VENTURE CAPITAL BANK B.S.C. (c) (“the Bank”)

Pillar 3 Disclosures – 31 December 2012 (unaudited)

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.

<u>Change in fiscal year-end</u>
As disclosed in note 1 to the reviewed interim condensed consolidated financial statements for the 12 months period ended 31 December 2012, the shareholders of the Bank at the EGM held on 25 April 2012 resolved to change the Bank’s financial reporting year end to 30 June with effect from 2013 and, accordingly, the Bank's next set of audited consolidated financial statements and Annual Report will be prepared for the 18 month period ending 30 June 2013.

These Pillar 3 Disclosures are therefore based on the interim reviewed condensed financial statements for the 12 months ended 31 December 2012 and is intended to supplement the information and disclosures provided in the reviewed financial statements in keeping with the spirit of comprehensive disclosures.

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 annually and on a restricted basis semi-annually.

2. Capital Structure

2.1 <u>Capital Base</u>

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 <u>Group structure</u>:

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

Subsidiary	Country	Capital	Percentage interest
Gulf Projects Company W.L.L	Bahrain	USD 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%

2.3 <u>Review of financial performance</u>:

The Bank commenced operations in October 2005 and achieved excellent returns in its initial years. The results for 2010 and 2011 were unfortunately affected by the regional market turmoil, as a consequence of which significant impairment provisions and fair value losses were recorded resulting in significant net losses for 2010 and 2011. However 2012 has witnessed a major turnaround, as the Bank has registered a net profit of US$ 18.51 million for the twelve months period ended 31 December 2012 by successfully exploring new markets, regionally and internationally.

Particulars	2008	2009	2010	2011	2012
Net profit (US$ m)	46.9	10.88	(47.60)	(58.67)	18.51
ROC (Return on paid up capital)	29%	6.3%	-18.6%	-22.9%	7.2%
Head count	79	73	76	66	42
Total investments to total assets	58%	64%	71%	76%	76%
Leverage (total liabilities / total equity)	8%	25%	4%	10%	6%
Retained earnings to paid up capital	22%	20%	-7%	-30%	-23%

As shown by the reviewed interim condensed consolidated financial statements, income from investment banking services is 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 Program

2.4 The Bank's capital adequacy management program 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, the 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 Standardized Approach, Foundation Internal Rating Based Approach and Advanced Internal Rating Based Approach. The Bank has adopted the Standardized 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 Standardized 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 Standardized Approach for market risk measurement.

c. For operational risk, there are three different approaches - Basic Indicator Approach, Standardized 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 measurement.

2.8 In determining its CAR, the Bank calculates its risk adjusted assets, which are then expressed as a factor of 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.

2.9 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 and a 12.5% trigger 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 2012, 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 finalized 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 minimize the risk exposure to particular geographical regions, counterparties, instruments and types of business.

2.13 The quantitative details of the Bank's CAR are depicted in the following tables:

Table 1: Regulatory Eligible Capital as at 31 December 2012

Details of Eligible Capital Base	USD '000	USD '000
	Tier 1	**Tier 2**
Issued and fully paid ordinary shares	250,000	
Less: Employee stock incentive program 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	(107,090)	
Unrealized gains arising from fair valuing equities (45% only)	6,637	
Minority interest in consolidated subsidiaries	133,236	
Less:		
Goodwill	-	
Current interim cumulative net losses	-	
Unrealized gross losses arising from fair valuing equity securities	26	
Reciprocal cross-holdings of bank capital (amount originally existed in Tier 1)	-	
Tier 1 Capital before PCD deductions	**304,186**	
Current interim profits (reviewed by external auditors)		18,507
Asset revaluation reserve - Property, plant, and equipment (45% only)		-
Unrealized gains arising from fair valuing equities (45% only)		-
Profit equalization reserve		-
Investment risk reserve		-
Less: Reciprocal cross-holdings of bank capital (amount originally existed in Tier 2)		-
Tier 2 Capital before PCD deductions		**18,507**
Total Available Capital		**322,693**
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	-	-
Additional deduction from Tier 1 to absorb deficiency in Tier 2	-	
Other deductions	2,377	2,377
Total Deductions	**2,377**	**2,377**
	i	**ii**
Net Available Capital	**301,809**	**16,130**
Total Eligible Capital (i + ii)	**317,939**	

Table 2 – Details of exposures as at 31 December 2012

Details of exposures and capital requirement			USD '000
Credit risk:	Gross exposures	Risk weighted exposures	Capital charge
Exposures to banks	31,500	6,302	756
Exposures to corporates	47,639	47,639	5,717
Investments in listed equities in banking book	1,409	1,409	169
Investments in unlisted equities in banking book	175,646	263,469	31,616
Investments in real estate	63,785	127,571	15,309
Premises occupied by the bank	10,560	10,560	1,267
Other exposures	104,062	104,062	12,487
Total credit risk exposure under standardized approach	**434,601**	**561,012**	**67,321**
Market risk:			
Trading equities position	87	173	21
Foreign exchange position	64,274	64,274	7,713
Total market risk under standardized approach	**64,361**	**64,447**	**7,734**
Operational risk under Basic Indicator Approach (ref. below)		**60,887**	**7,306**
Total		**686,346**	**82,361**
Total eligible capital - (Tier 1 + Tier 2)		**317,939**	
Total eligible capital - Tier 1		**301,809**	
Total Capital Adequacy Ratio (Tier 1 + Tier 2)		**46.3%**	
Tier 1 Capital Adequacy Ratio		**43.9%**	

Capital requirement for Operational Risk (Basic Indicator Approach)

			USD '000
	2011	**2010**	**2009**
Gross income for prior three years	(8,968)	(445)	32,473
Average of past 3 years gross income (excl. loss years)	32,473		
Capital requirement for Operational Risk (15%)	4,871		
Risk weighted exposure for Operational Risk	**60,887**		

					USD '000
Total unrealized fair value gains / (losses):	**2012**	**2011**	**2010**	**2009**	**2008**
Unrealized fair value (losses)/gains recognized in income	(2,020)	(15,413)	(15,158)	3,440	13,574
Unrealized fair value gains/(losses) recognized in equity	11	(648)	2,229	1,496	(85)

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

Table 2.1 – Details of market risk weighted exposures

USD '000

Particulars	31-Mar-12	30-Jun-12	30-Sep-12	31-Dec-12	Maximum	Minimum
Market risk exposures						
Listed equities held for trading	116	77	84	87	116	77
Foreign currency exposure	1,387	1,331	78,966	64,274	78,966	1,331
Market risk charge						
Listed equities held for trading	19	12	13	14	19	12
Foreign currency exposure	111	106	6,317	5,142	6,317	106
Total market risk charge	130	119	6,330	5,156	6,336	119
Market risk weighted exposure						
Listed equities held for trading	232	154	169	173	232	154
Foreign currency exposure	1,387	1,331	78,966	64,274	78,966	1,331
Total market risk weighted exposure	**1,619**	**1,485**	**79,135**	**64,447**	**79,198**	**1,485**

Table 2.2 – Details of credit risk weight on Islamic financing contracts at 31 December 2012, 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	4,631	4,631
Qard Hassan	6,648	11,376
Total Islamic Financing Contract	**11,279**	**16,007**

3. Risk Management

Risk Governance Structure

3.1 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; and
g. Displaced Commercial Risk (DCR).

3.2 An understanding of 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; and
   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; and
   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 to the board; and
   ii. Periodic internal audits of the Bank's control environment

3.3 The Bank's Board of Directors through its Risk Committee (a subcommittee 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 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.

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

3.5 Credit risk is defined as the potential that a 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 provisions made where necessary having regard to the nature of the exposure and the assessment of collection. Additionally, during 2012, due to continued negative market conditions, a collective impairment provision has also been recorded based on the recommendations of the external auditors. As at 31 December 2012, the total collective impairment provision stood at US$ 10.6 million.

3.8 The Bank uses the Standardized 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 recognized 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 "highly leveraged institutions".

3.9 All lines of counterparty credit limits are subject to annual reaffirmation by the Board of Directors. The limits are also reviewed frequently 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 securitization activities in relation to credit synthesis, acting as a sponsor, liquidity facility provider, credit enhancement facility provider, swap provider nor have any of its assets securitized 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 Program" which raised a total of US$ 55 million in 2010 through the issuance of Shari'ah compliant one year 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 rental yield of the VC Bank Building, a prime commercial property in the Diplomatic Area of the Kingdom of Bahrain. As at 31 December 2012, the Bank will act as a liquidity provider under the Program to take up any early redemption up to US$ 53 million which are not immediately taken up by replacement investors under the Liquidity Program.

Off-Balance Sheet Items

3.11 The Bank's off-balance sheet items comprise:

a. Contingent exposure of US$ 23.97 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 of US$ 61.64 million, and
c. Restricted investment accounts of US$ 3.68 million (refer to statement of changes in off-balance equity of investment account holders to the financial statements).

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 the Bank's exposures by geographic sector as at 31 December 2012

Geographic sector	GCC countries	Other MENA countries	Global	Cayman / Americas	Total
Assets					
Balances with banks	2,354	-	-	-	2,354
Placements with financial institutions	4,222	-	-	-	4,222
Investments	63,377	35,675	9,728	13,971	122,751
Investment in associates and joint ventures	26,340	1,402	-	-	27,742
Investment property	9,130	-	-	-	9,130
Receivable from investment banking services	7,196	8,477	3,615	2,267	21,554
Funding to project companies	3,109	1,542	-	627	5,278
Other assets	3,400	277	2,802	88	6,567
Property and equipment	9,906	-	-	-	9,906
Total Assets	**129,035**	**47,373**	**16,144**	**16,953**	**209,505**
Off statement of financial position items					
Equity of investment account holders	3,679	-	-	-	3,679
Commitments and contingencies	67,667	12,098	5,600	240	85,605
	200,381	**59,471**	**21,744**	**17,193**	**298,789**

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

b. *Table 4: Distribution of the Bank's exposures by Industry Sector as at 31 December 2012*

Industry sector	Trading & Mfg	Banks & financial Inst.	Real estate related	Oil and Gas	Health Care	Technology	Shipping	Others	Total
Assets									
Balances with banks	-	2,354	-	-	-	-	-	-	2,354
Placements with financial institutions	-	4,222	-	-	-	-	-	-	4,222
Investments	35,667	22,266	11,586	3,953	10,160	-	9,728	29,392	122,751
Investment in associates and joint ventures	-	4,127	20,991	-	1,222	-	-	1,402	27,742
Investment property	-	-	9,130	-	-	-	-	-	9,130
Receivable from investment banking services	758	2,462	1,536	-	536	-	3,614	12,648	21,554
Funding to project companies	1,542	75	1,777	-	1,257	627	-	-	5,278
Other assets	291	2,000	8	-	12	17	2,802	1,437	6,567
Property and equipment	-	-	8,876	-	-	-	-	1,030	9,906
Total Assets	**38,259**	**37,506**	**53,904**	**3,953**	**13,187**	**644**	**16,144**	**45,909**	**209,505**
Off statement of financial position items									
Equity of investment account holders	-	3,100	579	-	-	-	-	-	3,679
Commitments and contingencies	12,098	53,000	14,667	-	-	240	5,600	-	85,605
	50,356	**93,606**	**69,150**	**3,953**	**13,187**	**884**	**21,744**	**45,909**	**298,789**

c. Table 5: Exposures by maturity as at 31 December 2012

Distribution of Bank's exposures by maturity USD '000

Maturity-wise exposures	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
Assets								
Balances with banks	2,354	-	-	-	-	-	-	2,354
Placements with financial institutions	-	3,957	265	-	4,222	-	-	4,222
Investments	77	-	-	-	-	40,003	82,671	122,751
Investment in associates and joint ventures	-	-	-	-	-	-	27,742	27,742
Investment property	-	-	-	-	-	-	9,130	9,130
Receivable from investment banking services	-	6,719	2,756	1,890	11,365	8,654	1,536	21,554
Funding to project companies	-	588	-	1,020	1,608	1,266	2,404	5,278
Other assets	-	2,003	3,312	721	6,036	461	70	6,567
Property and equipment	-	-	-	-	-	-	9,906	9,906
Total assets	**2,431**	**13,267**	**6,333**	**3,631**	**23,231**	**50,384**	**133,459**	**209,505**
Off statement of financial position items								
Equity of investment account holders	3,679	-	-	-	-	-	-	3,679
Commitments and contingencies	85,605	-	-	-	-	-	-	85,605
	91,715	**13,267**	**6,333**	**3,631**	**23,231**	**50,384**	**133,459**	**298,789**
Liabilities								
Islamic financing payable	-	3,000	-	-	3,000	-	-	3,000
Employee accruals	-	-	-	-	-	-	4,562	4,562
Other liabilities	27	1,148	335	1,341	2,824	275	1,224	4,349
Total liabilities	**27**	**4,148**	**335**	**1,341**	**5,824**	**275**	**5,786**	**11,911**

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

d. Related party transactions:

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

RELATED PARTY TRANSACTIONS

2012	*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	-	-	1,058	1,058
Placements with financial institutions	-	-	1,413	1,413
Investments	-	-	46,623	46,623
Investments in associates and joint ventures	27,742	-	-	27,742
Receivable from investment banking services	604	-	3,893	4,497
Funding to project companies	7,071	-	4,215	11,286
Other assets	56	-	89	145
Liabilities				
Employee accruals	-	1,357	-	1,357
Income				
Income from investment banking services	1,906	-	-	1,906
Loss on investments	-	-	-	-
Share of profit/ (loss) of associates and joint venture accounted for using the equity method	(1,473)	-	-	(1,473)
Other income	2,796	-	-	2,796
Commitments and contingencies	240	-	-	240

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 market risk management relate to:

a. Those pertaining to profit-rate related instruments and equities in the trading book; and
b. Foreign exchange 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 United States Dollar. 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.

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.

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 recognized 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.

General allowance represents collective impairment against exposures which, although not specifically identified, are considered to have a greater risk of loss than when originally incepted.

Impaired Islamic financing facilities includes those where full repayment (collectability) of the principal or/and the profit is in doubt, highly questionable or considered uncollectible due to inadequate protection by the impaired paying capacity of the customer (or counterparty) or by impairment of the collateral pledged if any.

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

Impairment provisions - by asset class

USD '000

Particulars	Gross exposure	Impairment booked in 2012	Cumulative impairment	Net carrying value
Investments	41,707	117	28,113	13,594
Investments in associates and joint venture	4,702	259	4,702	-
Receivable from investment banking services	14,177	-	10,349	3,828
Funding to project companies	33,374	996	24,236	9,138
Other assets	1,433	300	1,409	24
Collective Impairment Allowance	-	1,340	10,665	-
Total	**95,393**	**3,012**	**79,474**	**26,584**

Impairment provisions - by industrial sector

USD '000

Particulars	Gross exposure	Impairment booked in 2012	Cumulative impairment	Net carrying value
Real estate	62,388	976	46,124	16,265
Health care	5,793	-	1,460	4,333
Technology	14,556	2	12,662	1,894
Oil and gas	1,331	1	818	514
Transportation	1,757	2	625	1,132
Others	9,568	691	7,121	2,447
Collective Impairment Allowance	-	1,340	10,665	-
Total	**95,393**	**3,012**	**79,474**	**26,584**

Unrealized 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) recognized in the statement of income are in accordance with the relevant International 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 and Investment Committee for approval.

Particulars (USD '000)	**2012**	**2011**	**2010**	**2009**	**2008**	**Total**
Private Equity investments -fair value (losses) / gains	(2,000)	(1,711)	-	3,830	3,300	3,419
Real Estate investments -fair value (losses) / gain	-	(13,572)	(15,100)	(750)	6,500	(22,922)
Listed equity investment - fair value (losses) / gains	(20)	(131)	(58)	360	3,774	3,926
Total unrealize fair value (loss)/gain	**(2,020)**	**(15,414)**	**(15,158)**	**3,440**	**13,574**	**(15,577)**

Liquidity Risk Management

3.31 Liquidity risk is defined as the risk that the Bank may have insufficient funds to meet its obligations as and when 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 5 to the interim condensed 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 funding liquidity risk.

3.34 The Bank funds its assets primarily through internal accruals and shareholders' equity. The Bank maintained a healthy liquidity position during the year. Its liquidity ratio (cash and cash equivalents plus marketable securities to total liabilities) stood at 56% as at 31 December 2012.

Liquidity ratio:	**31-Dec-12**	**31-Dec-11**	**31-Dec-10**	**31-Dec-09**	**31-Dec-08**
	USD'000	**USD'000**	**USD'000**	**USD'000**	**USD'000**
Cash at bank	2,354	3,286	2,672	14,287	1,093
Placements at bank	4,222	10,652	11,267	50,789	31,718
Marketable trading securities	87	107	1,293	1,351	4,646
Marketable AFS securities	-	2,247	2,883	2,473	1,607
Total liquid assets	**6,663**	**16,292**	**18,115**	**68,900**	**39,064**
Liabilities	**11,911**	**18,819**	**9,544**	**70,204**	**18,395**
Liquidity ratio	**56%**	**87%**	**190%**	**98%**	**212%**

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 2012 Repricing Period	**Rate Sensitive Assets**	**Rate Sensitive Liabilities**	**Gap**	**Cumulative Gap**	**Impact of 200 bp change**
1 day	-	-	-	-	-
> 1 day to 3 months	5,507	3,000	2,507	2,507	13
> 3 months to 6 months	265	-	265	2,772	3
> 6 months to 12 months	2,473	-	2,473	5,246	49
> 1 year to 5 years	-	-	-	5,246	-
> 5 years	-	-	-	5,246	-

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 US$ 13 thousand if the profit margin rate decreases by 200 basis points;
b. The Bank's net profit margin income for the repricing period of 3 months to 6 months would potentially decrease by US$ 3 thousand if the profit margin rate decreases by 200 basis points; and
c. The Bank's net profit margin income for the repricing periods of 6 months to 12 months would potentially decrease by US$ 49 thousand if the profit margin rate decreases by 200 basis points.

Equity of Investment Account Holders and Displaced Commercial Risk (DCR)

3.38 The Bank's exposure to Displaced Commercial Risk is limited to its Equity of Investment Account Holders 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 US$ 3.7 million. The Bank manages the fund as a Mudarib, in exchange for a fee of 20% of returns over a 10% simple return. The investments in the GCC Pre IPO Fund are exposed to the general equity market risks prevalent in the GCC countries and in the real estate and petrochemical sectors.

ii. The Bank's Investment Projects Mudarabah was set up in 2009 to provide liquidity financing to a selected investment project which comprised an investment of US$ 12 million on which it earned a return of 7% less the Bank's share of profit as Mudarib of 7% thereof distributable to investors on maturity. During the year, the Bank has settled in full the principal and profit payable relating to the Mudarabah. The investment in the Investment Projects Mudarabah was exposed to the risks prevalent in the real estate sector in Bahrain.

iii. Historical returns on Equity of Investment Account Holders:

5 years historical return data on equity of investment account holders	**2012**	**2011**	**2010**	**2009**	**2008**
	USD'000	**USD'000**	**USD'000**	**USD'000**	**USD'000**
GCC Pre IPO Fund					
Net profit/(loss)	-	71	(1,406)	129	30
Total assets	3,678	3,681	3,878	4,471	4,615
Total equity	3,678	3,681	3,878	4,471	4,615
Return on assets (ROA)	0%	2%	-36%	3%	1%
Return on equity (ROE)	0%	2%	-36%	3%	1%
VC Bank Investment Projects Mudarabah					
Net Profit	N/A	2,105	1,219	331	N/A
Total assets	N/A	14,105	13,219	12,331	N/A
Total equity	N/A	13,165	12,341	12,308	N/A
Return on assets (ROA)	N/A	15%	9%	3%	N/A
Return on equity (ROE)	N/A	16%	10%	3%	N/A

3.39 The Bank is aware of the importance of its fiduciary responsibilities in the management of the Equity of Investment account holders. Transactions with Investment Account Holders are entered into only on the basis of signed subscription and underlying investment agreements, and internal procedures are in place for the proper management and handling of these responsibilities. (Refer to statement of changes in off-balance equity of investment account holders to the 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.

5 Corporate Governance and transparency

Disclosures on corporate governance and transparency, including qualifications and experience of directors have been disclosed in the Annual Report for the year ended 31 December 2011. These will be updated in the Annual Report for the 18 months period ending 30 June 2013. 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 %
United Arab Emirate	3.3%
Kuwait	21.6%
Kingdom of Saudi Arabia	51.8%
Qatar	4.3%
Oman	2.3%
Kingdom of Bahrain	16.7%
Total	**100.0%**

5.2: Distribution of shareholders by size of shareholding:

Ownership %	Number of shareholders
Less than 1%	154
1% - 2%	15
2% - 3%	5
3% - 4%	2
4% - 5%	0
More than 5%	2
Total	**178**

Two of the Bank's shareholders own more than 5% ownership in the Bank. These are corporate shareholders noted below:

- The Commercial Real Estate Co. (K.S.C.C.) – 6.51% ownership; and
- Securities Group (K.S.C.C.) – 5.43% ownership.

5.3: Ownership of shares by government:

The Bahrain Development Bank B.S.C. (c), a public sector organization 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 total capital. No Board members have shareholding exceeding 1% of total capital, although a number of Board members represent corporate shareholders with shares ranging from 0.43% to 5.43%.

The Board is responsible for the stewardship of the Bank's business and affairs on behalf of the shareholders, with a view to enhancing long-term shareholder value whilst taking into account the interests of other stakeholders, and maintaining high standards of transparency and accountability. The Board comprises 12 members, all of whom are independent non-executive Directors except for the CEO.