BASEL II PILLAR III DISCLOSURES

31 DECEMBER 2013

ALUBAF Arab International Bank B.S.C (c)
Basel II -Pillar III disclosures
As at 31 December 2013

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1. Introduction

Central Bank of Bahrain (“CBB”), the regulating body for Banks and Financial Institutions in the Kingdom of Bahrain, provides a common framework for the implementation of Basel II accord.

The Basel II framework is based on three pillars:

- Pillar I defines the regulatory minimum capital requirements by providing rules and regulations for measurement of credit risk, market risk and operational risk. The requirement of capital has to be covered by own regulatory funds.
- Pillar II addresses the Bank’s internal processes for assessing overall capital adequacy in relation to risks (ICAAP). Pillar II also introduces the Supervisory review and Evaluation Process (SREP), which assesses the internal capital adequacy.
- Pillar III complements the other two pillars and focuses on enhanced transparency in information disclosure, covering risk and capital management, including capital adequacy.

This document gathers together all the elements of the disclosure required under Pillar III and complies with the public disclosure module of CBB, in order to enhance corporate governance and financial transparency. This disclosure report is in addition to the financial statements presented in accordance with International Financial Reporting Standards (IFRS).

2. Corporate Structure

ALUBAF Arab International Bank B.S.C. (c) ("the Bank") is a closed Bahraini joint stock company incorporated in the Kingdom of Bahrain and registered with the Ministry of Industry and Commerce under Commercial Registration (CR) number 12819. The Bank operates under a wholesale banking license issued by the Central Bank of Bahrain under the new integrated licensing framework. The Bank’s registered office is at Alubaf Tower , Al Seef District, P O Box 11529, Manama, Kingdom of Bahrain.

The Bank is majority owned by Libyan Foreign Bank (Shareholding 99.50%), a bank registered in Libya.

3. Capital Structure

The Bank's Capital base comprise of Tier I capital, which includes share capital, statutory reserve and retained earnings and Tier II capital, which includes collective impairment loss provision.

The Bank's issued and paid up capital was US$ 250 million as at 31 December 2013, comprising of 5 million equity shares of US$ 50 each.

Break down of Capital Base

	Tier I	Tier II	Total
	US$'000	US$'000	US$'000
Share capital	250,000	-	250,000
Statutory reserve	13,597	-	13,597
Retained earnings	52,504	-	52,504
Collective impairment loss provision	-	5,700	5,700
Total available capital base	316,101	5,700	321,801
Less: Regulatory deductions			
Excess amount over maximum permitted exposure	4,895	4,895	9,790
Net available capital base	311,206	805	312,011

ALUBAF recorded a net profit of US$ 36,640 thousand for the year ended 31 December 2013 and transferred 10% of profits (US$ 3,664 thousand) towards Statutory reserve.

The Bank proposed a dividend of US$ 25,000 thousand, i.e. US$ 5.00 per Ordinary share for the year 2013.

4. Capital Adequacy Ratio (CAR)

The purpose of capital management at the Bank is to ensure the efficient utilization of capital in relation to business requirements and growth, risk profile and shareholders' returns and expectations.

The Bank manages its capital structure and makes adjustments in the light of changes in economic conditions and risk characteristics of its activities.

Capital adequacy ratio calculation:

	US$ '000
Total Eligible Capital Base	312,011
Risk weighted assets (RWA)	
Credit risk	648,125
Market risk	4,063
Operational risk	59,978
	712,166
Capital adequacy ratio	43.81%

The Bank's capital adequacy ratio of 43.81% is well above the minimum regulatory requirement of 12%.

5. Profile of risk-weighted assets and capital charge

The Bank has adopted the standardized approach for credit risk, market risk and the Basic indicator approach for operational risk for regulatory reporting purposes. The Bank's risk weighted capital requirement for credit, market and operational risks are given below:

5.1 Credit risk

Definition of exposure classes per Standard Portfolio

The Bank has funded and unfunded credit portfolio. The exposures are classified as per the Standard portfolio approach mentioned under the CBB's Basel II capital adequacy framework covering the standardized approach for credit risk.

The descriptions of the counterparty classes along with the risk weights used to derive the risk weighted assets are as follows:

(a) Claims on sovereigns

These pertain to exposures to governments and their central banks. Claims on Bahrain are risk weighted at 0%, while claims on other sovereigns, denominated in a non-relevant currency and unrated are assigned a risk weight of 100%.

(b) Claims on banks

Claims on Banks are risk weighted based on the ratings assigned to them by external rating agencies. However, short term claims on locally incorporated banks and claims maturing within three months and denominated in Bahrain Dinars or US Dollars are risk weighted at 20%. Other claims on banks, which are in foreign currency, are risk weighted using standard risk weights ranging from 20% to 100%. Unrated claims on banks are assigned a risk weight of 20% & 50% respectively.

(c) Claims on corporate portfolio

Claims on corporate portfolio are risk weighted based on external credit ratings and are assigned a risk weight of 100% for unrated corporate portfolio.

(d) Past due exposure

Past due exposures include Loans and advances of which interest or repayment of principal are due for more than 90 days; Past due exposures, net of specific provisions are risk weighted as follows:

(a) 150% risk weight, when specific provisions are less than 20% of the outstanding amount of loan.

(b) 100% risk weight, when specific provisions are greater than 20% of the outstanding amount of the loan.

(e) Equity portfolios

Investments in listed equities are risk weighted at 100%.

(f) Other exposures

These are risk weighted at 100%.

5. Profile of risk-weighted assets and capital charge (continued)

5.1 Credit risk (continued)

Credit exposure and risk weighted assets *US$ '000*

	Funded exposures	Unfunded exposures	Gross credit exposures	Eligible collateral	Risk weighted assets	Capital charge
Claims on sovereigns	119,860	1,102	120,962	-	81,120	9,734
Claims on banks	913,141	157,844	1,070,985	51,481	489,022	58,683
Claims on corporate	62,956	11,896	74,852	305	60,482	7,258
Equity portfolio	2,911	-	2,911	-	2,911	349
Other exposures	14,590	-	14,590	-	14,590	1,751
Total	1,113,458	170,842	1,284,300	51,786	648,125	77,775

Gross credit exposure before credit risk mitigation

US$ '000

	Gross credit exposure	Average monthly gross exposure
Claims from Sovereigns	119,860	95,991
Claims from Banks	913,141	961,456
Claims on Corporate	62,956	57,483
Equity Portfolio	2,911	2,093
Other exposures	14,590	13,944
Total funded exposure	1,113,458	1,130,967
Unfunded exposures	170,842	180,371
Gross credit exposures	1,284,300	1,311,338

Average monthly balance represents the average of the sum of twelve month end balance for the year ended 31 December 2013.

5.2 Market risk

The Bank's capital requirement for market risk in accordance with the standardised methodology is as follows:

US$ '000

	Risk weighted exposures	Capital charge	Maximum value	Minimum value
Foreign exchange risk	4,063	488	4,063	1,125

5. Profile of risk-weighted assets and capital charge (continued)

5.3 Operational risk

In accordance with the Basic indicator approach, the total capital charge in respect of operational risk was US$ 7,197 thousand on operational risk weighted exposure of US$ 59,978 thousand. This operational risk weighted exposure is computed using the Basic indicator approach, where a fixed percentage (Alpha), which is 15% of the average previous of three years' annual gross income, is multiplied by 12.5 operational capital charge; years with positive gross income are counted for computation of capital charge. This computation is as per CBB rulebook.

6. Risk Management

Risk is inherent in the Bank's business activities and is managed through a process of on going identification, measurement, controlling and monitoring. The Bank is exposed to credit risk ,market and operational risk. Risk strategies of the Bank to mitigate the various risks were effective throughout the year.

Following is the Risk and Capital Management Structure :

Board of Directors

Board Audit, Risk & Compliance Committee
Management Risk Committee
Asset Liability Management Committee

The Board of Directors is responsible for the best practice management and risk oversight. Board of Directors defines the risk appetite and risk tolerance standards and oversees that risk process standards are in place. At the second level, Executive management is responsible for the identification and evaluation on a continuous basis of all significant risks to the business and implementation of appropriate internal controls to minimize them. Senior management is responsible for monitoring credit lending portfolio, country limits and interbank limits and general credit policy matters, which are reviewed and approved by the Board of Directors.

Independent internal audit of risk management process is conducted and its findings are to the Audit , Risk and Compliance Committee, which is appointed by the Board of Directors.

6.1 Credit risk concentrations and thresholds

The first level of protection against undue credit risk is through country and industry threshold limits, together with individual borrower threshold limits. Single name concentrations are monitored on an individual basis. 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% of the regulatory capital base.

6. Risk Management (continued)

6.1 Credit risk concentrations and thresholds (continued)

As at 31 December 2013, the Bank's exposure in excess of 15% of the obligor limits to individual counterparties is shown below:

US $ '000	Funded exposure	Unfunded exposure	Total
Counterparty A *	117,298	Nil	117,298
Counterparty B *	65,000	Nil	65,000
Counterparty C **	58,060	Nil	58,060

* These are interbank deposits maturing within 6 months from 31 December 2013.

**Exempted by CBB in January 2014.

Risk mitigation – collateral

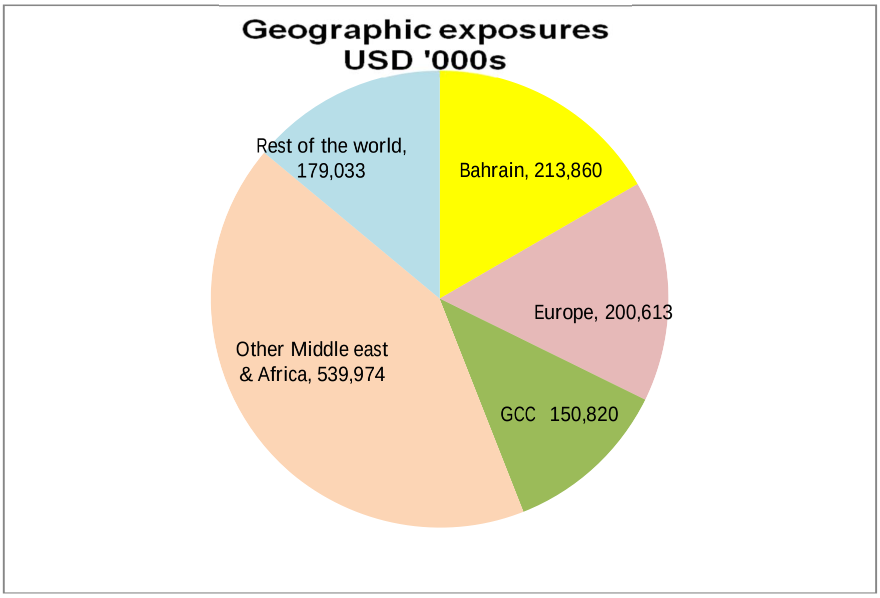
The amount and type of collateral depends on an assignment of the credit risk, credit rating and market conditions of the counterparty. The types of collateral mainly include cash collaterals for both funded and unfunded credit exposures, which is liquidated on maturity/expiry date. However, the impact on cash collateral will be nil with credit downgrade.

Majority of the collateral taken by the Bank is in cash; therefore, concentration risk on collateral is not significant. For further details on refer note 20.2 of the annual audited financial statements for the year ended 31 December 2013.

6.2 Geographical distribution of exposures based on residence is summarized below:

US$'000

	Gross credit exposure	Funded exposure	Unfunded exposure
Bahrain	213,860	213,860	-
Other GCC Countries	150,820	139,283	11,537
Other Middle east & Africa	539,974	382,813	157,161
Europe	200,613	200,503	110
Rest of the world	179,033	176,999	2,034
Total	1,284,300	1,113,458	170,842



6.2 Geographical distribution of exposures

The geographical distribution of gross credit exposures by major type of credit exposures can be analyzed as follows:

US$ '000

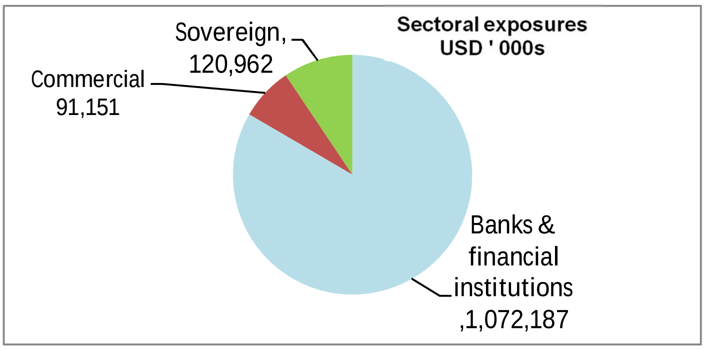
	Bahrain	Other GCC Countries	Other Middle East and Africa	Europe	Rest Of the world	Total
Claims from Sovereigns	22,370	14,096	59,265	5,168	18,961	119,860
Claims from Banks	171,811	107,194	323,522	161,766	148,848	913,141
Claims on Corporate	5,069	15,102	26	33,569	9,190	62,956
Equity Portfolio	20	2,891	-	-	-	2,911
Other exposures	14,590	-	-	-	-	14,590
Total funded exposure	213,860	139,283	382,813	200,503	176,999	1,113,458
Unfunded exposures	-	11,537	157,161	110	2,034	170,842
Gross credit exposures	213,860	150,820	539,974	200,613	179,033	1,284,300

6. Risk Management (continued)

6.3 Industry sector analysis of exposures is summarized below:

US$ '000

	Gross credit exposure	Funded exposure	Unfunded exposure
Sovereign	120,962	119,860	1,102
Banks & financial institutions	1,072,187	914,343	157,844
Commercial & other businesses	91,151	79,255	11,896
Total	1,284,300	1,113,458	170,842



The industry sector analysis of gross credit exposures by major types of credit exposures can be analyzed as follows:

USD '000s

	Banks & financial institutions	Sovereign	Commercial & other businesses	Total
Claims from Sovereigns	-	119,860	-	119,860
Claims from Banks	913,141	-	-	913,141
Claims on Corporate	-	-	62,956	62,956
Equity Portfolio	1,202	-	1,709	2,911
Other exposures	-	-	14,590	14,590
Total funded exposure	914,343	119,860	79,255	1,113,458
Unfunded exposures	157,844	1,102	11,896	170,842
Gross credit exposures	1,072,187	120,962	91,151	1,284,300

6. Risk Management (continued)

6.4 Exposure by external credit rating

The Bank uses external credit ratings from Standard & Poors, Moodys and Fitch, which are accredited External Credit Assessment Institutions (ECAI). The Bank assigns risk weights through the mapping process provided by CBB to the rating grades. The Bank uses the highest risk weight associated, in case of two or more eligible ECAI are chosen. The breakdown of the Bank's exposure into rated and unrated categories is as follows:

US$ '000

	Funded exposure	Unfunded exposure	Rated-High standard grade exposure	Rated-Standard grade exposure	Unrated exposure
Claims on sovereigns	119,860	1,102	-	71,939	49,023
Claims on banks	913,141	157,844	133,294	344,845	592,846
Claims on corporate	62,956	11,896	11,688	34,416	28,748
Equity portfolio	2,911	-	649	100	2,162
Other exposures	14,590	-	-	-	14,590
Total	1,113,458	170,842	145,631	451,300	687,369

6.5 Maturity analysis of funded exposures

Residual contractual maturities of the Bank's funded exposures are as follows:

US$ '000

	Within 1 month	*1-3 months*	*3-12 months*	*Total within 1 year*	*1-10 years*	*10-20 Years*	*Undated*	*Total*
Claims on Sovereigns	1,533	2,513	8,489	12,535	64,686	42,639	-	119,860
Claims on Banks	347,716	291,906	187,849	827,471	77,637	8,033		913,141
Claims on Corporate	250	1,014	4,500	5,764	36,177	21,015		62,956
Equity Portfolio	-	-	-	-	-	-	2,911	2,911
Other exposures	2	311	28	341	883	-	13,366	14,590
Total	349,501	295,744	200,866	846,111	179,383	71,687	16,277	1,113,458

6. Risk Management (continued)

6.6 Maturity analysis of unfunded exposures

US$ '000

	Notional principal	*Within 1 month*	*1-3 months*	*3-12 months*	*Total within 1 year*	*Over one year*	*Total*
Claims from Sovereign	1,102	1,102	-	-	1,102	-	1,102
Claims from Banks	157,844	22,547	37,105	91,067	150,719	7,125	157,844
Claims from Corporate	11,896	9,940	567	1,370	11,877	19	11,896
Total	170,842	33,589	37,672	92,437	163,698	7,144	170,842

Credit-related contingent items:

Credit related contingent items comprise letters of credit confirmations, acceptance and guarantees. For credit-related contingent items, the nominal value is converted to an exposure through the application of a credit conversion factor (CCF). The CCF applied is at 20% to convert off balance sheet notional amounts into an equivalent on balance sheet exposure.

6.7 Impairment of assets

The Bank makes an assessment at each balance sheet date to determine whether there is objective evidence that a specific financial asset may be impaired. If such evidence exists, an impairment loss is recognized in the statement of comprehensive income.

Evidence of impairment may include indications that a borrower is experiencing significant financial difficulty, default or delinquency in interest or principal payments, the probability that the borrower will enter bankruptcy or other financial re-organisation and where, observable data indicates, that there is a measurable decrease in the estimated future cash flows such as changes in arrears or economic conditions that correlate with defaults.

The Bank provides sufficiently by specific provision for any impairment and additionally, makes a minimum collective provision of 1% of the net loans portfolio as required by the regulator.
Refer Disclosures made under 7.2 for details of impaired loans and relative specific provision made during 2013.

6.8 Market Risk

Market risk is the risk of potential financial loss that may arise from adverse changes in the value of a financial instrument or portfolio of financial instruments due to movements in interest rates, foreign exchange rates and equity prices. This risk arises from asset - liability mismatches, changes that occur in the yield curve and foreign exchange rates. Given the Bank's low risk strategy, aggregate market risk levels are considered very low.

6. Risk Management (continued)

Interest rate risk on the Banking book arises from the possibility that changes in interest rates will affect the value of financial instruments. 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 basis point value approach, which measures changes in economic value resulting from changes in interest rates. The Bank's interest rate sensitivity position as of 31 December 2013 for a change in 200 basis points will result in an increase or decrease on statement of income by +/(-) US$ 2,331 thousand for US$ denominated and US$ 43 on Euro denominated financial instruments.

Currency risk arises from the movement of the rate of exchange over a period of time. The Banks currency risk is limited to Euro denominated assets and liabilities, as Bahrain Dinars and GCC Currencies (except Kuwaiti Dinars) are pegged to US Dollars. The Bank limits this risk by monitoring positions on a regular basis. Thus, the Banks' exposure to currency risk is minimal and insignificant.

Liquidity risk is the risk that the Bank will be unable to meet its funding requirements. Liquidity risk can be caused by market disruptions or a credit downgrade which may cause certain sources of funding to dry up immediately. During 2013, the Bank depended mainly on its own capital and assets were managed with liquidity in mind, maintaining a healthy balance of cash, cash equivalents and deposits with banks.

6.9 Operational Risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes or systems, or from external events. Operational risk is inherent in all business activities and can never be eliminated entirely, however shareholder value can be preserved and enhanced by managing, mitigating and, in some cases, insuring against operational risk. To achieve this goal, the Bank intends to make operational risk transparent throughout the enterprise, to which end processes are being developed to provide for regular reporting of relevant operational risk management information to senior management and the Board of Directors.

Operational functions of booking, recording and monitoring of transactions are performed by staff that are independent of the individuals initiating the transactions. Each business line including Operations, Information Technology, Human Resources, Compliance and Financial Control – is further responsible for employing the aforementioned framework processes and control programmes to manage its operational risk within the guidelines established by the Bank policy, and to develop internal procedures that comply with these policies.

6.Risk Management (continued)

6.10 Capital management :

Internal Capital Adequacy Assessment Process (ICAAP)

The Bank's capital management aims to maintain an optimum level of capital to enable it to pursue the Bank's corporate strategies whilst meeting regulatory ratio requirements.
Comprehensive assessment of economic capital, i.e., credit, market and operational risks and processes relating to other risks such as liquidity, is made, reviewed and monitored regularly. The Bank's capital adequacy ratio of 43.81% is well above the regulatory requirement and provides a healthy cushion against any stress conditions.

Supervisory Review and Evaluation Process (SREP):

Central Bank of Bahrain (CBB) is the regulator for the Bank and sets the minimum capital requirement. CBB requires the Bank to maintain a 12% minimum ratio of total capital to risk weighted assets, taking into account both on balance sheet and off balance sheet exposures. The Bank maintains a strong and healthy capital adequacy ratio.

7 Other Disclosures

7.1 Related Party transactions

Related party represents major shareholders, directors, key management personnel and entities significantly influenced by such parties. Pricing policies are at arm's length and approved by executive management and Board of Directors.

	31 December 2013 *US$ '000*
Exposures to related parties:	96,303
Liabilities to related parties:	
Connected deposits	262,613

For further detail refer note 22 of the annual audited financial statements for the year ended 31 December 2013.

7 Other Disclosures (continued)

7.2 Impaired loans and related provision:

	31 December 2013 *US$ '000*
Gross impaired loans	4,019
Less: Specific provision	(4,019)
Net impaired loans	-

Movement in impairment provision:

US$ '000	Specific Provision	Collective Provision	Interest in suspense	Total
Opening balance -1 January 2013	3,867	3,200	229	7,296
Charge /movement during the year	1,517	2,500	23	4,040
Closing balance -31 December 2013	5,384	5,700	252	11,336

The impaired loans and provisions against these loans (both collective and specific) relate to commercial and business loans in Middle east and Other GCC Countries. The collaterals consist of securities and properties which are managed by the syndicated agent and valued on an annual basis.

For policies and processes for collateral valuation refer note 20.2 of the annual audited financial statements for the year ended 31 December 2013.

Ageing analysis of past due and impaired loans by sector and geographical area:

US$'000s	Other GCC Countries	Middle East & North Africa	Total
	<= 3 years	More than 90 days	
Claims on corporate	2,502	-	2,502
Claims on Banks	-	1,517	1,517
Total	2,502	1,517	4,019
Less: Specific Provision	(2,502)	(1,517)	(4,019)
Net Impaired loans	-	-	-

7 Other Disclosures (continued)

7.3 Restructured facilities:

	31 December 2013
	US$ '000
Balance of any restructured credit facilities as at year end	8,828
Loans restructured during the year	3,705
Impact of restructured credit facilities on present and future earning	-

Interest concession was made on restructured loan.

7.4 Assets sold under recourse agreements: The Bank did not enter into any recourse agreements during the year ended 31 December 2013.

7.5 Equity positions in the banking book :

	31 December 2013
	US$ '000
Equity	2,911

The Bank's exposure to equity price risk is not significant. Please refer note 20.3.3 of the annual audited financial statements for the year ended 31 December 2013.