اليوباف
alubaf
بنك اليوباف العربي الدولي ش.م.ب (م)
Alubaf Arab International Bank B.S.C (c)

# BASEL III PILLAR 3 DISCLOSURES

## At 31 DECEMBER 2019

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## 1. Executive Summary

This document provides the disclosures pertaining to risk and capital management for Alubaf Arab International Bank B.S.C. (c) ("the Bank") as of 31 December 2019. The purpose of the document is to enhance the financial transparency through better public disclosure (as required by CBB public disclosure module) and facilitate the market discipline to align with Basel III accord.

Central Bank of Bahrain ("CBB"), the regulating body for Banks and Financial Institutions in the Kingdom of Bahrain has issued the directives relating to public disclosures. The disclosure requirements in PD module of CBB rulebook follow the requirements of Basel III Pillar 3 and are in addition to, or in some cases serve to clarify, the disclosure requirements of IFRS. This document gathers all the elements of the disclosures required under Pillar III and complies with the public disclosure module of CBB (including companies law), in order to enhance corporate governance and financial transparency. The Pillar 3 disclosures are to be read in conjunction with the financial statements of the Bank presented in accordance with International Financial Reporting Standards (IFRS) as of 31 December 2019 as well as the capital disclosures and liquidity disclosures published separately on the Bank's website.

For regulatory reporting purposes, the Bank has adopted the standardized approach for credit risk and market risk and the basic indicator approach for operational risk to determine the capital requirements under Pillar 1.

The Bank's total risk-weighted assets as of 31 December 2019 amounted to US$ 658.0 million (2018: US$ 709.9 million), comprising 89.6% credit risk, 0.3% market risk and 10.1% operational risk. The total capital adequacy ratio was 50.99% (2018: 42.84%), compared to the minimum regulatory requirement of 12.5%.

| Figures in $ 000s | FYE 2019 | FYE 2018 |
|---|---|---|
| Tier 1 capital | 328,615 | 296,278 |
| Tier 2 capital | 6,937 | 7,840 |
| **Total Capital** | **335,552** | **304,118** |
| Credit risk weighted assets | 589,831 | 627,192 |
| Market risk weighted assets | 1,675 | 150 |
| Operational risk weighted assets | 66,528 | 82,555 |
| **Total Risk Weighted assets** | **658,034** | **709,897** |
| **Tier 1 Capital Ratio** | **49.94%** | **41.74%** |
| **Total Capital Ratio** | **50.99%** | **42.84%** |

## 2. Basel III Framework

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

- Pillar 1: the calculation of risk-weighted assets (RWAs) and capital requirements for credit, market and operational risks.
- 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.

### 2.1 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. As at 31st December 2019, all banks incorporated in Bahrain are required to maintain a minimum capital adequacy ratio of 12.5 per cent and a tier 1 ratio of 10.5 per cent. 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.

The table below summarizes the Bank's approach for calculating RWAs and capital requirements for each risk type in accordance with the CBB's Basel 3 capital adequacy framework:-

| Approaches for determining regulatory capital requirements | | |
|---|---|---|
| Credit risk | Market risk | Operational risk |
| Standardized approach | Standardized approach | Basic indicator approach |

#### a) Credit Risk

For regulatory reporting purposes, the Bank applies the standardized approach for credit risk. 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.

#### b) Market Risk

For the regulatory market risk capital requirement, the Bank applies the standardized approach based on net open position of foreign currencies as per CA module of the CBB rule book.

#### c) Operational Risk

Under the CBB's Basel 3 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 standardized approach. Currently, the Bank uses the Basic Indicator Approach for calculating its capital requirement for operational risk.

## 2.2 Pillar 2

Pillar 2 defines the process of supervisory review of an institution's risk and capital management framework and, ultimately, its capital adequacy. Under the Pillar 2 guidelines, each Bank is required to internally assess its capital requirements taking into consideration all material risks through the ICAAP assessment process and establish internal minimum capital limits.

Pillar 2 comprises of two processes:-
- An Internal Capital Adequacy Assessment Process (ICAAP), and
- A supervisory review and evaluation process.

**Internal Capital Adequacy Assessment Process (ICAAP):**

The Bank has a capital management and planning framework which ensures adequate capital is available for any expected/unexpected loss and to support its strategic growth opportunities. The capital planning of the Bank is carried out through Internal Capital Adequacy Assessment Process (ICAAP) which covers inter-alia:

- Forecast of the strategic and business growth plan of the Bank over the next 3 years
- Quantitative and qualitative assessment of various external and internal risk factors
- Assessment of capital adequacy under normal and stress scenarios
- Planning of capital action, if any, required to accomplish the strategic and financial objectives of the Bank.

The Bank has a comprehensive internal capital adequacy assessment process (ICAAP) that includes board and senior management oversight, monitoring, reporting and internal control reviews, to identify and measure the various risks that are not covered under Pillar 1 risks and to regularly assess the overall capital adequacy considering the risks and the Bank's planned business strategies. The non-Pillar 1 risks covered under the ICAAP process include concentration risk, liquidity risk, interest rate risk in the banking book, reputational risk and strategic risks. The ICAAP also keeps in perspective the Bank's strategic plans, credit and investment growth expectations, future sources and uses of funds, dividend policy and the impact of all these on maintaining adequate capital levels. In addition, the ICAAP process also includes stress testing on the Bank's capital adequacy to determine the capital requirement and planning to ensure that the Bank is adequately capitalized in line with the overall risk profile.

The Bank has complied with regulatory capital requirements throughout the year. The Bank's capital adequacy ratio of 50.99% is well above the regulatory requirement and provides a healthy cushion against any stress conditions.

**Supervisory Review and Evaluation Process (SREP):**

The supervisory review and evaluation process represents the CBB's review of the Bank's capital management and an assessment of internal controls and corporate governance. The supervisory review and evaluation process is designed to ensure that Banks 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
- Concentration risk
- Interest rate risk in the banking book (IRRBB)
- Reputational risk
- Strategic risk

These are covered either by capital, or risk management and mitigation processes under Pillar 2.

## 2.3 Pillar 3

In the CBB's Basel 3 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 disclosures consisting mainly of quantitative analysis is required during half year reporting, whereas full disclosure is required to coincide with the financial year-end reporting. In this report, the Bank 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). These disclosures should be read in conjunction with the Bank's audited financial statements for the year ended December 31, 2019.

# 3. Organizational structure, Risk and Capital Management

## 3.1 Organization structure

The Bank operates under a wholesale banking license issued by Central Bank of Bahrain, to provide Treasury, Loan and Trade finance banking solutions. The Bank's customer base includes primarily Corporate, Banks, Investment Companies, Governments and Semi-government Entities, Public Sector Companies in the GCC and MENA markets as well select other countries across the world.

The Bank's largest single shareholder is Libyan Foreign Bank (99.50%); other shareholders comprise of National Bank of Yemen (0.28%) and Yemen Bank for Reconstruction and Development (0.22%). Libyan Foreign Bank (LFB) is 100% owned by the Central Bank of Libya.

The Bank's financial statements are prepared and published in accordance with IFRS. Regulatory capital is reported to the CBB on a regular basis (at least on quarterly basis by way of submitting the Prudential Information Return report) in accordance with CBB capital adequacy guidelines.

## 3.2 Risk and Capital Management

The Bank 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 Bank's risk management is underpinned by its ability to identify, measure, aggregate and manage the different types of risk it faces.

The overall authority for risk management in the Bank is vested in the Board of Directors. The Board defines the risk appetite and risk tolerance standards and oversees that adequate risk management standards are in place. The Board also approves appropriate risk policies that form part of its risk management framework, based on the recommendation of management. The Board is supported by the Audit, Risk and Compliance Committee (ARCC) which oversees the risk management, compliance and internal audit activities as well as ensuring integrity of the financial statements.

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, interbank limits, and general credit policy matters, which are reviewed and approved by the Board of Directors. The Bank has established various management committees that review and assess all risk issues. Approval authorities are delegated to different functionaries in the hierarchy depending on the amount, type of risk and nature of operations or risk and the same is codified in the Delegations of Authority (DOA) document approved by the Board.

The Risk Management Department of the Bank provides the necessary support to senior management and the business units in all areas of risk management. The risk management function under the Chief Risk Officer is independent of the business units of the Bank, reporting to the Board Audit, Risk and Compliance Committee and administratively to the Chief Executive Officer. The Financial Control Department is responsible for the capital planning process.

Independent internal audit of the risk management process is conducted and its findings are presented to the Audit, Risk and Compliance Committee.

Following is the governance structure for Risk and Capital Management in the Bank:

| Board of Directors | | | |
|---|---|---|---|
| Board Audit Risk and Compliance Committee (ARCC)* | | | |
| Chief Executive Officer (CEO) | | | |
| Assets and Liabilities Committee (ALCO) | Management Risk Committee (MRC) | Credit Investment Committee (CIC) | Special Asset Management Committee (SAMC) |

* Chief Risk Officer (CRO) is an independent function which reports to the ARCC, and administratively to the CEO.

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

| Chief Executive Officer | |
|---|---|
| Head of Financial Control | Chief Risk Officer (CRO) |
| Capital management framework<br>Regulatory Reporting | Risk management framework and policies<br>Credit Management<br>Credit risk<br>Market risk<br>Operational risk<br>Liquidity and Other risks |

The Bank's capital management policies aim to ensure that the Bank complies with regulatory capital requirements as well as to ensure adequate availability of capital to meet the Bank's strategic growth requirements and maximize shareholder value.

## 3.3 Risk Types

The major risks associated with the Bank's business activities are credit, market and operational risks. Additionally, other material risks that the Bank is exposed to include – liquidity, concentration, interest rate, reputational and strategic risks. These risks are continuously monitored and mitigated through effective process of ongoing identification, measurement, controlling and monitoring throughout the year. The following section provides the way these risks are managed and controlled.

## 3.4 Risks in Pillar I

Basel 3 Pillar 1, which forms the basis for the calculation of the regulatory capital requirement, addresses three specific risk types: credit, market and operational risk:

### a) Credit risk

The credit risk is the main financial risk relative to the other risks for the Bank because of its nature of business to finance and invest. Credit risk represents the potential financial loss as a consequence of a customer's inability to honour the terms and conditions of a credit facility. Such risk is measured with respect to counterparties for both on-balance sheet assets and off-balance sheet items.

The Bank measures and manages Credit Risk by adhering to the following principles:

- Consistent standards are applied across all customers in the Risk-evaluation process using a rating system. The Bank has in place a systematic rating system which provides a framework for objective risk assessment.
- The exposure should be reasonable in relation to the customer's creditworthiness, capital position or Networth components, and the customer should be able to substantiate its repayment ability
- Every extension of credit or material change to a credit facility (such as its tenor, collateral structure or major covenants) to any counterparty requires credit approval at the appropriate authority level
- The Bank regularly follows up on developments in the customer's financial position in order to assess whether the basis for the granting of credit has changed.
- The Bank assumes risks within the limits guided under its risk management framework and other rules prescribed by the CBB from time to time.

The Bank has in place a credit risk management framework comprising of detailed credit risk management policies and procedures, regular credit assessments and monitoring, internal rating grades, credit administration activities, collateral management and early warning indicator monitoring. Regular reviews are carried out for each exposure and risks identified are mitigated in a number of ways, which include obtaining collaterals or guarantees. The counterparty credit risks are continuously monitored for changes in external environments and other economic challenges that may impact the counterparty's credit profile as part of early warning indicator monitoring. Similarly, prudent norms have been implemented to govern the Bank's investment activities, which specify to the Bank's treasury department the acceptable levels of exposure to various products, based on its nature, tenor, rating, type, features and other relevant factors.

The business units of the Bank are responsible for business generation and initial credit review of proposals in accordance with the stipulated policy requirements. The Bank has an independent Credit Management unit which is responsible to perform a rigorous independent credit analysis for the counterparty and assign an internal rating reflecting the level of credit risk. In addition, the

independent credit administration unit ensures that adherence to the terms and conditions of all credit facilities are strictly implemented and collateral coverage is monitored. The Bank has an internal grading system and review process ensures identification of any deterioration in credit risk and consequent implementation of corrective action. The Bank's internal ratings are based on a 16-point scale (AAA to D), which takes into account the financial strength of a borrower as well as qualitative aspects to arrive at a comprehensive snapshot of the risk of default associated with the borrower. Risk ratings assigned to each borrower are reviewed on at least an annual basis. Regular monitoring of the portfolio enables the Bank to identify accounts, which witness deterioration in risk profile.

**b) Market Risk**

Market risk is the potential impact of adverse price movements such as benchmark interest rates, foreign exchange prices, equity prices and commodity prices on the Bank's earnings and capital. The exposure to market risk occurs throughout the contract which may negatively affect the earnings and value of an asset.

The categories of market risk to which the Bank 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. This Interest rate risk on the banking book arises due to the re-pricing mismatch in the assets and liabilities due to the tenure mismatch.

**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 Bank's foreign exchange positions in the banking book including its proprietary positions as well as positions arising from client servicing.

**Equity risk** arises from exposures to changes in the price and volatility of individual equities or equity indices. The Bank does not maintain any equity exposures as at reporting date and therefore is not exposed to equity price risks.

The Bank does not have material exposure to market risk on account of its limited trading activities. The Bank's market risk management framework comprises of a various concentration limits to diversify its market risk exposures as well as stop loss limits to minimize losses. The main market risk exposures arise from its forex risk exposures, wherein the Bank maintains net open position limits for each active currency which are monitored on a daily basis.

**c) 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.

The operational risk management framework (ORMF) is codified in the Bank's Operational risk management policy and broadly comprises of the following:

- Well defined governance framework and delegation of authorities
- Detailed policies and procedures for all activities of the Bank
- Segregation of duties and internal controls
- Risk and Controls Self-assessments
- Identifying and monitoring of Key Risk Indicators
- Incident reporting and collection of losses from operational incidents, including near misses.

Risk and Control Self-Assessment ("RCSA") is performed on a periodic basis, by obtaining senior management inputs to enhance the control environment of the Bank. Heads of departments and functions throughout the Bank are responsible for maintaining an acceptable level of internal control commensurate with the scale and nature of operations, and for identifying and assessing risks, designing controls and monitoring the effectiveness of these controls. The ORMF helps managers to fulfil these responsibilities by defining a standard risk assessment methodology and providing a tool for the systematic reporting of operational loss data. Operational incidents are monitored on an ongoing basis through the Bank's operational risk management system, and the same are reported to management on a monthly basis and to the Board on a quarterly basis. Moreover, the operational incident reports are reviewed jointly by risk management and the respective department for root cause analysis and to introduce additional controls to minimize chances of similar incident recurring.

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 as well support line is further responsible for employing the aforementioned framework processes and control programs to manage its operational risk within the guidelines established by the Bank policy, and to develop internal procedures that comply with these policies. Operational risk is also managed through effective staff training and frequent review and enhancement of internal controls of the various activities of the Bank. Further, the Bank has in place the Business Continuity and Disaster Recovery Policy (BCP/DRP) to ensure that the Bank is prepared and has contingency plans in place in the event of a disaster so that business is minimally impacted in such situations.

## 3.5 Risk in Pillar II

### a) Liquidity Risk

Liquidity risk is defined as the risk to the Bank's earnings and capital arising from its inability to meet timely obligations as and when they come due without incurring unacceptable losses. The Bank follows a conservative liquidity risk management strategy aligned with its business model. The strategy aims to address:

- Funding liquidity risk and
- Market liquidity risk

The Bank utilizes the liquidity management tools in line with Basel 3 and revised CBB guidelines on liquidity risk management. The Liquidity Coverage Ratio (LCR) addresses the sufficiency of a stock of high quality liquid assets to meet short-term liquidity needs under specified scenarios. Under LCR, the objective is to ensure that Bank maintains an adequate level of unencumbered, high quality assets that can be converted into cash to meet its liquidity needs, under specific prescribed cash inflows and outflows scenarios, for a 30 day time horizon.

The Net Stable Funding Ratio (NSFR) addresses longer-term structural liquidity mismatches. Under NSFR, the objective is to promote more medium and long-term funding of assets through the establishment of a minimum acceptable amount of stable funding over a one year horizon. The Bank maintains its liquidity standards with stable long term and short term liquidity ratios (NSFR, LCR, Liquidity Ratio etc.) above the regulatory limits.

The Bank has in place a liquidity risk management framework comprising of liquidity and funding strategy, liquidity risk limits, procedures for monitoring and reporting liquidity risks, liquidity stress testing and contingency planning. The liquidity risk management framework is codified in the Bank's Liquidity Risk Policy approved by the Board.

The Bank performs periodic stress testing of its liquidity risk profile to assess its impact on capital and liquidity position.

**b) Credit concentration risk**

Credit Concentration Risk is the risk that the Bank's exposures are concentrated to a sector/industry, geography, product, single party and customer groups, or countries which impacts the Bank's capital position. It is the risk of exposure to a single counterparty and group of related counterparties, as well as the exposure to selected economic sectors that has the potential to produce losses large enough (relative to the Bank's size) to undermine the health of the Bank. The existence of exposure concentration can lead to underestimation of Pillar I risks. The Bank monitors counterparty, sector and geographic concentration risks and manages the same through limits on the same. Regular reports are prepared and analyzed to ensure that undesired concentrations are avoided.

Concentration risk is captured in the Bank's Pillar 2 capital framework which considers single-name concentrations, Geographical and Industry concentrations in the credit portfolio and capital requirements to cover concentration risks are assessed.

**c) Interest rate risk in the Banking book**

Interest rate risk is the exposure of a bank's financial condition to adverse movements in Interest rates. Changes in Interest rates affect a bank's earnings by changing its net Interest income and the level of other Interest-sensitive income and operating expenses. Changes in Interest rates also affect the underlying value of the bank's assets, liabilities, and off-balance-sheet (OBS) instruments because the present value of future cash flows change when Interest rates change.

The Bank monitors the re-pricing gap and the market value of Asset and Liabilities as part of Interest Rate Risk management and also assesses the impact of a shift in market Interest rates on the expected net profit income of the Bank.

The Bank assesses the Earnings at Risk due to a shift of 200 bps in benchmark interest rates for allocating capital to cover its interest rate risk in the banking book.

**d) Reputational Risk**

Reputational risk is the risk of losses resulting from adverse perceptions about the Bank, its brand and relationship by its various stakeholders that is caused by a variety of internal and external factors. The Bank has developed a reputational risk management framework that ensures reputational risk is managed and mitigated and the same is codified in the Reputational risk management policy of the Bank.

**e) Strategic Risk**

Strategic risks refer to the risk that the Bank would be exposed in the event of business strategy and plan not materializing. It is the risk to earnings and profitability arising from strategic decisions, changes in the business conditions and improper implementation of decisions. Thus, a strategic risk arises due to adopting wrong strategies and choices that can cause loss to the bank in the form of a reduction in shareholder value and loss of earnings.

The strategic risk is managed through monthly reviews of performance versus budgeted performance and periodic reviews of the Bank's performance and alignment with the strategic plan.

# 4. Regulatory capital requirements and the capital base

## 4.1 Capital base

The Bank's Capital base comprise of Tier I capital, which includes share capital, statutory reserve, retained earnings and fair value changes FVOCI investments and Tier II capital, which includes expected credit loss, stage 1 and 2 (ECL Stage 1 & 2) provision.

The Bank's issued and paid up capital was US$ 250 million as at 31 December 2019, comprising of 5 million equity shares of US$ 50 each.

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

| Break down of Capital Base | US$ '000s | US$ '000s |
|---|---|---|
| | CET I | Tier II |
| Share Capital | 250,000 | - |
| Statutory reserve | 25,631 | - |
| Retained earnings | 23,478 | - |
| Current interim net profit | 28,741 | - |
| Cumulative fair value changes on FVOCI Investments (Debt) | 1,787 | - |
| **Total CET I capital prior to regulatory adjustments** | **329,637** | - |
| **Less: intangibles other than mortgage rights** | **(1,464)** | - |
| **Add: cash flow hedge reserve** | **442** | - |
| **Total CET I capital after regulatory adjustment** | **328,615** | - |
| Expected credit losses (ECL) Stage 1 & 2 | - | 6,937 |
| **Total** | **328,615** | **6,937** |
| **Total available capital** | | **335,552** |

Common equity tier 1 (CET 1) comprises of share capital, statutory reserve and retained earnings, adjusted with regulatory adjustments of revaluation gain or loss arising on the measurement to fair value of derivative cash flow hedging amortization and includes unrealized gains or losses arising on the measurement to fair value of investment securities. The Bank does not maintain any additional-Tier 1 (AT1) capital.

Tier II capital includes expected credit loss, stage 1 and 2 (ECL Stage 1 & 2) provision.

## 4.2 Regulatory capital requirements

For regulatory reporting purposes, the Bank calculates the capital requirements as per follows:

- **Credit Risk -** Credit risk capital requirements are based on the standardized approach. Under the standardized 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 3 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 standardized 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. The Bank uses ratings assigned by Standard & Poor's, Moody's and Fitch.
- **Market Risk –** The Bank uses a Standardized approach to calculate the regulatory capital requirements relating to market risk.

- **Operational Risk -** The capital requirement for operational risk is calculated in accordance with the basic indicator approach. Under this approach, the Bank's average gross income over the preceding three financial years is multiplied by alpha coefficients of 15% as prescribed in the CBB's Basel 3 capital adequacy framework.

- **Capital adequacy ratio calculation:**

The Bank's capital adequacy ratio of 50.99% is well above the minimum regulatory requirement of 12.5%.

| | US$ '000 |
|---|---:|
| Credit risk weighted assets | 589,831 |
| Market risk weighted assets | 1,675 |
| Operational risk weighted assets | 66,528 |
| **Total Risk weighted assets (RWA)** | **658,034** |
| **Total Eligible Capital Base (refer 4.1)** | **335,552** |
| **CET I ratio** | **49.94%** |
| **Capital adequacy ratio** | **50.99%** |

# 5. Credit risk-Pillar 3 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 3 framework in relation to Pillar 3 disclosure requirements.

## 5.1 Definition of exposure classes per Standard Portfolio

The Bank 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 3 capital adequacy framework for the standardized approach for credit risk. A high-level description of the counterparty exposure classes and 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 respective central banks. Claims on Bahrain and GCC governments are risk weighted at 0%. Foreign currency claims on other sovereign exposures are risk-weighted based on their external credit ratings or if unrated at 100%.

**(b) Claims on PSE**

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.

**(c) 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.

**(d) 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.

**(e) Equity portfolios**

Investments in listed equities are risk weighted at 100%.

**(f) Any exposure exceeding 15% of Total capital:** Claims on Banks or Corporate and other sovereigns or equity exposure that exceed 15% of total capital are risk weighted at 800%.

**(g) Other exposures:** These are risk weighted at 100%.

**(h) 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.

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

**5.2 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** | 567,048 | - | **567,048** | **-** | **72,220** | **9,028** |
| **Claims on banks** | 517,164 | 78,871 | **596,035** | **4,807** | **432,698** | **54,087** |
| **Claims on corporate** | 64,837 | - | **64,837** | **-** | **74,977** | **9,372** |
| **Other exposures** | 9,936 | - | **9,936** | **-** | **9,936** | **1,242** |
| **Total** | **1,158,985** | **78,871** | **1,237,856** | **4,807** | **589,831** | **73,729** |

*Balances are gross up of ECL

**5.2 (a). Gross credit exposure before credit risk mitigation**

| US$ '000 | Gross credit exposure | Average monthly gross exposure* |
|---|---|---|
| Claims from Sovereigns | 567,048 | 521,819 |
| Claims from Banks | 517,164 | 554,154 |
| Claims on Corporate | 64,837 | 59,488 |
| Other exposures | 9,936 | 2,405 |
| **Total funded exposure** | **1,158,985** | **1,137,866** |
| **Unfunded exposures** | **78,781** | **81,318** |
| **Gross credit exposures** | **1,237,856** | **1,219,184** |

* Average monthly balance represents the average of the sum of twelve-month end balance for the year ended 31 December 2019.

**5.3 Exposure by external credit rating**

The Bank uses external credit ratings from Standard & Poor's, Moody's 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 | Eligible collateral | Risk weighted assets | Capital charge |
|---|---|---|---|---|---|---|---|---|
| Claims on Banks | 517,164 | 78,871 | 156,862 | 329,883 | 109,290 | 4,807 | 432,698 | 54,087 |
| Claims on Sovereigns | 567,048 | - | 11,167 | 548,070 | 7,811 | - | 72,220 | 9,028 |
| Claims on Corporate | 64,837 | - | - | 41,208 | 23,629 | - | 74,977 | 9,372 |
| Other exposures | 9,936 | - | - | - | 9,936 | - | 9,936 | 1,242 |
| **Total** | **1,158,985** | **78,871** | **168,029** | **919,161** | **150,666** | **4,807** | **589,831** | **73,729** |

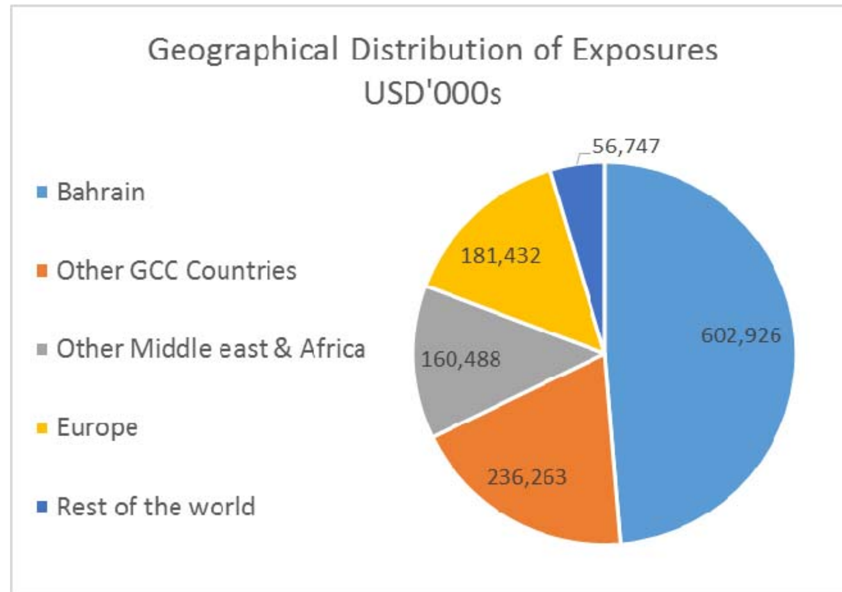
## 5.4 Geographical distribution of exposures

Geographical distribution of exposures based on residence is summarized below:

| US$'000 | Gross credit exposure | Funded exposure | Unfunded exposure |
|---|---|---|---|
| Bahrain | 602,926 | 602,926 | - |
| Other GCC Countries | 236,263 | 233,829 | 2,434 |
| Other Middle east & Africa | 160,488 | 105,677 | 54,811 |
| Europe | 181,432 | 160,522 | 20,910 |
| Rest of the world | 56,747 | 56,031 | 716 |
| **Total** | **1,237,856** | **1,158,985** | **78,871** |

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

| US$ '000 | Bahrain | Europe | Other GCC Countries | Other Middle East and Africa | Rest of the world | Total |
|---|---|---|---|---|---|---|
| Claims from Banks | 139,703 | 119,591 | 165,299 | 36,540 | 56,031 | **517,164** |
| Claims from Sovereigns | 448,251 | - | 49,660 | 69,137 | - | 567,048 |
| Claims on Corporate | 5,036 | 40,931 | 18,870 | - | - | 64,837 |
| Other exposures | 9,936 | - | - | - | - | 9,936 |
| **Total funded exposure** | **602,926** | **160,522** | **233,829** | **107,346** | **56,031** | **1,158,985** |
| **Unfunded exposures** | - | **20,910** | **2,434** | **54,811** | **716** | **78,871** |
| **Gross credit exposures** | **602,926** | **181,432** | **236,263** | **160,488** | **56,747** | **1,237,856** |

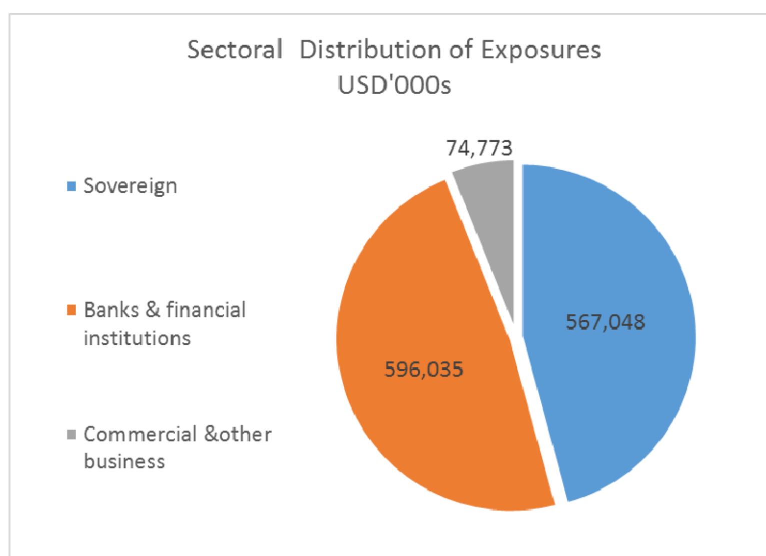



## 5.5 Industry sector analysis of exposures

| US$ '000 | Gross credit exposure | Funded exposure | Unfunded exposure |
|---|---|---|---|
| Sovereign | 567,048 | 567,048 | - |
| Banks & financial institutions | 596,035 | 517,164 | 78,871 |
| Commercial & other business | 74,773 | 74,773 | - |
| **Total** | **1,237,856** | **1,158,985** | **78,871** |

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

| USD '000s | Banks & financial institutions | Commercial & other businesses | Sovereign | Total |
|---|---|---|---|---|
| Claims from Banks | 517,164 | - | - | **517,164** |
| Claims from Sovereigns | - | - | 567,048 | **567,048** |
| Claims on Corporate | - | 64,837 | - | **64,837** |
| Other exposures | - | 9,936 | - | **9,936** |
| **Total funded exposure** | **517,164** | **74,773** | **567,048** | **1,158,985** |
| **Unfunded exposures** | **78,871** | **-** | **-** | **78,871** |
| **Gross credit exposures** | **596,035** | **74,773** | **567,048** | **1,237,856** |




## 5.6 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 | Total |
|---|---|---|---|---|---|---|
| Claims on Sovereigns | 77,234 | 195,316 | 106,782 | **379,332** | 187,716 | **567,048** |
| Claims on Banks | 343,174 | 87,228 | 38,724 | **469,126** | 48,038 | **517,164** |
| Claims on Corporate | 91 | 5,267 | 16,579 | **21,937** | 42,900 | **64,837** |
| Other exposures | 46 | 500 | 10 | **556** | 9,380 | **9,936** |
| **Total** | **420,545** | **288,311** | **162,095** | **870,951** | **288,034** | **1,158,985** |

## 5.7 Maturity analysis of unfunded exposures

| US$ '000 | Within 1 month | 1-3 months | 3-12 months | Total within 1 year | Total |
|---|---|---|---|---|---|
| Claims on Banks | 585 | 20,721 | 57,565 | **78,871** | **78,871** |
| **Total** | **585** | **20,721** | **57,565** | **78,871** | **78,871** |

## 5.8 Off- Balance sheet exposures

### i. 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 factors range from 20 per cent to 100 per cent depending on the type of contingent item, and is intended to convert off-balance sheet notional amounts into equivalent on balance sheet exposures.

Credit commitments and unutilized approved credit facilities represent commitments that have not been drawn down or utilized. The notional 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 unutilized amounts are unconditionally cancellable or irrevocable. The Bank has no obligation toward unutilized credit facilities as of Dec 31, 2019.

The notional principal amounts reported above are stated gross before applying credit risk mitigants, such as cash collateral, guarantees and counter-indemnities.

At 31st December 2019, the Bank held cash credit-related contingent items amounting to US$ 78.8 million.

**ii. Derivatives and Foreign exchange instruments:**

Derivatives including futures, forwards, swaps and options in the interest rate and foreign exchange. The Bank's derivative and foreign exchange activities are predominantly short-term in nature.

Derivatives and foreign exchanges exposures are exposed to market risk and settled on net basis. Due currency movement or interest rate changes, the contract may result into net asset or liability. Refer to Audited financial statements for the year ended 31 December 2019, Note 23 for material outstanding contracts.

## 5.9 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.

For further details on refer note 22.2 of the annual audited financial statements for the year ended 31 December 2019.

## 5.10 Impairment of assets

The Bank had adopted IFRS 9 methodology of recording impairment of assets, effective 1 January 2018. IFRS 9 adoption fundamentally changes to a forward looking and expected credit loss (ECL) approach. The Bank records an allowance for expected losses for all loans and other debt type financial assets not held at FVTPL, together with loan commitments and financial guarantee contracts. The allowance is based on the ECL associated with the probability of default in the next twelve months unless there has been a significant increase in credit risk since origination, in which case, the allowance is based on the probability of default over the life of the asset. Refer Disclosures made under Section 7 of Audited Financial Statement for the year ended December 2019, for details of impaired loans and relative specific provision made during 2019.

### i. Impaired loans and related provisions (stage 3):

| USD'000s | 1 to 3 year | over 3 years | Total |
|---|---|---|---|
| Gross impaired loans (stage 3) | 26,057 | 66,950 | **93,007** |
| Less: Specific Provision (stage 3) | (26,057) | (66,950) | **(93,007)** |
| **Net outstanding 31 December 2019** | **-** | **-** | **-** |

### ii. Movement in impairment provision including Expected credit losses - Loans and advances

| USD'000s | Stage 1 | Stage 2 | Stage 3 | Total |
|---|---|---|---|---|
| **Loans:** | | | | |
| At beginning of the year | 3,651 | 2,636 | 99,471 | **105,758** |
| Transfer to Stage 1 | 1 | (1) | - | **-** |
| Transfer to Stage 2 | - | - | - | **-** |
| Transfer to Stage 3 | - | (2,635) | 2,635 | **-** |
| Net re-measurement loss allowance | 303 | - | 18,133 | **18,436** |
| (Write back)/(Recoveries)/Write off | (2,020) | - | (27,128) | **(29,148)** |
| Exchange difference | - | - | (104) | **(104)** |
| **Balance as at 31 December 2019** | **1,935** | **-** | **93,007** | **94,942** |

### iii. Movement in expected credit losses – Investments

| USD'000s | Stage 1 | Stage 2 | Total |
|---|---|---|---|
| **Investments** | | | |
| At beginning of the year | 463 | 1,488 | **1,951** |
| Transfer to Stage 1 | - | - | **-** |
| Transfer to Stage 2 | (54) | 54 | **-** |
| Transfer to Stage 3 | - | - | **-** |
| Net re-measurement loss allowance | (90) | 2,790 | **2,700** |
| (Write back)/(Recoveries)/Write off | - | - | **-** |
| **Balance as at 31 December 2019** | **319** | **4,332** | **4,651** |

### iv. Movement in expected credit losses - Other Financial Assets and Off-Balance Sheet Items:

| USD'000s | Stage 1 | Stage 2 | Total |
|---|---|---|---|
| At beginning of the year | 808 | - | **808** |
| Transfer to Stage 1 | - | - | **-** |
| Transfer to Stage 2 | (1) | 1 | **-** |
| Transfer to Stage 3 | - | - | **-** |
| Net re-measurement loss allowance | (458) | 1 | **(457)** |
| (Write back)/(Recoveries)/Write off | - | - | **-** |
| **Balance as at 31 December 2019** | **349** | **2** | **351** |

### v. Specific Provision by Geographic and Sector (Stage 3):

| USD '000s | Europe | Other Middle East and Africa |
|---|---|---|
| Banks & Financial Institutions | - | 41,772 |
| Sovereigns | - | 2,804 |
| Corporate | 20,418 | 28,013 |
| **Total** | **20.418** | **72,589** |

Expected Credit loss (Stage 1 & 2) provision of US$ 6,937 thousand as at 31 December 2019 is not for any specific geographic region.

### 5.11 Restructured facilities

| | US$ '000 |
|---|---|
| Gross balance of any restructured credit facilities as at 31 December 2019 | 5,908 |
| **Total** | ***5,908*** |

During the year ended 31 December 2019, no loans were restructured. The facilities restructured prior to year 2019 have been categorized as per IFRS -9 requirement and required Expected credit loss provision (ECL) has been considered during the year under IFRS 9.

## 6. Market risk - Pillar 3 disclosures

For allocating capital to market risks, the Bank uses the Standardized Measurement Method (SMM) for the measurement of market risk and capital allocation based on net open position of foreign currencies as defined under the CA module of CBB Rulebook:

| US$ '000 | Risk weighted exposures | Capital charge | Maximum value | Minimum value |
|---|---|---|---|---|
| Foreign Exchange Risk | 1,675 | 209 | 2,375 | 100 |

Currency risk arises from the movement of the rate of exchange over a period of time. The Bank's currency risk is mainly towards assets and liabilities denominated in GBP and Euro, as Bahrain Dinars and GCC Currencies (except Kuwaiti Dinars) are pegged to US Dollars. The Bank manages this risk through net open position limits established for each currency and monitoring net open currency positions on a daily basis. Refer to Audited financial statements for year ended 31 December 2019, note 22.3.2 for further details.

## 7. Operational risk- Pillar 3 disclosures

Whilst operational risk cannot be eliminated in its entirety, the Bank endeavours to minimize it by ensuring that a strong control infrastructure is in place throughout the organization. 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.

The Bank has in place an Operational Risk Management Framework (ORMF) to manage and control its operational risk in a cost-effective manner within targeted levels of operational risk consistent with the

Bank's risk appetite. The ORMF defines minimum standards and processes, and the governance structure for the management of operational risk and internal controls.

The Bank adopted the Basic indicator approach in line with CBB regulation to compute total capital charge in respect of operational risk was US$ 8,316 thousand on operational risk weighted exposure of US$ 66,528 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.

## 8. Pillar 2 Risk Disclosures

### a. Credit 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. The Bank has calculated the exposure concentration risk under Bank Pillar 2 capital framework using Herfindahl–Hirschman Index (HHI).

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.

As at 31 December 2019, the Bank's exposure in excess of 15% of the obligor limits to individual counterparties is shown below:

| US $ '000 | On Balance sheet exposure | Off-Balance sheet exposure | |
|---|---|---|---|
| Counterparty A * | 414,168 | Nil | 414,168 |
| Counterparty B * | 52,345 | Nil | 52,345 |

* Comprise of exempted large exposure to sovereign and bank.

The Bank has already put in place credit risk management policies as well as and monitoring tools to proactively assess Exposure Concentration risk. The Bank has internal limits to monitor and control concentration in sectors, geography and counterparty. Regular reports are prepared and analyzed to ensure that undesired concentrations are avoided.

### b. Liquidity Risk

The Bank maintains adequate liquid assets such as inter-bank placements, treasury bills and other readily marketable securities, to support its business and operations. The Bank monitors the maturity profile of its assets and liabilities so that adequate liquidity is maintained at all times. The Bank's ability to maintain a stable liquidity profile is primarily on account of its success in maintaining a stable funding base. The Bank monitors the stability of its funding base on an ongoing basis by ensuring maintaining strong relationship with its key depositors. The

Asset Liability Committee (ALCO) reviews the liquidity gap profile and the liquidity scenario and addresses strategic issues concerning liquidity risk.

Refer Liquidity risk disclosures made under Section 22.4 of Audited Financial Statement for the year ended December 2019. In accordance with Liquidity Risk Management module of CBB, the Bank computes the Net Stable Funding ratio (NSFR) and Liquidity Coverage ratio (LCR) and maintain these ratio greater than 100% respectively.
As of December 31, 2019, the Bank's NSFR is 196% and LCR is 572% (Refer Leverage and Liquidity Disclosures -31 December 2019).

**c. Interest rate risk in Banking Book**

The Bank is exposed to interest rate risk because of mismatches or gaps in the amounts of assets and liabilities and off-balance sheet instruments that mature or re-price in a given period. The Bank manages this risk by matching the re-pricing of assets and liabilities through basis point value approach, which measures changes in economic value resulting from changes in interest rates. The Bank measures its interest rate sensitivity by measuring the earnings at risk due to a 200 bps parallel shock in interest rates. The ALCO regularly reviews the interest rate gap and sensitivity profile and takes decisions to ensure stability of interest income stream over time.

The following table demonstrates the sensitivity to 200 basis points increase in interest rates, with all other variables held constant, of the Bank's statement of income for the year ended 31 December 2019.

| US$ '000 | 31-Dec-19 | |
|---|---|---|
| Currency | Sensitivity of net Interest income | |
| USD | +/- | 3,223 |
| AED | +/- | 662 |
| Other currencies | +/- | 46 |

The decrease in the basis points will have an opposite impact on the net interest income.

The details of interest rate sensitive assets and liabilities are as follows:

| US$ '000 | Less than 3 months | Three months to one year | Over one year | Total |
|---|---|---|---|---|
| **Assets** | | | | |
| Balances and deposits with banks and other financial institutions | 689,141 | 118,216 | - | 807,357 |
| Loans & advances | 5,420 | 14,981 | 74,275 | 94,676 |
| **Total** | **694,561** | **133,197** | **74,275** | **902,033** |
| **Liabilities** | | | | |
| Deposits from banks and other financial institutions | 289,917 | 356,853 | - | 646,770 |
| Due to Banks and other financial institutions | 89,196 | - | - | 89,196 |
| Due to Customers | 75,504 | - | - | 75,504 |
| **Total** | **454,617** | **356,853** | **-** | **811,470** |
| **On Balance sheet gap** | **239,944** | **(223,656)** | **74,275** | **90,563** |

**d. Reputational Risk**

Bank relies upon a reputation for integrity in order to maintain its existing business and to pursue its strategies for growth and new business. The Bank has no risk appetite for reputational risk and a number of initiatives are dedicated to the avoidance of reputational damage, including controls relating to maintaining regulatory compliance, anti-money laundering controls and data security.

Bank has prepared a scorecard to evaluate Reputational risk score based on guidance provided by CBB and bank's internal as well external operating environment. The score derived from the scorecard is used to assess the capital requirements for reputational risk.

**e. Strategic risk**

Business / strategic risk primarily arises out of either wrong strategic direction and or wrong strategy/ business plan implementation that could have an adverse impact on the Bank's profitability and capital Positions. The Bank has various monitoring mechanism including Key Performance Indicator, Performance Reports etc. and on a periodic basis to assess any deviation from the approved business plans that could impact the bank's performance in terms of its profitability, asset growth, financial health etc. The strategic risk is managed through monthly reviews of performance versus budgeted performance and periodic reviews of the Bank's performance and alignment with the strategic plan.

## 9. Other disclosures:

### a. Related Party transactions

Related parties represent shareholders, directors and key management personnel of the Bank, and entities controlled, jointly controlled or significantly influenced by such parties. Pricing policies and terms of these transactions are approved by the Bank's management.

| US$ '000 | 31-Dec-19 |
|---|---|
| **Statement of profit or loss** | |
| Interest & similar income | 172 |
| Interest expense | 15,820 |
| Fee and commission income | 1,054 |
| **Assets** | |
| Cash and balances with banks | 7,391 |
| Deposit with banks and financial institutions | - |
| Loans and advances | 4,561 |
| Interest receivable | 38 |
| Other assets | 45 |
| **Liabilities** | |
| Deposits from banks and other financial institutions | 519,918 |
| Due to banks and other financial institutions | 20,635 |
| Interest payable | 1,692 |
| Other liabilities | 336 |
| **Contingent liabilities** | |
| Letters of credit and letters of guarantee | 23,403 |
| Assets under management | 21,535 |

b. **Assets sold under recourse agreements**: The Bank did not enter into any recourse agreement during the year ended 31 December 2019.

c. **Equity positions in the banking book** : Nil

### d. Leverage Ratio

| US$ '000 | 31-Dec-19 |
|---|---|
| Total exposure on-balance sheet (all unweighted) | 1,138,017 |
| Total Off Balance Sheet items - with relevant Credit Conversion Factors | 15,827 |
| **Total** | **1,153,844** |
| **Tier One Capital** | **328,615** |
| **Leverage Ratio** | **28.48%** |