## 1 EXECUTIVE SUMMARY

This report has been prepared in accordance with Pillar III disclosure requirements prescribed by the Central Bank of Bahrain, herein referred to as "CBB". The report has been designed to provide BBK Group's stakeholders with detailed information on the Bank's approach in managing capital and risk, having due regard to the operating environment.

The Bank applies the Basel framework in the measurement of its capital adequacy, and in its capital management strategy and risk management framework. CBB's Basel III capital rules and guidelines became effective on 1st January 2015 as the common framework for the implementation of the Basel Committee on Banking Supervision's (Basel Committee) Basel III capital adequacy framework for banks incorporated in the Kingdom of Bahrain.

The disclosures in this report are in addition to the disclosures set out in the consolidated financial statements for the year ended 31st December 2017 presented in accordance with the International Financial Reporting Standards (IFRS). Disclosures with respect to Corporate Governance and Remuneration are provided in relevant sections of the Annual Report.

## 2 INTRODUCTION TO THE BASEL III FRAMEWORK

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

- Pillar I: calculation of the Risk Weighted Assets (RWAs) and capital requirement.
- Pillar II: the supervisory review process, including the Internal Capital Adequacy Assessment Process (ICAAP).
- Pillar III: rules for the disclosure of risk management and capital adequacy information.

Amongst the three pillars, it is Pillar I that has been affected most and largely amended with the introduction of Basel III. Additional disclosure requirements have also been introduced under Pillar III.

**Pillar I**

Pillar I prescribes the basis for the calculation of the regulatory capital adequacy ratio. Pillar I sets out the definitions and calculations of the RWAs, and the derivation of the regulatory total capital. Capital adequacy ratios are calculated by dividing regulatory capital by the total RWAs.

As part of Basel III implementation, while the calculation of RWAs remained almost the same as under Basel II, the definition of regulatory capital witnessed significant changes as Basel III focuses on increasing both the quantity and quality of banks' capital. To this end, Tier 1 capital "T1" must be the main component of capital, and the predominant form of T1 capital must be common shares and retained earnings. Deductions from capital and prudential filters have been harmonized and generally applied at the level of common equity. The remainder of T1 capital base must be comprised of instruments that are subordinated, have fully discretionary noncumulative dividends or coupons and have neither a maturity date nor an incentive to redeem. Certain instruments that previously qualified as regulatory capital such as innovative hybrid capital instruments are no longer accepted and the existing ones will be phased out. In addition, Tier 2 capital "T2" instruments have been harmonized with more restrictions and a limit on their contribution to total regulatory capital, and the so-called Tier 3 capital instruments, which were only available to cover market risks, were eliminated.

Furthermore, Basel III introduced a number of capital buffers to promote the conservation of capital (capital conservation buffer or "CCB") and the build-up of adequate buffers above the minimum required capital during times of good economic conditions that can be drawn down in periods of stress (countercyclical capital buffer).

CBB minimum required total capital adequacy ratio (including CCB) increased from 12 percent to 12.5 percent, compared to 10.5 percent recommended by the Basel Committee. Moreover, there are newly introduced limits and minima by the CBB under Basel III, such as minimum Common Equity Tier 1 Capital Ratio "CET1" of 9 percent (including CCB) and minimum T1 Capital Ratio of 10.5 percent (including CCB). In the event that the total capital adequacy ratio falls below 12.5 percent, additional prudential reporting requirements apply, and a formal action plan setting out the measures to be taken to restore the ratio above the minimum required level is to be formulated and submitted to the CBB. Consequently, the CBB requires BBK to maintain an effective minimum total capital adequacy ratio above 12.5 percent.

The table below summarizes the approaches available for calculating RWAs for each risk type in accordance with the CBB's Basel III capital adequacy framework:

| Credit Risk | Market Risk | Operational Risk |
|---|---|---|
| Standardised Approach | Standardised Approach | Basic Indicator Approach |
| | Internal Models Approach | Standardised Approach |

The approach applied by BBK for each risk type is as follows:-

### i) Credit Risk

For regulatory reporting purposes, BBK is using the Standardised Approach for credit risk. Credit risk constitutes nearly 90 percent of the overall risk for the Bank. The bank has a robust credit risk management architecture which is explained in greater detail in Note 28 and 29 of the Annual Report. The credit 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.

### ii) Market Risk

For the regulatory market risk capital requirement, BBK is using the Internal Model Approach based on Value-at-Risk (VaR) model. The use of the Internal Model Approach for the calculation of regulatory market risk capital has been approved by the CBB and the model is subject to periodic independent internal and external validation.

### iii) Operational Risk

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 Standardised Approach. The CBB's capital framework does not currently permit the use of the Advanced Measurement Approach (AMA) for operational risk. For regulatory reporting purposes, BBK is currently using the Basic Indicator Approach whereby the operational risk weighted exposures and regulatory capital requirement are calculated by applying an alpha co-efficient of 15 percent to the average gross income for the preceding three financial years.

**Pillar II**

Pillar II defines the process of supervisory review of an institution's risk management framework and, ultimately, its capital adequacy.

Under the CBB's Pillar II guidelines, all banks incorporated in Bahrain are required to maintain total capital adequacy ratio above 12.5 percent.

Pillar II comprises two processes:

- an Internal Capital Adequacy Assessment Process (ICAAP), and
- a supervisory review and evaluation process.

The ICAAP incorporates a review and evaluation of risk management and capital relative to the risks to which the bank is exposed. BBK has developed an ICAAP document and it addresses all components of BBK's risk management, from the daily management of more material risks to the strategic capital management of the Group. The projected growth in risk assets, operating profit, shareholders' funds and the corresponding capital requirement are estimated by the bank as part of the 3 years strategy approved by the Board. In addition, the bank also forecasts the Capital Base whenever there is likely reduction in the capital components, and necessary actions are taken in order to ensure regulatory compliance. The bank has also a Dividend Policy in place as part of capital management strategy.

The Bank uses the RAROC model in its credit decisions in order to assess risk-reward matrix for each credit exposure. The Bank has adopted a Risk Appetite Framework which is reviewed periodically. The Bank also adopts a Risk Management Strategy annually covering all types of relevant risks.

The supervisory review and evaluation process represents the CBB's review of the Group's capital management and an assessment of internal controls and corporate governance. The supervisory review and evaluation process is designed to ensure that institutions identify their material risks, 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 I framework. Other risk types which are not covered by the minimum capital requirements in Pillar I include liquidity risk, interest rate risk in the banking book, strategic risk, concentration risk, reputational risk, and residual risk. These are covered either by capital, or risk management and mitigation processes under Pillar II.

BBK conducts stress testing of its portfolio as part of the ICAAP process.

**Pillar III**

Pillar III deals with the Market Discipline guidelines of the regulator to ensure adequate disclosure of risk management practices, corporate governance standards and capital adequacy information. The banks publishes disclosures periodically and in the Annual Report.

The disclosures comprise detailed qualitative and quantitative information. The purpose of the Pillar III 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 disclosure consisting mainly of quantitative analysis is required during half year reporting, whereas full disclosure is required to coincide with the financial year end reporting.

### Regulatory Reforms

The Bank is categorized as a Domestic Systemically Important Bank (DSIB). Currently, the CBB has not prescribed any Countercyclical Buffer or additional capital requirements for DSIBs.

The framework on Leverage Ratio will be part of the Pillar 1 after its introduction by the CBB.

The Bank is evaluating Expected Credit Loss as per the guidelines in IFRS 9.

## 3 GROUP STRUCTURE

The Group's financial statements are prepared and published on a full consolidation basis, with all subsidiaries being consolidated in accordance with IFRS. For capital adequacy purposes, all financial subsidiaries are included within the Group structure. However, the CBB's capital adequacy methodology accommodates both normal and aggregation forms of consolidation.

The principal Subsidiaries, Associates and Joint Ventures and basis of consolidation for capital adequacy purposes are as follows:-

| | Domicile | Ownership | Consolidation basis |
|---|---|---|---|
| **Subsidiaries** | | | |
| CrediMax B.S.C. (c ) | Kingdom of Bahrain | 100% | Full Consolidation |
| Invita B.S.C. (c ) | Kingdom of Bahrain | 100% | Risk Weighted |
| Invita – Kuwait* | State of Kuwait | 60% | Risk Weighted |
| Global Payment Services W.L.L. (GPS)** | Kingdom of Bahrain | 55% | Full Consolidation |
| **Associates** | | | |
| Bahrain Liquidity Fund | Kingdom of Bahrain | 24% | Risk Weighted |
| Bahrain Commercial Facilities Company B.S.C. | Kingdom of Bahrain | 23% | Risk Weighted |
| The Benefit Company B.S.C (c ) | Kingdom of Bahrain | 22% | Risk Weighted |
| **Joint Venture** | | | |
| Sakana Holistic Housing Solutions B.S.C. (c ) | Kingdom of Bahrain | 50% | Risk Weighted |
| Aegila Capital Management Limited | United Kingdom | 50% | Risk Weighted |
| BBK Geojit Securities KSC | State of Kuwait | 40% | Risk Weighted |

* Shareholding through Invita Subsidiary
** Shareholding through CrediMax Subsidiary

There are no restrictions on the transfer of funds or regulatory capital within the Group.

## 4 STATEMENT OF FINANCIAL POSITION UNDER THE REGULATORY SCOPE OF CONSOLIDATION

The table below shows the link between the statement of financial position in the published financial statements (accounting statement of financial position) and the regulatory statement of financial position.

| | Statement of financial position as in published financial statements BD '000 | Statement of financial position as per regulatory reporting BD '000 | Reference |
|---|---|---|---|
| **Assets** | | | |
| **Cash and balances with central banks** | **469,436** | **469,436** | |
| **Treasury bills** | **427,130** | **427,130** | |
| **Deposits and amounts due from banks and other financial institutions** | **223,824** | **223,824** | |
| **Loans and advances to customers** | **1,740,651** | **1,740,651** | |
| Of which Expected Credit Loss (1.25% of Credit risk weighted assets) | | (29,578) | a |
| Of which net loans and advances (gross of Expected Credit Loss) | 1,740,651 | 1,770,229 | |
| **Investment securities** | **748,985** | **748,985** | |
| Of which related to equity investments in financial entities | | 24,916 | b |
| Of which investments in financial entities under CET1 | | 22,538 | c |
| Of which investments in financial entities under Tier 2 | | 2,378 | d |
| Of which related to other investments | | 699,153 | |
| **Investments in associated companies and joint ventures** | **46,958** | **49,786** | |
| Of which Investment in own shares | 475 | 475 | e |
| Of which equity investments in financial entities | 32,681 | 32,681 | f |
| Of which other investments | 13,802 | 16,630 | |
| **Interest receivable and other assets** | **79,680** | **77,801** | |
| Of which deferred tax assets due to temporary differences | 1,631 | 1,631 | g |
| Of which Interest receivable and other assets | 78,049 | 76,170 | |
| **Premises and equipment** | **26,436** | **26,283** | |
| **Total assets** | **3,763,100** | **3,763,896** | |
| **Liabilities and Equities** | | | |
| **Liabilities** | | | |
| **Deposits and amounts due to banks and other financial institutions** | **193,472** | **193,472** | |
| **Borrowings under repurchase agreement** | **161,314** | **161,314** | |
| **Term borrowings** | **199,012** | **199,012** | |
| **Customers' current, savings and other deposits** | **2,623,577** | **2,625,300** | |
| **Interest payable and other liabilities** | **84,890** | **84,343** | |
| **Total liabilities** | **3,262,265** | **3,263,441** | |
| **Equity** | | | |
| **Share capital** | **108,165** | **108,165** | h |
| **Treasury stock** | **(998)** | **(998)** | i |
| **Perpetual tier 1 convertible capital securities** | **86,098** | **86,098** | j |
| **Share premium** | **41,016** | **41,016** | k |
| **Statutory reserve** | **54,082** | **54,082** | l |
| **General reserve** | **54,082** | **54,082** | m |
| **Cumulative changes in fair values** | **(8,349)** | **(8,349)** | |
| Of which cumulative changes in fair values on bonds and equities | (8,573) | (8,573) | n |
| Of which Fair value changes in cash flow hedges | 224 | 224 | o |
| **Foreign currency translation adjustments** | **(9,271)** | **(9,271)** | |
| Of which related to unconsolidated subsidiary | | (71) | p |
| Of which related to Parent | | (9,200) | q |
| **Retained earnings** | **134,632** | **134,632** | |
| Of which employee stock options | 3,036 | 3,036 | |
| Of which Retained earnings | 131,596 | 131,596 | r |
| **Appropriations** | **39,161** | **39,161** | s |
| ATTRIBUTABLE TO THE OWNERS OF THE BANK | 498,618 | 498,618 | |
| Non-controlling interest | 2,217 | 1,837 | |
| **Total equity** | **500,835** | **500,455** | |
| **Total Liabilities and equities** | **3,763,100** | **3,763,896** | |

**Legal entities included within the accounting scope of consolidation but excluded from the regulatory scope of consolidation:**

| Name | Principle activities | Total Assets | Total Equities |
|---|---|---|---|
| Invita B.S.C. (c ) | Business process outsourcing services | 3,756 | 3,209 |

## 5 CAPITAL COMPONENTS – CONSOLIDATED

Under the CBB's Basel III capital framework, total regulatory capital consists of Tier 1 capital "T1" and Tier 2 capital "T2". T1 capital is further divided into Common Equity Tier 1 capital "CET1" and Additional Tier 1 capital "AT1". CET1 capital consists of : (a) Issued and fully paid common shares that meet the criteria for classification as common shares for regulatory purposes, (b) Disclosed reserves including: i) General reserves; ii) Legal / statutory reserves; iii) Share premium; iv) Fair value reserves arising from fair valuing financial instruments; and v) Retained earnings or losses (including net profit/ loss for the reporting period, whether reviewed or audited), (c) Common shares issued by consolidated subsidiaries and held by third parties (i.e. minority interest) that meet the criteria for inclusion in CET1, and (d) Regulatory adjustments applied in the calculation of CET1. AT1 capital consists of: (a) Instruments issued by the bank that meet the criteria for inclusion in AT1, (b) Share premium resulting from the issue of instruments included in AT1, (c) Instruments issued by consolidated subsidiaries and held by third parties that meet the criteria for inclusion in AT1 and are not included in CET1, and (d) Regulatory adjustments applied in the calculation of AT1. T2 capital consists of: (a) Instruments issued by the bank that meet the criteria for inclusion in T2, (b) Share premium resulting from the issue of instruments included in T2, (c) Instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in T2 capital and are not included in T1, (d) General loan loss provisions (Expected Credit Loss), (e) Asset revaluation reserves which arise from the revaluation of fixed assets and investment properties from time to time in line with the change in market values, and (f) Regulatory adjustments applied in the calculation of T2. At present, the T2 capital of BBK consists solely of general loan loss provision (Expected Credit Loss).

The CBB applies various limits and minima to the components of the regulatory capital, as shown in the below table. There is also a restriction on the amount of general loan loss provision (also called collective impairment provision\ Expected Credit Loss) that may be included as part of T2 capital, which should be a maximum of 1.25 percent of the credit risk weighted assets.

| | Optional | Minimum Ratio |
|---|---|---|
| **Components of Consolidated CAR** | | |
| Core Equity Tier 1 (CET 1) | | 6.50% |
| Additional Tier 1 (AT1) | 1.50% | |
| Tier 1 (T1) | | 8.00% |
| Tier 2 (T2) | 2.00% | |
| Total Capital | | 10.00% |
| Capital Conservation Buffer (CCB) | | 2.50% |
| **CAR including CCB** | | |
| CET 1 plus CCB | | 9.00% |
| Tier 1 plus CCB | | 10.50% |
| Total Capital plus CCB | | 12.50% |

| | Optional | Minimum Ratio |
|---|---|---|
| **Components of Solo CAR** | | |
| Core Equity Tier 1 (CET 1) | | 4.50% |
| Additional Tier 1 (AT1) | 1.50% | |
| Tier 1 (T1) | | 6.00% |
| Tier 2 (T2) | 2.00% | |
| Total Capital | | 8.00% |
| Capital Conservation Buffer (CCB) | | 0.00% |

In accordance with the CBB's Basel III capital adequacy framework, certain exposures are required to be deducted from regulatory capital rather than included in RWAs. The CBB's Basel III capital adequacy framework requires that most of the deductions be made from the CET1.

There are no impediments on the transfer of funds or regulatory capital within the Group other than restrictions over transfers to ensure minimum regulatory capital requirements are met for subsidiary companies.

## REGULATORY CAPITAL COMPONENTS

The table below provides a detailed breakdown of the bank's regulatory capital components, including all regulatory adjustments. The table also provides reference to the comparison displayed in the previous table between accounting and regulatory statement of financial positions.

| | Component of regulatory capital BD '000 | Amounts subject to pre-2015 treatment BD '000 | Source based on reference letters of the statement of financial positions under the regulatory scope of consolidation |
|---|---|---|---|
| **Common Equity Tier 1: Instruments and reserves** | | | |
| Directly issued qualifying common share capital plus related stock surplus | 148,183 | | h+i+k |
| Retained earnings | 170,686 | | p+r+s |
| Accumulated other comprehensive income and losses (and other reserves) | 90,615 | | l+m+n+o+q |
| **Common Equity Tier 1 capital before regulatory adjustments** | **409,484** | **–** | |
| **Common Equity Tier 1 capital: regulatory adjustments** | | | |
| Cash flow hedge reserve | 224 | | o |
| Investments in own shares | 475 | | e |
| Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation, net of eligible short positions, where the bank does not own more than 10% of the issued share capital (amount above 10% threshold) | – | 22,538 | c |
| **Total regulatory adjustments to Common equity Tier 1** | **699** | **22,538** | |
| **Common Equity Tier 1 capital (CET1)** | **408,785** | | |

### 5 CAPITAL COMPONENTS – CONSOLIDATED (continued)

| | Component of regulatory capital BD '000 | Amounts subject to pre-2015 treatment BD '000 | Source based on reference letters of the statement of financial positions under the regulatory scope of consolidation |
|---|---|---|---|
| **Additional Tier 1 capital: regulatory adjustments** | | | |
| Directly issued qualifying Additional Tier 1 instruments plus related stock surplus | 86,098 | | j |
| of which: classified as equity under applicable accounting standards | 86,098 | | |
| **Additional Tier 1 capital before regulatory adjustments** | **86,098** | **–** | |
| **Additional Tier 1 capital: regulatory adjustments** | | | |
| **Total regulatory adjustments to Additional Tier 1 capital** | – | – | |
| **Additional Tier 1 capital (AT1)** | **86,098** | **–** | |
| **Tier 1 capital (T1 = CET1 + AT1)** | **494,883** | | |
| **Tier 2 capital: regulatory adjustments** | | | |
| Provisions | 29,578 | | a |
| **Tier 2 capital before regulatory adjustments** | **29,578** | | |
| **Tier 2 capital: regulatory adjustments** | | | |
| Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation, net of eligible short positions, where the bank does not own more than 10% of the issued common share capital of the entity (amount above the 10% threshold) | – | 2,378 | d |
| Total regulatory adjustments to Tier 2 capital | – | 2,378 | |
| **Tier 2 capital (T2)** | **29,578** | | |
| **Total capital (TC = T1 + T2)** | **524,462** | | |
| **Total risk weighted assets** | **2,620,687** | | |
| **Capital ratios and buffers** | | | |
| Common Equity Tier 1 (as a percentage of risk weighted assets) | 15.60% | | |
| Tier 1 (as a percentage of risk weighted assets) | 18.88% | | |
| Total capital (as a percentage of risk weighted assets) | 20.01% | | |
| Institution specific buffer requirement (minimum CET1 requirement plus capital conservation buffer plus countercyclical buffer requirements plus G-SIB buffer requirement, expressed as a percentage of risk weighted assets) | 9.00% | | |
| of which: capital conservation buffer requirement | 2.50% | | |
| of which: bank specific countercyclical buffer requirement | N/A | | |
| of which: G-SIB buffer requirement | N/A | | |
| Common Equity Tier 1 available to meet buffers (as a percentage of risk weighted assets) | 15.60% | | |
| **National minima (where different from Basel III)** | | | |
| CBB Common Equity Tier 1 minimum ratio (Excluding Capital Conservation Buffer) | 6.50% | | |
| CBB Tier 1 minimum ratio (Excluding Capital Conservation Buffer) | 8.00% | | |
| CBB total capital minimum ratio (Excluding Capital Conservation Buffer) | 10.00% | | |
| **Amounts below the thresholds for deduction (before risk weighting)** | | | |
| Non-significant investments in the capital of other financials | 24,916 | | b |
| Significant investments in the common stock of financials | 32,681 | | f |
| Deferred tax assets arising from temporary differences (net of related tax liability) | 1,631 | | g |
| **Applicable caps on the inclusion of provisions in Tier 2** | | | |
| Provisions eligible for inclusion in Tier 2 in respect of exposures subject to standardised approach (prior to application of cap) | 48,169 | | |
| Cap on inclusion of provisions in Tier 2 under standardised approach | 29,578 | | a |

## 6 CAPITAL ADEQUACY

The Group's policy is to maintain a strong capital base so as to preserve investor, creditor and market confidence and to sustain the future development of the business. The impact of the level of capital on shareholders' return is also recognized, as well as the need to maintain a balance between the higher returns that might be possible with greater gearing and the advantages and security afforded by a sound capital position. The Group manages its capital structure and makes adjustments to the structure taking account of changes in economic conditions and strategic business plans. The capital structure may be adjusted through the dividend payout and other discretionary payments and the issue of new shares and other capital instruments.

As per its ICAAP, BBK aims to maintain a minimum total capital adequacy ratio in excess of the capital assessed as per its ICAAP document of 13.90 percent. The CBB's current minimum total capital adequacy ratio (including CCB) for banks incorporated in Bahrain is set at 12.5 percent. The total capital adequacy ratio of the Group as at 31 December 2017 was 20.01 percent.

**Strategies and methods for maintaining a strong capital adequacy ratio**

BBK prepares multi-year strategic projections on a rolling annual basis which include an evaluation of short term capital requirements and a forecast of longer-term capital resources.

**Capital ratios – consolidated and subsidiaries above 5% of group capital**

| | Total capital ratio | Tier 1 capital ratio |
|---|---|---|
| BBK – GROUP | 20.01% | 18.88% |
| CrediMax | 63.59% | 63.59% |

## 7 CREDIT RISK – PILLAR III DISCLOSURES

This section describes BBK's exposure to credit risk, and provides detailed disclosures on credit risk in accordance with the CBB's Basel III framework, in relation to Pillar III disclosure requirements.

**Definition of exposure classes**

BBK has a diversified on and off statement of financial position credit portfolio, the exposures of which are divided into the counterparty exposure classes defined by the CBB's Basel III capital adequacy framework for the standardised approach for credit risk. A high-level description of the counterparty exposure classes, referred to as standard portfolios in the CBB's Basel III capital adequacy framework, and the generic treatments, i.e. the risk weights to be used to derive the RWAs, are as follows:-

**Sovereigns portfolio**

The sovereigns portfolio comprises exposures to governments and their respective central banks. The risk weights are zero percent for exposures in the relevant domestic currency, or in any currency for exposures to GCC sovereigns. Foreign currency claims on other sovereigns are risk weighted based on their external credit ratings.

Certain multilateral development banks as determined by the CBB may be included in the sovereigns portfolio and treated as exposures with a zero percent risk weighting.

**Public Sector Entities (PSE) portfolio**

Claims on Bahraini PSEs, and claims on PSEs on domestic currency – which are assigned a zero percent risk weight by their respective country regulator, can be assigned a zero percent risk weight. All other PSEs are risk weighted according to their external ratings.

**Banks portfolio**

Claims on banks are risk weighted based on their external credit ratings. A preferential risk weight treatment is available for qualifying short term exposures. Short term exposures are defined as exposures with an original tenor of three months or less. The Bank's portfolio also includes claims on certain investment firms, which are risk weighted based on their external credit ratings, though without any option for preferential treatment for short term exposures.

**Corporates portfolio**

Claims on corporates are risk weighted based on their external credit ratings. A 100 percent risk weight is assigned to exposures to unrated corporates. A preferential risk weight treatment is available for certain corporates owned by the Government of Bahrain, as determined by the CBB, which are assigned a zero percent risk weight.

**Regulatory retail portfolio**

Claims on retail portfolio are risk weighted at 75 percent, except for past due portfolio.

**Mortgage portfolio**

Claims which are fully secured by first mortgages on residential property that is or will be occupied by the borrower, or that is leased, must carry a risk weighting of 75 percent. Claims secured by mortgages on commercial real estate are subject to a minimum of 100 percent risk weight. If the borrower is rated below BB-, the risk-weight corresponding to the rating of the borrower must be applied.

**Equities portfolio**

The equities portfolio comprises equity investments in the banking book. A 100 percent risk weight is assigned to listed equities while unlisted equities are weighted at 150 percent, unless subject to the following treatments. The amount of any significant investments in commercial entities (A "significant investment" in a commercial entity is defined as any investment in the capital instruments of a commercial entity by the bank which is equivalent to or more than 10 percent of the issued common share capital of the issuing commercial entity) above 15 percent (individually) and 60 percent (collectively) of the bank's capital (the "Total Capital materiality thresholds") must be risk weighted at 800 percent. Moreover, significant investments in the common shares of unconsolidated financial entities must be risk weighted at 250 percent.

In addition to the standard portfolios, other exposures are assigned to the following exposure classes:

**Investments in funds portfolio**

The risk weight for claims on corporates will be used to determine the risk weight for investments in rated funds. Unrated funds will be assigned a risk weight of 100 percent if listed, and 150 percent if not listed.

## 7 CREDIT RISK – PILLAR III DISCLOSURES (continued)

**Past due exposures**

This includes claims, for which the repayment is overdue for more than ninety days. The risk weighting applied for such loans is either 100 percent or 150 percent, depending on the level of provisions maintained against the loan.

**Holding of real estate**

All holding of real estate by banks (owned directly or by the way of investments in real estate companies, subsidiaries or associated companies or other arrangements such as trusts, funds or REITS) must be risk weighted at 200 percent. Premises occupied by the bank are weighted at 100 percent.

**Other assets and holdings of securitisation tranches**

Other assets are risk weighted at 100 percent, whereas securitization exposures are risk weighted at 20 percent to 1,250 percent, depending on the external rating.

All BBK's holding of securitizations is part of the bank's investment portfolio.

**Large Exposures**

The excess amount of any exposure above 15 percent of the bank's regulatory capital to any counterparty or a group of closely related counterparties must be risk weighted at 800 percent, unless it is an exempted exposure in accordance with the requirements of the CBB Rulebook.

**External rating agencies**

BBK uses ratings issued by Moody's and Fitch to derive the risk weightings under the CBB's Basel III capital adequacy framework. Where ratings vary between rating agencies, the highest rating from the lowest two ratings is used to represent the rating for regulatory capital adequacy purposes.

**Credit risk presentation under Basel III**

The credit risk exposures presented in most of this report differ from the credit risk exposures reported in the consolidated financial statements. Differences arise due to the application of different methodologies, as illustrated below:-

- Under the CBB's Basel III framework, off statement of financial position exposures are converted into credit exposure equivalents by applying a credit conversion factor (CCF). The off statement of financial position exposure is multiplied by the relevant CCF applicable to the off statement of financial exposure position category. Subsequently, the exposure is treated in accordance with the standard portfolios as referred to above in this report, in the same manner as on statement of financial position exposures.
- In case of Over-the-Counter (OTC) derivative contracts, in addition to the default risk capital requirements for counterparty credit risk, the bank must add a capital charge to cover the risk of mark-to-market losses on the expected counterparty risk (such losses being known as credit value adjustments or CVA).
- Credit risk exposure reporting under Pillar III is frequently reported by standard portfolios based on the type of counterparty. The financial statement presentation is based on asset class rather than the relevant counterparty. For example, a loan to a bank would be classified in the Bank's standard portfolio under the capital adequacy framework although is classified in loans and advances in the consolidated financial statements.
- Certain eligible collateral is applied to reduce exposure under the Basel III capital adequacy framework, whereas no such collateral netting is applicable in the consolidated financial statements.
- Based on the CBB's Basel III guidelines, certain exposures are either included in, or deducted from, regulatory capital rather than treated as an asset as in the consolidated financial statements.

## 8 CAPITAL REQUIREMENT FOR RISK WEIGHTED EXPOSURE

| | Gross credit exposures (before risk mitigation) BD '000 | Eligible financial collateral BD '000 | Credit risk after risk mitigation BD '000 | Risk weighted asset BD '000 | Regulatory capital required 12.5% BD '000 |
|---|---|---|---|---|---|
| Sovereign | 1,213,110 | – | 1,213,110 | 19,615 | 2,452 |
| Public Sector Entities | 18,972 | – | 18,972 | – | – |
| Banks | 426,337 | – | 426,337 | 231,332 | 28,917 |
| Corporates | 1,529,467 | 16,069 | 1,513,398 | 1,394,605 | 174,326 |
| Regulatory retail | 398,830 | 442 | 398,388 | 298,791 | 37,349 |
| Mortgage | 93,829 | 126 | 93,703 | 70,277 | 8,785 |
| Investment in securities | 95,100 | – | 95,100 | 150,671 | 18,834 |
| Past Due | 46,168 | 366 | 45,802 | 48,172 | 6,022 |
| Real Estate | 42,242 | – | 42,242 | 70,065 | 8,758 |
| Other assets and cash items | 98,355 | – | 98,355 | 82,684 | 10,336 |
| **Total Credit Risk** | **3,962,410** | **17,003** | **3,945,407** | **2,366,212** | **295,779** |
| **Market Risk** | – | – | – | 28,050 | 3,506 |
| **Operational Risk** | – | – | – | 226,425 | 28,303 |
| **Total Risk Weighted Exposure** | **3,962,410** | **17,003** | **3,945,407** | **2,620,687** | **327,588** |

**Credit Risk Mitigation and Collateral valuation policy**

BBK employs a range of techniques to mitigate risk in its credit portfolio. Credit risk mitigation includes an objective assessment of the counterparty's capacity and willingness to meet its commitments in the normal course. The bank strives to optimize facility structure, collateral, lending covenants, terms and conditions.

The Bank has detailed policies and procedures for valuing collateral/ securities offered for various credit facilities. The collateral is valued, at minimum, quarterly or annually, based on the type of security. More frequent valuations are also considered if warranted by market volatility and declining trends in valuations are observed. The collaterals and support include mortgages, cash collaterals, marketable securities, personal and corporate guarantees and guarantees from sovereigns and financial institutions. The basis of valuation for different types of securities such as equity, debt, and real estate is also clearly defined in the policies.

## 9 OPERATIONAL RISK

| Year | 2014 BD '000 | 2015 BD '000 | 2016 BD '000 | Total BD '000 |
|---|---|---|---|---|
| **Gross Income** | **113,720** | **116,732** | **131,818** | **362,270** |
| Number of years with positive Gross Income | | | | 3 |
| **Average** | | | | **120,757** |
| Alpha relating the industry wide level of required capital to the industry wide level of the indicator | | | | 15% |
| **Capital Charge under the Basic Indicator Approach-K-BIA** | | | | **18,114** |
| Multiplier | | | | 12.5 |
| Risk Weighted Exposure | | | | **226,425** |

## 10 FUNDED AND UNFUNDED TOTAL CREDIT EXPOSURE

| Total gross credit exposures | Total funded credit exposures BD '000 | Total un-funded credit exposures BD '000 |
|---|---|---|
| Sovereign | 1,209,360 | 3,750 |
| Public Sector Entities | 18,616 | 356 |
| Banks | 415,433 | 10,904 |
| Corporates | 1,373,454 | 156,013 |
| Regulatory retail | 398,830 | – |
| Mortgage | 93,829 | – |
| Investment in securities | 95,100 | – |
| Past due | 46,168 | – |
| Real estate | 42,242 | – |
| Other assets and cash items | 98,355 | – |
| **Total credit risk** | **3,791,387** | **171,023** |

## 11 AVERAGE CREDIT EXPOSURE

The following are the average quarterly balances for the year ended 31st December 2017:

| | BD'000 |
|---|---|
| Sovereign | 1,065,552 |
| Public Sector Entities | 20,287 |
| Banks | 523,398 |
| Corporates | 1,502,475 |
| Regulatory retail | 378,223 |
| Mortgage | 90,761 |
| Investment in securities | 99,137 |
| Past Due | 60,655 |
| Real estate | 40,360 |
| Other assets and cash items | 84,542 |
| **Total credit risk** | **3,865,390** |

## 12 CONCENTRATION OF CREDIT RISK BY REGION (EXPOSURES SUBJECT TO RISK WEIGHTING)

| | GCC BD'000 | North America BD'000 | Europe BD'000 | Asia BD'000 | Others BD'000 | Total BD'000 |
|---|---|---|---|---|---|---|
| Cash and balances with central banks | 465,496 | – | – | 3,940 | – | **469,436** |
| Treasury bills | 418,093 | – | – | 9,037 | – | **427,130** |
| Deposits in banks and other financial institutions | 163,999 | 27,311 | 14,949 | 17,565 | – | **223,824** |
| Loans and advances to customers | 1,559,046 | – | 78,619 | 109,783 | 22,792 | **1,770,240** |
| Investments in associated companies | 45,823 | – | 660 | – | – | **46,483** |
| Investment securities | 496,595 | 10,235 | 123,890 | 80,426 | 38,943 | **750,089** |
| Other assets | 98,437 | – | 397 | 5,351 | – | **104,185** |
| **Total funded exposure** | **3,247,489** | **37,546** | **218,515** | **226,102** | **61,735** | **3,791,387** |
| Unfunded commitments and contingencies | 149,886 | 80 | 6,336 | 14,708 | 13 | **171,023** |
| **Total credit risk** | **3,397,375** | **37,626** | **224,851** | **240,810** | **61,748** | **3,962,410** |

## 13 CONCENTRATION OF CREDIT RISK BY INDUSTRY (EXPOSURES SUBJECT TO RISK WEIGHTING)

| | Trading and manufacturing BD '000 | Banks and other financial institutions BD '000 | Construction and real estate BD '000 | Government and public sector BD '000 | Individuals BD '000 | Others BD '000 | Total BD '000 |
|---|---|---|---|---|---|---|---|
| Cash and balances with central banks | – | 18,597 | – | 450,839 | – | – | **469,436** |
| Treasury bills | – | – | – | 427,130 | – | – | **427,130** |
| Deposits in banks and other financial institutions | – | 223,824 | – | – | – | – | **223,824** |
| Loans and advances to customers | 585,605 | 176,473 | 380,243 | 13,418 | 449,359 | 165,142 | **1,770,240** |
| Investments in associated companies | – | 42,102 | – | – | – | 4,381 | **46,483** |
| Investment securities | 44,111 | 196,540 | 18,339 | 477,456 | – | 13,643 | **750,089** |
| Other assets | – | – | – | – | – | 104,185 | **104,185** |
| **Total funded exposure** | **629,716** | **657,536** | **398,582** | **1,368,843** | **449,359** | **287,351** | **3,791,387** |
| Unfunded commitments and contingencies | 94,624 | 15,669 | 36,852 | 738 | 148 | 22,992 | **171,023** |
| **Total credit risk** | **724,340** | **673,205** | **435,434** | **1,369,581** | **449,507** | **310,343** | **3,962,410** |

## 14 CONCENTRATION OF CREDIT RISK BY MATURITY (EXPOSURES SUBJECT TO RISK WEIGHTING)

| | Within 1 month BD '000 | 1 to 3 months BD '000 | 3 to 6 months BD '000 | 6 to 12 months BD '000 | 1 to 5 years BD '000 | 5 to 10 years BD '000 | 10 to 20 years BD '000 | Above 20 years BD '000 | Total BD '000 |
|---|---|---|---|---|---|---|---|---|---|
| Cash and balances with central banks | 389,128 | – | – | – | – | – | – | 80,308 | **469,436** |
| Treasury bills | 49,929 | 135,726 | 124,198 | 117,277 | – | – | – | – | **427,130** |
| Deposits in banks and other financial institutions | 185,205 | 38,619 | – | – | – | – | – | – | **223,824** |
| Loans and advances to customers | 252,085 | 161,699 | 123,896 | 163,084 | 742,113 | 241,279 | 45,872 | 40,212 | **1,770,240** |
| Investments in associated companies | – | – | – | – | – | – | – | 46,483 | **46,483** |
| Investment securities | 29,085 | 29,727 | 12,182 | 7,547 | 305,248 | 226,442 | 26,891 | 112,967 | **750,089** |
| Other assets | 68,311 | – | – | – | 32,601 | 304 | 1,257 | 1,712 | **104,185** |
| **Total funded exposure** | **973,743** | **365,771** | **260,276** | **287,908** | **1,079,962** | **468,025** | **74,020** | **281,682** | **3,791,387** |
| Unfunded commitments and contingencies | 62,534 | 32,229 | 28,258 | 40,810 | 3,150 | 2,916 | 378 | 748 | **171,023** |
| **Total credit risk** | **1,036,277** | **398,000** | **288,534** | **328,718** | **1,083,112** | **470,941** | **74,398** | **282,430** | **3,962,410** |

## 15 IMPAIRED LOANS AND PROVISIONS

| | Principle outstanding BD '000 | Impaired loans BD '000 | Stage 3: Lifetime ECL credit- impaired BD '000 | Net Specific charges during the period BD '000 | Write off during the period BD '000 |
|---|---|---|---|---|---|
| Trading and manufacturing | 624,856 | 50,041 | 30,513 | 20,600 | 18,499 |
| Banks and other financial institutions | 180,319 | 2,379 | 1,839 | 11 | – |
| Construction and real estate | 400,838 | 29,214 | 17,977 | 5,076 | 14,614 |
| Government and public sector | 20,795 | 16,204 | 7,240 | 886 | – |
| Individuals | 459,540 | 8,466 | 7,773 | 2,313 | 2,347 |
| Others | 166,630 | 1,227 | 920 | 26 | 9,436 |
| **Total** | **1,852,978** | **107,531** | **66,262** | **28,912** | **44,897** |

## 16 AGEING OF IMPAIRED AND PAST DUE LOANS BY REGION

| | GCC BD '000 | North America BD '000 | Europe BD '000 | Asia BD '000 | Others BD '000 | Total BD '000 |
|---|---|---|---|---|---|---|
| 3 months up to 1 year | 74,555 | – | – | 1,120 | – | **75,675** |
| 1 to 3 years | 17,465 | – | – | – | – | **17,465** |
| Over 3 years | 14,377 | – | – | 14 | – | **14,391** |
| **Total past due and impaired loans** | **106,397** | **–** | **–** | **1,134** | **–** | **107,531** |
| Stage 3: Lifetime ECL credit– impaired | (65,971) | – | – | (291) | – | **(66,262)** |
| Stage 1: 12-month ECL and stage 2 : Lifetime ECL not credit- impaired | (46,065) | – | – | – | – | **(46,065)** |

## 17 AGEING OF IMPAIRED AND PAST DUE LOANS BY INDUSTRY

| | Trading and manufacturing BD '000 | Banks and other financial institutions BD '000 | Construction and real estate BD '000 | Government and public sector BD '000 | Individuals BD '000 | Others BD '000 | Total BD '000 |
|---|---|---|---|---|---|---|---|
| 3 months up to 1 year | 41,812 | 2,379 | 11,842 | 16,204 | 2,214 | 1,224 | **75,675** |
| 1 to 3 years | 5,421 | – | 9,225 | – | 2,816 | 3 | **17,465** |
| Over 3 years | 2,808 | – | 8,147 | – | 3,436 | – | **14,391** |
| **Total past due and impaired loans** | **50,041** | **2,379** | **29,214** | **16,204** | **8,466** | **1,227** | **107,531** |
| Stage 3: Lifetime ECL credit- impaired | (30,513) | (1,839) | (17,977) | (7,240) | (7,773) | (920) | **(66,262)** |
| Stage 1: 12-month ECL and stage 2: Lifetime ECL not credit- impaired | (15,239) | (4,592) | (9,895) | (349) | (11,693) | (4,297) | **(46,065)** |

## 18 RESTRUCTURED LOANS

| | BD'000 |
|---|---|
| Loans restructured during the period | 89,739 |
| Impact of restructured facilities and loans on provisions | 15,512 |

The above restructuring did not have any significant impact on present and future earnings and were primarily extentions of the loan tenor, revisions in interest rate, and additional collateral received.

## 19 MARKET RISK DISCLOSURES FOR BANKS USING THE INTERNAL MODELS APPROACH (IMA) FOR TRADING PORTFOLIOS

The "Market Risk Internal Model" is being used to measure Value-at-Risk (VaR) for calculating Capital Charge arising from Market Risk exposures (mainly Foreign Exchange and Interest Rate Risk positions) of the Trading Book. The VaR Model quantifies the maximum potential loss that could occur in the Trading book risk positions under normal market conditions, at 99% confidence level, on a 10-day horizon.

BBK maintains a prudent approach to Manage Market Risk exposures guided by Market Risk Policy and Procedure. The Position, Stoploss and VaR limits are monitored by Treasury Middle Office (reporting to Risk and Credit Administration Department and Independent of Business unit) and a daily risk report is circulated to the Senior Management.

In addition to the above, the Treasury Middle Office also carries out valuation of the Investment Portfolio independently as per the internal policies and procedures. Furthermore BBK also conducts Stress Testing and Back Testing of Market Risk positions.

The summary of VaR of the trading book for the period January 2017 to December 2017 is as follows:

**VaR Results for 2017 (10 day 99%)**
**Global (BAHRAIN and KUWAIT)**

### 1 January 2017 to 31 December 2017

| Asset class | Limit BD '000 | VaR 31 December 2017 BD '000 | High VaR BD '000 | Low VaR BD '000 | Average VaR BD '000 |
|---|---|---|---|---|---|
| Foreign exchange | 641.00 | 147.37 | 270.19 | 87.46 | 159.22 |
| Interest rate | 151.00 | 2.03 | 8.87 | 0.11 | 1.22 |
| | **792.00** | **149.40** | **271.35** | **88.47** | **160.44** |

The Bank conducts Backtesting of VaR on a daily basis in compliance with CBB regulations to validate the internal VaR model and to check whether or not the model can predict potential losses with a fair degree of accuracy. Under Backtesting, the daily VaR numbers are compared with the mark-to-market profit or loss figures (on actual average Profit and Loss basis and also hypothetical Profit and Loss basis). If this comparison is close enough, the Backtest raises no issues regarding quality of the risk measurement model.

The Backtesting results for the period January-December 2017 confirmed that there was one occasion on which a daily trading loss exceeded VaR figure.

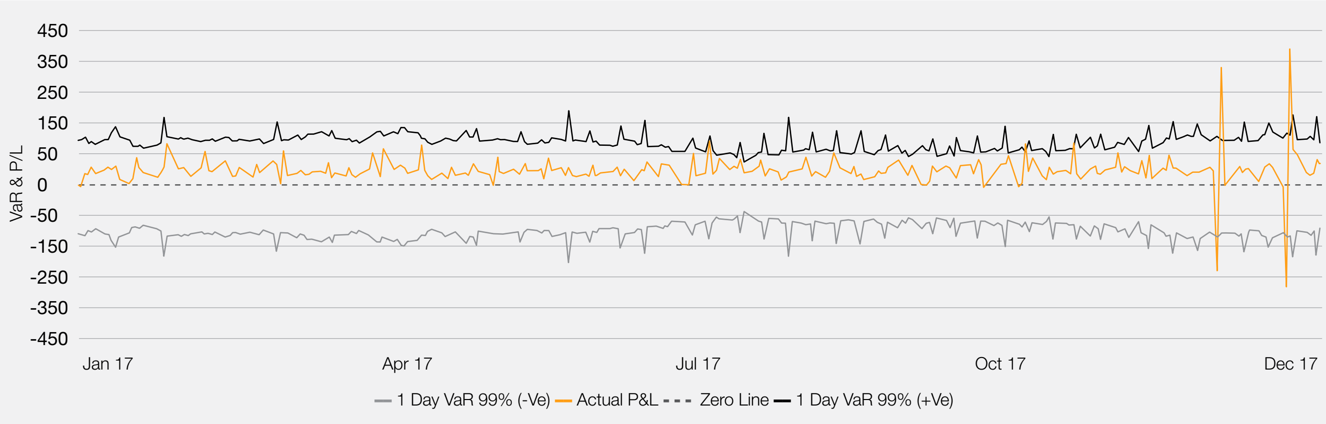
## 19 MARKET RISK DISCLOSURES FOR BANKS USING THE INTERNAL MODELS APPROACH (IMA) FOR TRADING PORTFOLIOS (continued)

**Month end VaR (10 day 99%)**

| Month | VaR BD'000 |
|---|---|
| January 2017 | 175 |
| February 2017 | 231 |
| March 2017 | 181 |
| April 2017 | 162 |
| May 2017 | 159 |
| June 2017 | 137 |
| July 2017 | 129 |
| August 2017 | 109 |
| September 2017 | 120 |
| October 2017 | 158 |
| November 2017 | 166 |
| December 2017 | 149 |

The following graph shows the daily average Profit and Loss (Actual Average P & L basis) vis-à-vis one day VaR, for the review period.

**Value-at-Risk Backtesting January – December 2017**




## 20 CONCENTRATION RISK TO INDIVIDUALS WHERE THE TOTAL EXPOSURE IS IN EXCESS OF SINGLE OBLIGOR LIMIT OF 15%

| | BD '000 |
|---|---|
| Sovereign | 914,450 |
| **Total** | 914,450 |

## 21 CREDIT DERIVATIVES EXPOSURE

BBK is not exposed to any credit derivatives as at 31st December 2017.

## 22 EQUITY POSITIONS IN THE BANKING BOOK

| | BD '000 |
|---|---|
| Publicly traded equity shares | 40,979 |
| Privately held equity shares | 23,720 |
| **Total** | 64,699 |
| **Capital required** | 8,087 |

## 23 GAINS ON EQUITY INSTRUMENTS

| | BD '000 |
|---|---|
| Realised Gains/ Losses in statement of profit or loss | 442 |
| Realised Gains/ Losses in retained earnings | (1,325) |
| Unrealised Gains/ Losses in CET1 Capital | (20,530) |