BASEL II
PILLAR 3 DISCLOSURES

For the year ended 31 December 2011

CONTENTS

1 INTRODUCTION

These disclosures have been prepared in accordance with the Central Bank of Bahrain's (CBB) Basel II guidelines on capital adequacy and the Public Disclosure Module ("PD"), Chapter 1.3 of the CBB Rule Book, Volume II for Islamic Banks. These disclosures also reflect Basel II - Pillar 3 and the Islamic Financial Services Board's (IFSB) recommended disclosures for Islamic banks, and should be read in conjunction with the Risk and Capital Management Disclosures and other notes made in the Annual Report of Venture Capital Bank ('the Bank") for the year ended 31 December 2011.

These disclosures provide qualitative and quantitative information on the Bank's risk exposures and risk management processes. The Bank makes these disclosures on a comprehensive basis comprising qualitative and quantitative information annually and on a restricted basis semi-annually.

2 CAPITAL STRUCTURE

2.1 Capital Base

The authorized share capital of the Bank is US$ 500 million, comprising 500 million common shares of US$ 1 each. The Bank's initial paid up capital was US$ 66 million, which was increased to US$ 150 million in 2007 through a rights issue and a private placement to new strategic investors. In addition, a further 15 million shares were authorized for allocation to the Bank's Employee Share Ownership Plan ("ESOP").

The Bank undertook a further capital increase in 2009 which increased its paid up capital to US$ 250 million par value during 2010, comprising 250 million shares of US$ 1 each, including 24.85 million shares allotted to the Bank's ESOP.

2.2 Group Structure

The Bank has the following operational subsidiaries which are fully consolidated in its consolidated financial statements.

Subsidiary	Country	Capital	% interest
Gulf Projects Company W.L.L.	Bahrain	BHD 1,000,000	100%
The Lounge Serviced Offices Co. W.L.L.	Bahrain	BHD 20,000	100%
Lime Restaurant Management & Catering Services Co. W.L.L.	Bahrain	BHD 20,000	100%
Mena SME Fund Manager Limited	Cayman Islands	USD 2	100%
Tatweer Consultancy Co. W.L.L.	Bahrain	BHD 40,000	100%

2.3 Review of Financial Performance

The Bank commenced operations in October 2005 and achieved excellent returns in its initial years as indicated below. The results for 2010 and 2011 were unfortunately affected by the global and regional market turmoil, as a consequence of which significant impairment provisions and fair value losses were recorded resulting in net losses for 2010 and 2011, as disclosed in the consolidated financial statements.

Particulars	2007	2008	2009	2010	2011
Net profit (loss) (US$ m)	31.4	46.9	10.88	(47.60)	(58.67)
ROC (Return on paid up capital)	19%	29%	6.3%	-18.6%	-22.9%
Head count	50	79	73	76	66
Total investments to total assets	37%	58%	64%	71%	76%
Leverage (total liabilities / total equity)	10%	8%	25%	4%	10%
Retained earnings (losses) to paid up capital	8%	22%	20%	-7%	-30%

As shown in the consolidated financial statements, income from investment banking services comprises the main contributor to net income. With the anticipated growth in assets under management, the Bank expects to increase the proportion of recurring income from management fees going forward to provide an increased level of sustainable income.

In this regard, the Bank intends to accelerate its growth by stepping-up investment deal flow and attracting high quality investor in-flows.

Capital Adequacy Management Programme

2.4 The Bank's capital adequacy management programme ensures that the Bank not only complies with regulatory capital requirements, but also continues to maintain a strong and robust capital base to support its growing lines of business.

2.5 To manage its capital, the Bank employs a risk adjusted measure of capital adequacy (i.e. Capital Adequacy Ratio or "CAR") based on the local regulatory regime implemented by the CBB that is consistent with the Basel II guidelines issued by the Basel Committee on Banking Supervision's International Convergence of Capital Measurement and Capital Standards.

2.6 Beginning January 2008, CBB has required all Bahrain banking institutions to implement Pillar 1 of these Basel II guidelines that deals with the maintenance of a minimum level of capital calculated for three major components of risk exposures i.e. credit risk (including investment risks), operational risk and market risk.

2.7 The Bank uses the Standardised Approach to quantify its credit and market risk weighted exposures and the Basic Indicator Approach to measure its operational risk weighted exposures.

- **(a)** Credit risk weighted exposures may be calculated in three different methods of varying degrees of sophistication, namely the Standardised Approach, Foundation Internal Rating Based Approach and Advanced Internal Rating Based Approach. The Bank has adopted the Standardised Approach for credit risk measurement, which uses fixed risk weights for different categories of credit risk.
- **(b)** Market risk weighted exposures may be quantified using the Standardised Approach, which uses fixed capital charges for specific categories of market risk, or the Internal Models Approach subject to prior approval by CBB. The Bank uses the Standardised Approach for market risk measurement.
- **(c)** For operational risk, there are three different approaches - Basic Indicator Approach, Standardised Approach, and Advanced Measurement Approach. The Bank uses the Basic Indicator Approach, which uses the average of the gross income for the past three years as a basis for the calculation of capital charges for operational risk.

2.8 In determining its CAR, the Bank calculates its risk adjusted assets, which are then divided by regulatory eligible capital rather than the equity capital appearing in the Bank's statement of financial position. Regulatory capital is composed of two elements:

- **(a)** Tier 1 Capital which 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 treasury stock, minority interests and negative fair value reserves. Local regulations also require that certain investments or exposures should be deducted from Tier 1 capital.
- **(b)** Tier 2 Capital, which consists of the qualifying portion of subordinated loans and unrealised gains arising on fair valuation. Under the CBB 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.

2 CAPITAL STRUCTURE (continued)

2.9 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% minimum CAR.

2.10 The Bank's capital adequacy position is reviewed and stress tested regularly for various scenarios given the nature of the Bank's investments in alternative assets. Reports on the Bank's capital adequacy are filed quarterly with the CBB.

2.11 During 2011, the Bank continued the development and enhancement of its risk management and internal capital adequacy assessment framework. This framework includes a capital allocation process as well as a process description for scenario analysis of the Bank's strategy. It is envisaged that once the framework is finalised and implemented, quantitative details of capital allocated to each business line as well as a scenario analysis of the Bank's strategy will be provided.

2.12 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, instruments and types of business.

2.13 The quantitative details of the Bank's capital adequacy ratio are depicted in the following tables:

Details of eligible capital base	USD '000 **Tier 1**	USD '000 **Tier 2**
Issued and fully paid ordinary shares	250,000	
Less: Employee stock incentive programme funded by the bank (outstanding)	22,764	
Disclosed reserves	44,193	
General reserves	-	
Legal / statutory reserves	10,415	
Share premium	28,429	
Capital redemption reserve	-	
Others	5,349	
Retained profit brought forward	(27,730)	
Unrealised gains arising from fair valuing equities (45% only)	6,925	
Minority interest in consolidated subsidiaries	49,824	
Less:		
Goodwill	-	
Current interim cumulative net losses	43,388	
Unrealised gross losses arising from fair valuing equity securities	35,984	
Reciprocal cross-holdings of bank capital (amount originally existed in Tier 1)	-	
Tier 1 Capital before PCD deductions	**221,076**	
Current interim profits (reviewed by external auditors)		-
Asset revaluation reserve - Property, plant, and equipment (45% only)		-
Unrealised gains arising from fair valuing equities (45% only)		-
Profit equalisation reserve		-
Investment risk reserve		-
Less: Reciprocal cross-holdings of bank capital (amount originally existed in Tier 2)		-
Tier 2 Capital before PCD deductions		**-**
Total Available Capital		**221,076**
Loss: Deductions		
Unconsolidated majority-owned or -controlled banking, securities or other financial entities		-
Capital shortfall of non-consolidated entities subsidiaries		-
Significant minority investments in banking, securities and other financial entities unless pro-rata consolidated		-
Capital shortfall not pro-rata consolidated significant banking, securities or other financial entities		-
Capital shortfall in insurance subsidiaries		-
Excess amount over materiality thresholds in case of investment in commercial entities		-
Investment in insurance entity greater than or equal to 20%		-
Excess amount over maximum permitted large exposure limit	13,576	13,576
Additional deduction from Tier 1 to absorb deficiency in Tier 2	13,576	
Other deductions		
Total Deductions	27,151	13,576
	i	ii
Net Available Capital	**193,925**	-
Total Eligible Capital (i + ii)	**193,925**	

2 CAPITAL STRUCTURE (continued)

2.13 (continued)

Table 1: Regulatory eligible capital as at 31 Dec 2011

Details of exposures and capital requirement USD '000

Credit risk:	**Gross exposures**	**Risk weighted exposures**	**Capital charge**
Exposures to banks	9,824	1,967	236
Exposures to corporates	31,174	31,174	3,741
Investments in listed equities in banking book	3,323	3,323	399
Investments in unlisted equities in banking book	151,797	227,695	27,323
Investments in real estate	72,962	145,923	17,511
Other exposures	9,147	9,147	1,098
Total credit risk exposure under standardised approach	**278,226**	**419,229**	**50,307**
Market risk:			
Trading equities position	107	215	26
Foreign exchange position	1,384	1,384	166
Total market risk under standardised approach	**1,491**	**1,599**	**192**
Operational risk under Basic Indicator Approach (ref. below)		**107,363**	**12,884**
Total		**528,190**	**63,383**
Total eligible capital - (Tier 1 + Tier 2)		**193,925**	
Total eligible capital - Tier 1		193,925	
Total Capital Adequacy Ratio (Tier 1 + Tier 2)		**36.7%**	
Tier 1 Capital Adequacy Ratio		36.7%	

Capital requirement for Operational Risk (Basic Indicator Approach)

USD '000

	2010	**2009**	**2008**
Gross income for prior three years	445-	32,473	82,047
Average of past 3 years gross income (excl. loss years)	57,260		
Capital requirement for Operational Risk (15%)	8,589		
Risk weighted exposure for Operational Risk	**107,363**		

Total unrealised fair value gains / (losses):	**2011**	**2010**	**2009**	**2008**	**2007**
Unrealised fair value (losses)/gains recognised in income	(15,413)	(15,100)	3,080	9,800	3,625
Unrealised fair value gains/(losses) recognised in equity	(648)	2,229	1,496	(85)	180

The maximum and minimum values of each category of market risk exposure during the year are detailed in the table below:

Details of market risk weighted exposures

USD '000

Particulars	31-Mar-11	30-Jun-11	30-Sep-11	31-Dec-11	Maximum	Minimum
Market risk exposures						
Listed equities held for trading	1,171	1,591	1,468	107	1,591	107
Foreign currency exposure	1,768	2,014	1,840	1,384	2,014	1,384
Market risk charge						
Listed equities held for trading	187	255	235	17	255	17
Foreign currency exposure	141	161	147	111	161	111
Total market risk charge	**329**	**416**	**382**	**128**	**416**	**128**
Market risk weighted exposure						
Listed equities held for trading	2,342	3,182	2,937	215	3,182	215
Foreign currency exposure	1,768	2,014	1,840	1,384	2,014	1,384
Total market risk weighted exposure	**4,110**	**5,196**	**4,777**	**1,599**	**5,196**	**1,599**

Credit risk weight on Islamic financing contracts at 31 Dec 2011, which is representative of the average exposure during the period:

USD '000

Asset Categories for Credit Risk	Credit Exposure	Credit Risk Weighted Assets
Commodity Murabaha	2,882	2,882
Qard Hassan	3,136	6,244
Total Islamic financing contracts	**6,018**	**9,126**

3. RISK MANAGEMENT

3.1 Risk Governance Structure

As an Islamic investment bank dealing predominantly in alternative assets, the Bank is exposed to various risks in the normal course of its business and these risks include:

(a) Credit and counterparty credit risk
(b) Market risk
(c) Operational risk
(d) Equity risk in the Banking Book (Investment risk)
(e) Liquidity risk
(f) Profit margin rate risk in the Banking Book
(g) Displaced commercial risk (DCR)

3. RISK MANAGEMENT (continued)

3.2 An understanding of risk-taking and transparency in risk-taking are key elements in the Bank's business strategy. The Bank maintains a prudent and disciplined approach towards risk taking, and embeds a structured risk management process as an integral part of its decision making practice. This risk management process, which is applicable to the various risks the Bank is exposed to, is divided into three key components comprising the following:

a) Risk Identification and Measurement

(i) Procedures for the identification and quantification of risks
(ii) The use of quantitative models and qualitative approaches to assess and manage risks

b) Risk Control

(i) Clearly defined risk exposure limits
(ii) Criteria for risk acceptance based on risk and return as well as other factors
(iii) Portfolio diversification and, where possible, other risk mitigation techniques
(iv) Robust operating policies and procedures
(v) Appropriate Board Committee's authorization and approval for investment transactions

c) Risk Monitoring and Reporting

(i) Ongoing review of exposures and risks by Risk Management Department, including stress testing and frequent reporting
(ii) Periodic internal audits of the control environment

3.3 The Bank's Board of Directors through its Risk Committee (a sub committee of the Board of Directors) has the responsibility for ensuring the establishment and effective implementation of an integrated risk management framework for the Bank. Further, the Risk Management Department (a department which functionally reports to the Risk Committee) is empowered to independently identify and assess risks that may arise from the Bank's investing and operating activities; as well as recommend directly to the Executive Management Committee any prevention and mitigation measures as it deems fit. In addition, the Internal Audit Department, which is independent of both operations and the Bank's investments units, also assists in the risk management process. In particular, the Internal Audit Department is charged with a periodic review of the effectiveness of the Bank's policies and internal controls, including those relating to the risk management process.

3.4 The Internal Audit Department of the Bank adopts a risk-based audit approach whereby the nature, timing and extent of the audits are determined with regard to the risk relevant to each business or support unit of the Bank. A risk assessment is carried out annually to determine the major risks faced by each business or support unit and accordingly, an annual audit plan is prepared by the Internal Audit Department and approved by the Board's Audit Committee. The annual plan envisages the coverage, amongst others, of the Risk Management and Compliance Departments.

Detailed operational risk assessments and tests of effectiveness of internal controls designed to mitigate risks (covering each of the risk components as mentioned above) are carried out in accordance with the annual audit plan. A follow up audit to ascertain the status of implementation of observations previously made by internal or external audit is also part of the annual audit plan.

The key findings arising from the work performed by Internal Audit is reported to the Board Audit Committee and senior management of the Bank.

3.5 Credit and Counterparty Credit Risk Management (PD 1.3.22 + 1.3.26)

Credit risk is defined as the potential that a bank's borrower or counterparty will fail to meet its obligations in accordance with agreed terms.

3.6 The Bank is not involved in the granting of credit facilities in the normal course of its business activities. Further, the Bank is not engaged in retail business and therefore does not use credit "scoring" models.

3.7 The credit risk exposures faced by the Bank are in respect of its own short term liquidity related to placements with other financial institutions, and in respect of investment related funding made to projects. The investment related funding exposures arise in the ordinary course of its investment banking activities and are generally transacted without contractual due dates, collateral or other credit risk mitigants. All such exposures are however reviewed periodically for recoverability and specific provision made where necessary having regard to the nature of the item and the assessment of collection. Additionally, during 2011, due to continued negative market conditions a collective impairment provision has also been recorded based on the recommendations of the external auditors and the Central Bank of Bahrain.

3.8 VCBank uses the Standardised Approach under the Basel II framework for measuring its credit risk. As it does not use an internal credit "scoring" system, the Bank depends, where available, on ratings from an External Credit Assessment Institution recognised by the CBB e.g. S&P, Fitch, Moody's and Capital Intelligence for its bank counterparty exposures. In the absence of such an external rating – e.g. in the case of an investee company, a detailed credit risk assessment of the obligor is performed by the investment team and independently reviewed by the Risk Management Department. In addition, the Bank does not have any credit exposure to a "highly leveraged institution".

3.9 All lines of counterparty credit limits are subject to annual reaffirmation by the Board of Directors. The limits are also reviewed more frequently as necessary to ensure consistency with the Bank's investment strategies and to take into account the latest market developments. 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 exposure. Overall, the Bank's Management considers that its policies and procedures constitute a reasonable approach to managing the credit risk in the activities it is engaged in.

Securitisation

3.10 The Bank does not generally participate in securitisation activities in relation to credit synthesis; acting as sponsor, liquidity facility provider, credit enhancement facility provider, swap provider and has not securitised any of its assets and therefore has no recourse obligations under such transactions as defined by the Financial Stability Task Force. However, the Bank has structured and arranged the "Liquidity Programme" which raised a total of US$ 55 million in 2010 through the issuance of Shari'ah compliant 1 year tenor liquidity certificates with early redemption options of 30 days, 90 days and 180 days with attractive yields, which has been more than fully subscribed by investors. These certificates are backed by an 84.61% share in the VCBank Building, a prime commercial property in the Diplomatic Area of Bahrain. The Bank also concluded arrangements with a local Islamic bank to act as a liquidity provider under the Programme to take up early redemptions up to USD 15 million which are not immediately taken up by replacement investors under the Liquidity Programme.

3. RISK MANAGEMENT (continued)

Off-Balance Sheet Items

3.11 The Bank's off-balance sheet items comprise

(a) a contingent exposure (USD21.95 million) associated with the issuance of guarantees for investment related funding made by financial institutions to the Bank's investment projects. Since these may expire without being drawn upon, the total contract amounts do not necessarily represent future cash requirements;

(b) commitments to finance and invest totaling USD 41.14 million, and

(c) restricted investment accounts of USD16.8 million (see notes to financial statements for details).

Concentration Risk

3.12 Concentration of risks arises when a number of obligors, counterparties or investees 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 Bank's performance to developments affecting a particular industry or region.

3.13 The Bank has established limits based on geographic regions and industry sectors. The Bank's Large Exposure Policy details the Bank's exposure limits and is in compliance with the concentration limits laid down by the CBB.

3.14 The quantitative details of the Bank's credit risk exposures are depicted in the following tables, which are representative of the position during the period and, accordingly, of the average exposures:

A) Table 3: Distribution of Bank's Exposures by Geography

Distribution of bank's exposures by geographic sector USD '000

Geographic sector	GCC countries	Other MENA countries	Europe	Cayman / Americas	Total
Assets					
Balances with banks	3,286	-	-	-	**3,286**
Placements with financial institutions	10,652	-	-	-	**10,652**
Investment securities	62,417	24,838	11,728	13,971	**112,954**
Investment in associates and joint ventures	27,716	1,758	-	-	**29,474**
Investment property	9,130	-	-	-	**9,130**
Receivable from investment banking services	3,171	450	1,702	1,227	**6,550**
Short-term financing to project companies	4,719	1,120	-	-	**5,839**
Other assets	4,027	280	5,278	88	**9,673**
Property and equipment	10,977	-	-	-	**10,977**
Total Assets	**136,095**	**28,446**	**18,708**	**15,286**	**198,535**
Off balance sheet assets					
Restricted investment accounts	16,846	-	-	-	**16,846**
Commitments and contingencies	52,581	10,513	-	-	**63,094**
	205,522	**38,959**	**18,708**	**15,286**	**278,475**

Note: Allocation of the Bank's exposures is based on the asset's country of risk.

B) Table 4: Distribution of Bank's Exposures by Industry Sector

Distribution of Bank's exposures by industry sector USD'000

Industry sector	Trading & Mfg	Banks & financial Inst.	Real estate related	Oil and Gas	Health Care	Technology	Shipping	Others	Total
On balance sheet									
Balances with banks	-	3,286	-	-	-	-	-	-	**3,286**
Placements with financial institutions	-	10,652	-	-	-	-	-	-	**10,652**
Investments	35,370	22,265	12,091	6,200	10,160	-	11,728	15,140	**112,954**
Investment in associates and joint ventures	-	4,319	21,723	-	1,673	-	-	1,759	**29,474**
Investment property	-	-	9,130	-	-	-	-	-	**9,130**
Receivable from investment banking services	450	1,350	1,536	-	304	-	1,702	1,208	**6,550**
Funding to project companies	1,120	283	1,443	-	2,993	-	-	-	**5,839**
Other assets	319	2,750	96	104	136	13	5,228	1,027	**9,673**
Property and equipment	-	-	9,188	-	-	-	-	1,789	**10,977**
Total on balance sheet	**37,259**	**44,905**	**55,207**	**6,304**	**15,266**	**13**	**18,658**	**20,923**	**198,535**
Off balance sheet exposures									
Restricted investment accounts	-	3,097	13,165	-	-	-	-	584	16,846
Commitments and contingencies	10,513	37,260	14,421	-	-	900	-	-	63,094
Total gross credit exposure	**47,772**	**85,262**	**82,793**	**6,304**	**15,266**	**913**	**18,658**	**21,507**	**278,475**

C) Table 5: Exposure by Maturity

USD '000

Credit exposure by maturity	No fixed maturity	Up to 3 months	3 to 6 months	6 months to 1 year	Total up to 1 year	1 to 3 years	Over 3 years	Total USD'000
Assets								
Balances with banks	-	3,286	-	-	3,286	-	-	**3,286**
Placements with financial institutions	-	10,652	-	-	10,652	-	-	**10,652**
Investment securities	112,954	-	-	-	-	-	-	**112,954**
Investment in associates and joint ventures	29,474	-	-	-	-	-	-	**29,474**
Investment property	9,130	-	-	-	-	-	-	**9,130**
Receivable from investment banking services	-	33	763	1,981	2,777	2,238	1,535	**6,550**
Short-term financing to project companies	-	-	283	4,112	4,395	-	1,444	**5,839**
Other assets	-	4,531	4,242	675	9,448	137	88	**9,673**
Property and equipment	10,977	-	-	-	-	-	-	**10,977**
Total assets	**162,535**	**18,502**	**5,288**	**6,768**	**30,558**	**2,375**	**3,067**	**198,535**
Off-balance sheet items								
Restricted investment accounts	-	-	13,165	-	13,165	3,681	-	**16,846**
Commitments and contingencies	-	3,393	-	-	3,393	59,701	-	**63,094**
	162,535	**21,895**	**18,453**	**6,768**	**47,116**	**65,757**	**3,067**	**278,476**

Note: There are no dues which are expected to be of longer duration than 5 years.

3. RISK MANAGEMENT (continued)

D) Related party transactions

In the ordinary course of its business the Bank enters into transactions with related parties which are at arm's length terms and approved by management. The following table gives an analysis of related party transactions and balances:

Related party transactions

2011	Associates and joint venture USD '000	Key management personnel USD '000	Significant shareholders / entities in which directors are interested USD '000	Total USD '000
Assets				
Balances with banks	313	-	321	**634**
Placements with financial institutions	-	-	3,555	**3,555**
Investments	-	-	46,623	**46,623**
Investments in associates and joint ventures	29,474	-	-	**29,474**
Receivable from investment banking services	373	-	2,853	**3,225**
Funding to project companies	8,732	-	3,523	**12,255**
Other assets	270	-	424	**694**
Liabilities				
Employee accruals	-	2,713	-	**2,713**
Payable on acquisition of investment property	-	-	-	**-**
Payables	-	-	-	**-**
Income				
Income from investment banking services	1,818	-	130	**1,948**
Loss on investments	(13,572)	-	(3,000)	**(16,572)**
Share of profit/ (loss) of associates and joint venture				
accounted for using the equity method	(1,179)	-	-	**(1,179)**
Other income	3,028	-	-	**3,028**
Expenses (excluding compensation for key management personnel)				
Impairment allowances against investments	1,024	-	-	**1,024**
Impairment allowances against receivables	6,085	-	6,086	**12,170**
Commitments and contingencies	435	-	11,831	**12,266**
Equity of investment account holders	13,165	-	-	**13,165**

Market Risk Management

3.15 Market risk is defined as the risk of losses in the Bank's on-balance sheet and off-balance sheet positions arising from movements in market prices. The risks subject to this requirement are:

(a) Those pertaining to profit-rate related instruments and equities in the trading book; and

(b) Foreign exchange risk and commodities risk throughout the Bank.

3.16 The Bank's market risk exposures arise predominantly from its trading portfolio of listed equities and a small portfolio of foreign currency denominated assets that are not pegged to the USD. Management opines that the Bank's market risk is currently not a major source of risk since the Bank's business strategy does not envisage taking on significant market risk. The Bank measures its market risk exposure using the Standardised Approach under the Basel II framework.

Operational Risk Management

3.17 Operational risk is defined as the risk of direct and indirect losses resulting from inadequate or failed processes, people and systems or from external events. This definition includes legal risk but excludes strategic and reputational risks. Operational risk differs from other banking risks in that it is not directly taken in return for an expected reward but exists in the natural course of corporate activity, which in turn affects the risk management process.

3.18 The Bank is exposed to operational risk due to the complex nature of its alternative investment products and the intricacy of the documentary, legal and other regulatory requirements that surround such investment transactions. Operational risk emanates from all areas of the Bank from the front office to the back office and support areas and, not just the operations department.

3.19 The Bank uses the Basic Indicator Approach under the Basel II Framework for measuring its operational risk. Currently, the Bank conducts its business from a single location. Accordingly, the number of client relationships and volume of transactions at the Bank are lower than at institutions having multi-location or retail operations.

3.20 Notwithstanding this, the Bank's operations are conducted according to well-defined process and procedures. These process and procedures include a broad 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, bank and securities accounts and other checks to enable it to detect, on a timely basis, any erroneous or improper transactions which may have occurred.

3.21 The Bank is currently enhancing its operational risk management framework that will

(a) help track operational loss events and potential exposures as well as report these on a regular basis; and

(b) improve the Bank's loss mitigation process and hence, the overall operational risk management framework.

In addition, the Bank is reviewing and updating its Business Continuity Plan to mitigate the risk of loss from business disruption due to unexpected events.

Legal Risks

3.22 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.

3.23 The Bank's 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 staff training as well as internal and external reviews. As on the reporting date, the Bank has no significant material legal contingencies including pending legal actions.

3. RISK MANAGEMENT (continued)

Shari'ah compliance

3.24 The Shari'ah Supervisory Board (SSB) is entrusted with the duty of directing, reviewing and supervising the activities of the Bank in order to ensure that they are in compliance with the rules and principles of Islamic Shari'ah. The Bank also has a dedicated internal Shari'ah reviewer who performs an ongoing review of the compliance with the fatwas and rulings of the SSB on products and processes and also reviews compliance with the requirements of the Shari'ah standards prescribed by AAOIFI. The SSB reviews and approves all products and services before launching and offering to the customers and also conducts periodic reviews of the transactions of the Bank. An annual audit report is issued by the SSB confirming the Bank's compliance with Shari'ah rules and principles.

Equity Risk In The Banking Book (Investment Risk)

3.25 The Bank invests predominantly in three major segments of alternative assets, namely venture capital, private equity and real estate with the main objective to generate consistent superior returns with reasonable risks from high quality, rigorously investigated, efficiently structured and well managed investments. The intent of such investments is a later sale at a profit to strategic investors either through a private placement offering or trade sale.

3.26 The Bank uses the Standardised Approach under the Basel II Framework for measuring its investment risks, which is considered a part of its "Banking Book". The Bank manages its investment risks at the specific investment level through an in depth pre-entry due diligence process based on an established set of guidelines, criteria and parameters, as well as active ongoing consulting-based monitoring by investment teams. The Bank also seeks to diversify its investments, not only geographically and sectorally, but across various revenue stages of investments as well.

3.27 Notwithstanding this, the Risk Management Department independently reviews and provides inputs on areas of risk in potential investments at an early stage of the due diligence process. Working in close co-operation with the respective investment teams, these independent risk reviews support the investment decision making process through both a qualitative assessment and quantitative analysis.

Impairment Provisions

3.28 The Bank follows a prudent policy of regularly reviewing all assets for impairment. Impairment is recognised and charged to the income statement when circumstances indicate that the recoverability of the asset is in doubt or the investment is not expected to perform as expected.

3.29 The impairment provisions recorded is summarized in the tables below:

Impairment provisions - by asset class USD '000

Particulars (USD '000)	Gross exposure	Impairment booked in 2011	Cumulative impairment	Net carrying value
Available for sale investments	47,653	6,223	31,338	16,315
Investments in associates and joint venture	4,702	1,025	4,443	259
Receivable from investment banking services	13,899	5,429	10,397	3,502
Short term funding to project companies	32,613	12,755	23,241	9,372
Other assets	1,150	415	1,060	90
Collective impairment allowance	-	9,325	9,325	-
Total	**100,016**	**35,172**	**79,804**	**29,538**

Impairment provisions - by industrial sector USD '000

Particulars (USD '000)	Gross exposure	Impairment booked in 2011	Cumulative impairment	Net carrying value
Real estate	60,626	18,056	45,148	15,478
Healthcare	9,556	182	1,482	8,074
Technology	13,264	6,072	13,264	-
Oil and gas	6,919	817	4,158	2,761
Transportation	1,750	623	623	1,127
Others	7,902	98	5,804	2,097
Collective impairment allowance	-	9,325	9,325	-
Total	**100,016**	**35,172**	**79,804**	**29,538**

Unrealised Fair Value Gains (losses)

3.30 The Bank's investments which are designated at fair value through income are re-valued at every half calendar year, and the gains / (losses) recognised in the income statement in accordance with the relevant Internal Financial Reporting Standards. The valuations are performed by the Bank's investment divisions using appropriate internal valuation models with relevant market inputs and assumptions. These valuations are then independently reviewed by the Risk Management Department and the external auditors, and presented to the Board's Finance & Investment Committee for approval.

Particulars (USD '000)	2011	2010	2009	2008	2007	Total
Private Equity investments - Fair value (losse)/gain	(1,711)	-	3,830	3,300	3,108	**8,527**
Real Estate investments - Fair value (losse)/gain	(13,572)	(15,100)	(750)	6,500	-	**(22,922)**
Venture Capital investments - Fair value gains	-	-	-	-	518	**518**
Total unrealised fair value (loss)/gain	**(15,283)**	**(15,100)**	**3,080**	**9,800**	**3,626**	**(13,877)**

Liquidity Risk Management

3.31 Liquidity risk is defined as the risk that the Bank may have insufficient funds to meet its obligations as they fall due i.e. risk of being unable to satisfy claims without impairment of its financial capital due to mismatches in the timing of cash flows.

3.32 The Bank does not currently have any borrowings other than an insignificant amount of bank financing and routine accounts payables for operating costs. Accordingly, it does not have any significant liquidity risk exposure from borrowings. However, the Bank has extended certain guarantees and undertaken commitments in support of its investment projects as disclosed in Note 34 to the Consolidated Financial Statements.

3.33 Although this gives rise to a level of liquidity funding risk, management carefully monitors liquidity through regular forecasts prepared by the Bank's Treasury Department in consultation with the business and finance functions of the Bank, including considerations of stress scenarios. The Bank also has a portfolio of quoted equity securities which are available to meet any unexpected shortfalls in funding requirements. Accordingly, management considers that the Bank is not exposed to any significant liquidity funding risk.

3. RISK MANAGEMENT (continued)

3.34 The Bank funds its assets primarily through internal accruals and shareholders equity. (See Note 35 (c) to the Consolidated Financial Statements), and has enjoyed a strong liquidity position during the year. Its liquidity ratio (cash and cash equivalents plus marketable securities to total liabilities) stood at 87% at 31 Dec 2011.

Liquidity ratio:	31-Dec-11 USD'000	31-Dec-10 USD'000	31-Dec-09 USD'000	31-Dec-08 USD'000	31-Dec-07 USD'000
Cash at bank	3,286	2,672	14,287	1,093	170
Placements at bank	10,652	11,267	50,789	31,718	69,823
Marketable trading securities	107	1,293	1,351	4,646	1,396
Marketable AFS securities	2,247	2,883	2,473	1,607	3,360
Total liquid assets	**16,292**	**18,115**	**68,900**	**39,064**	**74,749**
Liabilities	**18,819**	**9,544**	**70,204**	**18,395**	**19,392**
Liquidity ratio	**87%**	**190%**	**98%**	**212%**	**385%**

Profit Margin Rate Risk Management in the Banking Book

3.35 As a financial intermediary, the Bank may encounter profit margin risks that arise from timing differences in the maturity and repricing of the Bank's assets and liabilities. While such repricing mismatches are fundamental to the business of banking, these can expose a bank's income and underlying economic value to unanticipated fluctuations as profit margins vary. This however, is not a major source of risk for the Bank.

3.36 The table below depicts a profit margin sensitivity analysis in the Bank's banking book.

USD'000

Position at 31 December 2011 Repricing Period	Rate Sensitive Assets	Rate Sensitive Liabilities	Gap	Cumulative Gap	Impact of 200 bp change
1 day	-	-	-	-	-
> 1 day to 3 months	10,652	8,631	2,021	2,021	10
> 3 months to 6 months	-	-	-	2,021	-
> 6 months to 12 months	2,304	-	2,304	4,325	46
> 1 year to 5 years	-	-	-	4,325	-
> 5 years	-	-	-	4,325	-

3.37 Applying Basel II's requirement of quantifying the impact on the value of net profit margin income for a benchmark change of 200 basis points in profit rates, the following are noted:

(a) The Bank's net profit margin income for the repricing period of >1 day to 3 months would potentially decrease by USD 225 thousand if profit margin rate decreases by 200 basis points.

(b) The Bank's net profit margin income for the repricing periods of > 3 months to 6 months would potentially by USD 0.3 thousand if profit margin rate increases by 200 basis points.

Restricted Investment Accounts (RIA) and Displaced Commercial Risk (DCR)

3.38 The Bank's exposure to Displaced Commercial Risk is limited to its Restricted Investment Accounts (RIA) which comprises the following:

i) The GCC Pre IPO Fund, which was set up in 2006 to invest in the shares of unlisted GCC companies in the pre-IPO stage. The total size of the fund is relatively small with funds under investment of approximately USD 4.5 million.The Bank manages the fund as mudarib, in exchange for a fee of 20% of returns over a 10% simple return.

ii) The VCBank Investment Projects Mudarabah, which was set up in 2009 to provide liquidity financing to selected investment projects of VCBank. The Mudarabah comprises an investment of USD 12 million on which it earns a return of 7% less the Bank's share of profit as Mudarib of 7% thereof, which is distributed to investors on maturity.

iii)

5 years historical data on RIA	2011 USD'000	2010 USD'000	2009 USD'000	2008 USD'000	2007 USD'000
GCC Pre IPO Fund					
Net profit/(loss)	71	(1,406)	129	30	134
Total assets	3,681	3,878	4,471	4,615	5,110
Total equity	3,681	3,878	4,471	4,615	5,110
Return on assets (ROA)	2%	-36%	3%	1%	3%
Return on equity (ROE)	2%	-36%	3%	1%	3%
VCBank Investment Projects Mudarabah					
Net Profit	2,105	1,219	331	N/A	N/A
Total assets	14,105	13,219	12,331	N/A	N/A
Total equity	13,165	12,341	12,308	N/A	N/A
Return on assets (ROA)	15%	9%	3%	N/A	N/A
Return on equity (ROE)	16%	10%	3%	N/A	N/A

3.39 The Bank is aware of its fiduciary responsibilities in management of the RIA investments and has clear policies on discharge of these responsibilities. The summarized financial statements of the RIA's are also included in the Bank's audited consolidated financial statements.

4. BOARD AND EXECUTIVE MANAGEMENT REMUNERATION

4.1 The Nomination and Remuneration Committee of the Board assists the Board in determining the remuneration and compensation of the Board and Executive Management, including executive incentives and employee share ownership plan entitlements.

4.2 Board compensation comprises board remuneration on a formula approach reflecting the Bank's profitability and participation in Board meetings, and attendance fees per meeting attended.

4.3 Executive Management compensation comprises, in addition to salaries that are in line with industry norms, incentives based on profitability and performance, plus participation in the Bank's employee share ownership plan, as disclosed in Notes 24 and 25 to the Consolidated Financial Statements.

5 CORPORATE GOVERNANCE AND TRANSPARENCY

Disclosures on corporate governance and transparency, including qualifications and experience of directors are provided in the Annual Report which should be referred to in this regard. The following tables give details of distribution of shares by nationality, ownership of shares by directors etc.

5.1: Distribution of shareholders by nationality:

Country	Ownership %
UAE	3.3%
Kuwait	21.6%
Saudi Arabia	51.8%
Qatar	4.3%
Oman	2.3%
Bahrain	16.7%
Total	**100.0%**

5.2: Distribution of shareholders by size of shareholding:

Ownership %	Number of shareholders
Less than 1%	148
1% - 2%	15
2% - 3%	5
3% - 4%	2
4% - 5%	0
More than 5%	3
Total	**173**

5.3: Ownership of shares by government:

The Bahrain Development Bank BSC (c), a public sector organisation owned by the Government of Bahrain has a 1.07% interest in the share capital of the Bank.

5.4: Ownership of shares by board members:

Seven members of the board have shareholdings ranging from 0.13% to 0.98% of capital.

No board members have shareholding exceeding 1% of capital, although a number of board members represent corporate shareholders with shares ranging from 0.22% to 6.51% of capital.