financial assets (refer note 11 of consolidated financial statements).

11. MARKET RISK

Market risk is defined as potential adverse changes in the fair value or future cash flows of a trading position or portfolio of financial instruments resulting from the movement of market variables, such as interest rates, currency rates, equity prices and commodity prices, market indices as well as volatilities and correlations between markets. As its primary tool, the Bank measures its market risk exposure using the Standardised Approach under Basel II.

11.10. Interest rate risk

Interest rate risk is the risk that changes in market interest rates will affect (a) the fair value of financial instruments (“fair value interest rate risk”) and/or (b) the future cash flows associated with financial instruments subject to periodic repricing (“cash flow interest rate risk”). The Bank is exposed to interest rate risk as a result of mismatches or gaps in the amounts of assets and liabilities and off-balance sheet instruments that mature or reprice in a given period. The Bank manages this risk by matching the repricing of assets and liabilities through a variety of means, such as the daily risk analysis reports from the market risk model which assist the management in measuring and monitoring the Bank’s exposure to interest rate risk. The Bank’s interest rate sensitivity position is based on the contractual repricing or maturity dates, whichever dates are earlier, as follows:

Table 9: Interest Rate Gap Report

	Up to <u>1 month</u> <u>US\$000</u>	2 – 3 <u>months</u> <u>US\$000</u>	4 - 6 <u>months</u> <u>US\$000</u>	7 - 12 <u>months</u> <u>US\$000</u>	2 – 5 <u>years</u> <u>US\$000</u>	Over <u>5 years</u> <u>US\$000</u>	Non- interest <u>bearing</u> <u>US\$000</u>	<u>Total</u> <u>US\$000</u>
Cash and cash equivalents	2,318	-	-	-	-	-	-	2,318
Placement with financial institutions	4,000	-	-	-	-	-	-	4,000
Trading securities	-	-	-	-	-	-	437	437
Available-for-sale investments	-	-	-	-	-	-	21,544	21,544
Held-to-maturity investments	-	-	-	-	-	4,624	-	4,624
Loans and advances	3,083	5,690	4,386	-	7,797	-	-	20,956
Other assets	-	-	-	-	-	-	858	858
Total assets	9,401	5,690	4,386	-	7,797	4,624	22,839	54,737
Deposit from financial institutions	3,000	3,000	-	-	-	-	-	6,000
Deposits from customers	3,288	-	-	-	-	-	1,801	5,089
Borrowings	-	1,389	-	-	10,000	-	-	11,389
Other liabilities	-	-	-	-	-	-	1,839	1,839
Equity	-	-	-	-	-	-	30,445	30,445
Total liabilities and Equity	6,288	4,389	-	-	10,000	-	34,085	54,762
Total interest rate sensitivity gap	3,113	1,301	4,386	-	(2,203)	4,624		

12. INTEREST RATE RISK IN THE BANKING BOOK (IRRBB)

The Bank's interest rate sensitive Banking Book consists of the following financial instruments sovereign bonds, Installment Sale Receivable (ISR), deposits and medium term loans. The Bank employs various analytical techniques to measure interest rate sensitivity within the Banking Book. Chief among these is the use of VaR which is used to measure the economic value of such a change on the Bank's equity for a standard interest rate shock and stress-testing earnings at risk and economic value of equity for a number of stressed interest rate scenarios including the yield curve steepening and flattening. A 200 basis point shift in interest rates would affect the Banking Book as at 31 December 2012 as follows:

Table 10: IRRBB- 200 basis point economic value impact

	200 basis points movement
Assets (US\$000)	-/+ 343
Liabilities (US\$000)	+/- 422
Total (US\$000)	+/- 79

Under its CAAP, the Bank allocates capital for interest risk in the Banking Book using a 200 basis point parallel Yield curve shock as required by CBB's guideline in Pillar 2.

13. LIQUIDITY RISK

Liquidity risk is primarily the risk that the Bank will be unable to meet its payment obligations as they fall due and/or to replace funds when they are withdrawn ("liability liquidity risk"). It also represents the risk that the Bank will be unable to realise its assets in a timely fashion for prices close to their carrying values ("asset liquidity risk"). BMB strives to minimise liability liquidity risk by diversifying its sources of funding across markets, instruments and counterparties, and by matching the maturity of liabilities to the maturity of assets. The Bank seeks to maintain high quality marketable securities within its portfolio as well as sizeable short-term deposits with banks as a cash reserve. In its investing activities, BMB seeks to diversify its assets across instruments and markets and to avoid obligor concentrations which could constitute asset liquidity risk. This is particularly the case for our investments in unlisted private equity funds where BMB has consciously implemented a strategy of reducing our average individual investment size. Liquidity is managed on a daily basis and senior management closely monitors significant daily changes to the liquidity position. In evaluating the liquidity position, the Bank also takes into account the possible call of undrawn commitments in its investment portfolio. The maturity profile of the Group's assets and liabilities as at 31 December 2012 is shown below:

Table 11: Maturity Gap Report

	<u>Within 1 month</u>	<u>2–3 months</u>	<u>4–6 months</u>	<u>7–12 Months</u>	<u>2–5 years</u>	<u>6–10 Years</u>	<u>11–20 years</u>	<u>Total</u>
Assets								
Cash and cash equivalents	2,318	-	-	-	-	-	-	2,318
Placement with financial institutions	4,000	-	-	-	-	-	-	4,000
Trading securities	437	-	-	-	-	-	-	437
Available-for-sale investments*	-	-	-	5,859	12,306	3,379	-	21,544
Held-to-maturity investments	-	-	127	-	-	-	4,624	4,751
Loans and advances	3,083	5,690	4,386	-	8,933	-	-	22,092
Other assets	175	285	-	67	331	-	-	858
Total assets	10,013	5,975	4,513	5,926	21,570	3,379	4,624	56,000
Liabilities								
Deposits from financial institutions	3,000	3,000	-	-	-	-	-	6,000
Deposits from customers	1,715	-	-	-	3,374	-	-	5,089
Borrowings	-	1,397	-	506	11,516	-	-	13,419
Other liabilities	1,155	646	-	38	-	-	-	1,839
Total liabilities	5,870	5,043	-	544	14,890	-	-	26,347
Net liquidity gap	4,143	932	4,513	5,382	6,680	3,379	4,624	29,653

14. PRIVATE EQUITY RISK

BMB invests in private equity with the intent of later sale of these investments at a profit to third parties either through a sale to another business (“trade sale”) or an initial public offering (“IPO”). Private equity risk is the risk that the Bank will not be able to sell its investments at a profit within the intended time period. This risk arises from three factors:

- 1) The first relates to the risk that the funded underlying business does not develop a sustainable business or its line of business is not attractive to other investors
- 2) The second factor relates to macro trends in markets for IPO’s and mergers and acquisition activity. The state of these markets affects both the price and timing of any “exit” from an investment and
- 3) The third factor is that these investments typically are realised over the medium term and are not traded on organised exchanges, hence they have limited liquidity.

BMB uses the Standardised Approach under the Basel II Framework for measuring and managing its private equity risk, which is considered a part of its Banking Book. The Bank manages risks at the specific investment level in the following ways. First, it invests primarily in independently managed third party funds whose managers have a demonstrated successful track record over the entire economic cycle. Second, the Bank seeks to diversify its investments across fund managers, different stages in the investment cycle (various stages of

venture capital, buy-out, etc.), geographical locations and industries. Diversification is also a key tool for dealing with the inherent limited liquidity of this asset class. The goal is to reduce exposure to any one investment. Trends in macro economic events and their effects on the IPO and trade sale market are largely out of the control of the Bank. In addition, from time to time, the Bank approaches leading investment banks to determine realistic market opportunities for the securitisation of private equity assets.

The Bank holds the equities in its Banking Book primarily for capital gains rather than current income, relationship or other reasons, and all of the equities held in BMB's books are accounted for as Available for Sale Assets at fair value with any changes in fair value taken to the Fair Value Reserve in equity. The Bank uses two methods to value the equities in its Banking Book. The bulk of equities in the Bank's Banking Book are unlisted or private equities. For private equity funds, the Bank relies on financial reports provided by the respective fund managers. Fund reports are generally received quarterly with the annual reports audited by major international accounting firms and prepared according to IFRS/IAS. The Bank determines its pro-rata share of an investment in a fund and adjusts for any transactions including asset realizations and further drawdowns from the date of the fund statement until the date of the preparation of the Bank's own financials. This value is used as the carrying value with any required valuation adjustment passed directly to the fair value reserve in equity.

For direct private investments, the Bank also primarily relies upon the investee company's financial statements as the source of information. Where these have been prepared using IFRS standards, the Bank uses the fair value in the investee company's financials as the basis for its own valuation. Where fair values are not provided in the investee company financial reports, the Bank uses a variety of techniques focused primarily on determining impairment from original cost. Where fair value cannot reliably be determined, cost is used. As at 31 December 2012, the amount of direct private equity carried at cost was US\$ 38,000 representing less than 1% of the total private equity portfolio.

15. EQUITY EXPOSURE RISK

Equity risk is the risk of adverse impact on the Bank's income and economic value arising from adverse movements in equity prices. The Bank is exposed to equity exposure risk arising from its trading portfolio of equities listed in the GCC, India, UK/Europe and the US. The Bank has Board-approved geographic equity exposure limits based on cost as the first line of defence against equity risk. The Bank uses the Standardised Approach for calculating capital charges for equity risk exposures as part of its market risk capital charge under Basel II.

DETAILS OF EQUITY INVESTMENTS IN BANKING BOOK

	USD '000	USD '000
	Carrying value	Capital Requirement
Unquoted Equities	21,538	2,584
Quoted Equities	6	1
Total	21,544	2,585
Unrealized loss recognized under Tier 1 Capital	3,122	
45% of unrealized gains recognized under Tier 2 Capital	2,055	

16. OPERATIONAL AND LEGAL RISK

Operational risk is the risk of loss arising from errors that can be made in instructing payments or settling transactions, breakdown in technology and internal control systems. BMB uses the Basic Indicator Approach under the Basel II framework for measuring and managing its operating risk. Currently, the Bank conducts its business from a single location. BMB is an investment bank and does not operate a retail or commercial banking franchise. Accordingly, the number of client relationships and volume of transactions at BMB are lower than at such institutions. The nature of transactions differ as well given the Bank's focus on investing in unlisted private equities for its own and its clients' accounts. These factors mitigate to some extent the operational risks to which the Bank is exposed both in terms of volumes of transactions and the liquidity of the assets underlying these transactions. As noted above, the Bank does not provide commercial or retail banking products and as such does not offer its clients cash deposit/withdrawal services, ATMs, credit cards, letter of credit or loan facilities.

BMB's operations are conducted according to well-defined procedures. These procedures include a comprehensive system of internal controls, including segregation of duties and other internal checks, which are designed to prevent either inadvertent staff errors or malfeasance prior to the release of a transaction. The Bank also engages in subsequent monitoring of accounting records, daily reconciliation of cash and securities accounts and other checks to enable it detect any erroneous or improper transactions which may have occurred.

Legal risk includes the risk of non-compliance with applicable laws or regulations, the illegality or unenforceability of counterparty obligations under contracts and additional unintended exposure or liability resulting from the failure to structure transactions or contracts properly. Legal risks are mitigated through legal counsel review of transactions and documentation, as appropriate. Where possible, the Bank uses standard formats for transaction documentation. To prevent potential association with any money laundering activities, the Bank has designed and implemented a comprehensive set of policies and procedures. Adherence to the Bank's policies and procedures is reinforced through periodic staff training and internal and external reviews, as well as internal and external review by auditors. To further mitigate operational and legal risks, the Bank uses insurance contracts to transfer risk off its books.

17. RELATED-PARTY TRANSACTIONS AND BALANCES

Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions. Related parties include entities over which the Bank exercises significant influence, major shareholders, directors and executive management of the Bank (Note 25 – Annual Financial Statements).