# Basel II, Pillar 3 Disclosures

## RISK AND CAPITAL MANAGEMENT

## FOR THE SIX MONTH PERIOD ENDED

## *30 June 2011*

*These disclosures have been prepared in accordance with the Public Disclosure Module ("PD"), Section PD-3.1.6, CBB Rule Book, Volume I for Conventional Banks. These disclosures should be read in conjunction with the Notes, in particular the Significant Accounting Policies and Financial Risk Management, in the Bank's Financial Statements.*

*These disclosures have been reviewed by the Bank's external auditors KPMG based on agreed upon procedures as required under Para PD-A.2.4 of the PD Module.*

# Contents

## EXECUTIVE SUMMARY

SICO Investment Bank is a Conventional Wholesale bank licensed by the Central Bank of Bahrain (CBB). SICO provides innovative products and investment banking services that include Asset Management, Corporate Finance, Brokerage and Market Making.

This Risk and Capital Management report encompasses the Basel II Pillar 3 disclosure requirements prescribed by the CBB based on the Basel Committee's Pillar 3 guidelines. The report contains a description of SICO's risk management and capital adequacy practices, including detailed information on the capital adequacy process.

The information presented herein pertains to Securities and Investment Company BSC (c) consolidated with its subsidiaries (together termed as "SICO" or the "Bank").

All figures presented in this report are as at **30th June 2011** unless otherwise stated.

## 1. INTRODUCTION

### 1.1 CBB Rulebook

The Central Bank of Bahrain's (CBB) Basel II guidelines prescribes the capital adequacy framework for banks incorporated in the Kingdom of Bahrain. During January 2008, the CBB introduced these guidelines and all banks in Bahrain were requested to comply with them.

These semi-annual disclosures have been prepared in accordance with the CBB requirements outlined in the Public Disclosure Module ("PD"), Section PD-3.1.6: Additional Requirements for Semi Annual Disclosures, CBB Rule Book, Volume I for Conventional Banks. These semi-annual quantitative disclosure requirements follow the requirements of Basel II - Pillar 3.

### 1.2 BASEL II Framework

**Basel II** is the second of the Basel Accords, which was issued by the Basel Committee on Banking Supervision. The Basel II framework consists of 3 pillars. The pillars are as follows:

- Pillar 1 - Describes the minimum capital requirements by applying risk based methodology in the calculation of the risk weighted assets (RWAs) and capital requirement for the major asset classes to derive to the capital adequacy ratio (CAR).
- Pillar 2 - Describes the supervisory review processes, which includes the Internal Capital Adequacy Assessment Process (ICAAP)
- Pillar 3 - Describes Market discipline, which includes disclosure of risk management process and capital adequacy requirements and guidelines.

| BASEL II | | |
|---|---|---|
| **Pillar 1** | **Pillar 2** | **Pillar 3** |
| **Minimum Capital Requirements** | **Supervisory Review Process** | **Market Discipline** |
| **Risk based capital requirements for:**<br><br>- Credit Risk<br>- Market Risk<br>- Operational Risk | **Regulatory Framework for Banks:**<br>Internal Capital Adequacy Assessment Process (ICAAP)<br><br>**Supervisory Framework:**<br>Supervisory Review & Evaluation Process | **Disclosure requirement for banks:**<br><br>- Specific Quantitative and qualitative disclosures<br>- Transparency for market participants concerning the bank's risk position (scope of application, risk management etc.)<br>- Enhanced comparability of banks |

### 1.2.1 Pillar 1

Pillar 1 lays down the basis for the calculation of the regulatory Capital Adequacy Ratio (CAR). Pillar 1 sets out the definition and calculations of the RWAs, and the derivation of the regulatory capital base. The capital adequacy ratio is calculated by dividing the regulatory capital base by the total RWAs.

Below are the approaches used for determining for deriving the CAR.

| Approaches for determining regulatory capital requirements | | |
|---|---|---|
| **Credit Risk** | **Market Risk** | **Operational Risk** |
| Standardized Approach | Standardized Approach | Basic Indicator Approach |
| Foundation IRB Approach (Internal Ratings Based) | Internal Models Approach (IMA) | Standardized Approach |
| Advanced IRB Approach (Internal Ratings Based) | - | Advanced Measurement Approach (AMA) |

SICO has adopted the Standardized Approach for Credit Risk and Market Risk and follows the Basic Indicator Approach for Operational Risk to determine its capital requirements.

### 1.2.2 Pillar 2

Pillar 2 sets out the supervisory review & evaluation process of an institution's risk management framework and accordingly its capital adequacy through ICAAP.

The supervisory review and evaluation process represents the CBB's review of the Bank's capital management and an assessment of internal controls and corporate governance. The process is designed to ensure that institutions identify their material risks and allocate adequate capital, and employ sufficient management processes to support such risks. It process also encourages institutions to develop and apply enhanced risk management techniques for the measurement and monitoring of risks in addition to the credit, market and operational risks addressed in the core Pillar 1 framework.

Other risk types which are not covered by the minimum capital requirements in Pillar 1 include liquidity risk, interest rate risk in the banking book, business risk and concentration risk. These are covered either by capital, or risk management and mitigation processes under Pillar 2.

Pillar 2 also comprises an Internal Capital Adequacy Assessment Process (ICAAP). The ICAAP incorporates a review and evaluation of risk management and capital relative to the risks to which the bank is exposed. The ICAAP addresses all components of the Bank's risk management, from the daily management of more material risks to the strategic capital management of the Bank. The brief and final ICAAP will be based on the Bank's economic capital framework which is designed to ensure that the Bank has sufficient capital resources available to meet regulatory and internal capital requirements, even during periods of economic or financial stress.

### 1.2.3 Pillar 3

The third pillar as per the CBB's Rulebook, describes the level of qualitative and quantitative information that should be disclosed about an institution's risk management and capital adequacy practices.

Under the current regulations, partial disclosure consisting mainly of quantitative analysis is required during half year reporting, whereas fuller disclosure is required to coincide with the financial year end reporting.

## 1.3 Scope of Application

SICO Investment Bank is a conventional wholesale bank incorporated in Bahrain and is regulated by the CBB. SICO provides investment banking services on a regional basis with principal focus on the GCC. There is a regulatory requirement to calculate and maintain minimum regulatory capital ratios on both a solo as well as consolidated basis.

The principal subsidiary that is fully consolidated into the financial statements of SICO is SICO Funds Services Company BSC (c) ("SFS"), also incorporated in Bahrain, which provides custody and administration services.

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## 2 CAPITAL STRUCTURE, RISK WEIGHTED ASSETS AND CAPITAL ADEQUACY

### 2.1 Capital Structure

| | 30 June 2011 |
|---|---|
| **Tier 1 Capital** | |
| Issued and fully paid ordinary shares | 42,652 |
| Statutory Reserve | 3,971 |
| General Reserve | 1,737 |
| Share Premium | 630 |
| Retained Earnings Brought forward | 3,962 |
| Gross unrealised loss arising from fair valuing equity securities | (253) |
| Securitisation exposures subject to deduction | - |
| **Total Tier 1 capital (A)** | **52,699** |
| **Tier 2 Capital** | |
| Current Interim Profits (reviewed by External Auditors) | 499 |
| 45% of gross unrealised gains arising from fair valuing equity securities | 251 |
| Securitisation exposures subject to deduction | - |
| **Total Tier 2 capital (B)** | **750** |
| **Total regulatory capital (C) = (A) + (B)** | **53,449** |
| Credit risk weighted exposures | 47,510 |
| Market risk weighted exposures | 20,276 |
| Operational risk weighted exposures | 10,027 |
| **Total risk weighted exposures (D)** | **77,813** |
| **Tier 1 Capital Adequacy Ratio (A)/(D)** | **67.73%** |
| **Total Capital Adequacy Ratio (C)/(D)** | **68.69%** |

### 2.2 Changes to Capital Structure

During the period, 1,236,542 shares of 100 fils each were issued under the employees share based compensation for the year 2010. These shares were issued at the NAV of 134 fils per share as at 31 December 2010. Accordingly, the share capital increased by BD 124 to the extent of the nominal value of the shares of 100 fils each. The share premium of BD 41 relating to the issue of these shares at a premium of 34 fils per share has been credited to the statutory reserve.

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## 3. RISK EXPOSURES

### 3.1 Credit Risk

#### *3.1.1 Gross credit exposures*

**As at 30 June 2011**

| | Gross credit exposure | | | Credit risk weighted assets | Capital requirement @ 12% |
|---|---|---|---|---|---|
| | On-balance sheet (Funded) | Off-balance sheet (Unfunded) | Total | | |
| Cash items | 881 | - | 881 | - | - |
| Claims on Sovereigns | 2,044 | - | 2,044 | - | - |
| Claims on Bahraini Public Sector Entities | 500 | - | 500 | - | - |
| Claims on Banks | 62,389 | - | 62,389 | 19,638 | 2,356 |
| Claims on Corporates | 44 | - | 44 | 48 | 6 |
| Investments in Securities | 21,320 | 279 | 21,599 | 23,164 | 2,780 |
| Holdings in Real Estate | 1,271 | 121 | 1,392 | 2,784 | 334 |
| Other Assets | 3,040 | 375 | 3,415 | 3,415 | 410 |
| **TOTAL** | **91,489** | **775** | **92,264** | **49,049** | **5,886** |

The on-balance sheet and off-balance sheet gross exposures have been risk weighted using the applicable risk weights and CCF's (credit conversion factors).

The balances above are representative of the position during the period; hence the average balances for the period is not separately disclosed.

The exposures are not backed by collaterals and hence no benefit for credit risk mitigation is applicable.

#### *3.1.2 Large exposure limits*

As at 30 June 2011, the following exposures exceeded the single obligor limit (15 per cent of the Bank's regulatory capital base) as defined in the CM Module of the CBB:

| Counterparty | Country | Amount | Exposure as a % to the eligible capital base |
|---|---|---|---|
| Counterparty A* | Bahrain | 12,719 | 23.78% |

**The above exposure qualifies as exempt exposure as it is in the nature of short term inter-bank exposures and hence no regulatory capital deduction is considered necessary.*

For the six month period ended 30 June 2011 BHD '000

*3. RISK EXPOSURES (continued)*

*3.1 Credit Risk (continued)*

***3.1.3 Maturity profile***

| As at 30 June 2011 | Less than 3 months | Over 3 months to 6 months | Over 6 months to 1 year | Over 1 year to 5 years | Over 5 years to 10 years | Over 10 years | Total |
|---|---|---|---|---|---|---|---|
| Cash and Bank balances | 40,550 | 3,770 | - | - | - | - | 44,320 |
| Investments at fair value through profit or loss | 8,247 | - | | 7,185 | - | - | 15,432 |
| Available-for-sale investments | - | - | | 23,821 | - | - | 23,821 |
| Held-to-maturity investments | - | - | | - | - | - | - |
| Other assets | 1,558 | 112 | 656 | 2,439 | - | | 4,765 |
| **Total gross credit exposures** | **50,355** | **3,882** | **656** | **33,445** | **-** | **-** | **88,338** |
| **Commitments and contingencies** | **-** | **-** | | **1,159** | **-** | **-** | **1,159** |

*Note: None of the exposures have a maturity period in excess of ten years.*
*The Trading and AFS investments as of 30-Jun-2011 also include repo transactions.*

***3.1.4 Sectoral distribution***

| As at 30 June 2011 | Commercial banks | Other banks | Services | Managed funds | Others | Total |
|---|---|---|---|---|---|---|
| Cash and Bank balances | 44,320 | - | - | - | - | 44,320 |
| Investments at fair value through profit or loss | 1,381 | 355 | 3,645 | 1,943 | 8,108 | 15,432 |
| Available-for-sale investments | 2,018 | 1,480 | 1,350 | - | 18,973 | 23,821 |
| Held-to-maturity investments | - | - | - | - | - | - |
| Other assets | - | - | - | - | 4,765 | 4,765 |
| **Total gross credit exposures** | **47,719** | **1,835** | **4,995** | **1,943** | **31,846** | **88,338** |
| **Commitments and contingencies** | **-** | **377** | **-** | **-** | **782** | **1,159** |

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*3. RISK EXPOSURES (continued)*

*3.1 Credit Risk (continued)*

***3.1.5 Geographical distribution***

| As at 30 June 2011 | GCC countries | USA | Europe | Other MENA | Total |
|---|---|---|---|---|---|
| Cash and Bank balances | 44,320 | - | - | - | 44,320 |
| Investments at fair value through profit or loss | 9,834 | 1,943 | 3,655 | - | 15,432 |
| Available-for-sale investments | 10,993 | - | 12,404 | 424 | 23,821 |
| Held-to-maturity investments | - | - | - | - | - |
| Other assets | 4,765 | - | - | - | 4,765 |
| **Total gross credit exposures** | **69,912** | **1,943** | **16,059** | **424** | **88,338** |
| **Commitments and contingencies** | **556** | **-** | **603** | **-** | **1,159** |

***3.1.6 Impairment on available-for-sale investment securities***

During the period, the Bank has taken the following impairments.

| Items | Amount in BHD 000' |
|---|---|
| Impairment on available-for-sale investments | (39) |

**3.2 Market Risk**

The market risk weighted assets and the capital requirement is computed as follows:

| | Market risk weighted assets | | | Capital requirement @ 12% of (A) |
|---|---|---|---|---|
| | During the period ended 30 June 2011 | | As at 30 June 2011 (A) | |
| | Minimum | Maximum | | |
| Interest Rate Position Risk | 439 | 563 | 563 | 68 |
| Equities Position Risk | 151 | 956 | 956 | 115 |
| Foreign Exchange Risk | 103 | 269 | 103 | 12 |
| **Total minimum capital required for market risk** | | | **1,622** | **195** |
| Multiplier | | | 12.5 | 12.5 |
| **TOTAL** | | | **20,276** | **2,433** |

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*3. RISK EXPOSURES (continued)*

### 3.3 Operational risk

The operational risk weighted assets are computed as per the guidelines of the CBB which are as follows:

Average gross income for the past 3 years * 15% * 12.5
(Excluding extraordinary and exceptional income)

| | 2008 | 2009 | 2010 |
|---|---|---|---|
| Gross income | 3,031 | 6,068 | 6,668 |
| Average gross income (A) | | | 5,256 |
| Alpha (B) | | | 15% |
| (C) = (A) * (B) | | | 788 |
| **Risk weighted exposures (D) = ((C) * 12.5)** | | | **9,854** |
| **Capital requirement @ 12% of (D)** | | | **1,183** |

The Bank did not have any material legal contingencies during the six months period ended 30 June 2011.

### 4 INTEREST RATE RISK IN THE BANKING BOOK

A 200 bps increase or decrease in market interest rates would affect the value of the fixed income securities in the available-for-sale and held-to-maturity portfolios as follows:-

| | 200 bp increase | 200 bp decrease |
|---|---|---|
| **As at 30 June 2011** | (323,591) | 360,552 |

The interest rate risk on the Bank's placements is considered minimal and hence no sensitivity analysis has been presented.

### 5 EQUITY POSITIONS IN THE BANKING BOOK

**As at 30 June 2011**

| | Gross exposure | Risk Weighted assets (A) | Capital requirement @ 12% of (A) |
|---|---|---|---|
| Equity investments | | | |
| - Listed | 1,796 | 1,796 | 216 |
| - Unlisted | 1,564 | 2,346 | 282 |
| Investment in rated funds | 6,117 | 1,404 | 168 |
| Investment in unrated funds | | | |
| - Listed/Unlisted | 12,122 | 17,619 | 2,114 |
| **Total** | **21,599** | **23,164** | **2,780** |

**During the period ended 30 June 2011**

| | Amount |
|---|---|
| Realised net gain during the period | 997 |
| Dividend income during the period | 194 |
| Unrealised net gain/loss recognised in equity as at 30 June 2011 | 677 |
| Gross unrealised losses deducted from Tier 1 capital | 253 |
| 45% of unrealized gains recognised under Tier 2 capital | 251 |

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## 6 RELATED PARTY TRANSACTIONS

The following are the related party transactions during the period. All these transactions are in the ordinary course of business and on normal commercial terms.

Transactions with funds owned by the Subsidiary companies namely SICO Funds Company BSC (c), SICO Funds Company II BSC (c), SICO Funds Company III BSC (c), SICO Funds Company IV BSC (c), SICO Funds Company V BSC (c), SICO Funds Company VI BSC (c), SICO Funds Company VII BSC (c) and SICO Ventures Company SPC.

| | Six months ended 30 June 2011 |
|---|---|
| Fee Income | 363 |

| | As at 30 June 2011 |
|---|---|
| Other assets | 180 |
| Funds under management | 48,480 |
| Investments in own funds | 3,913 |

*Transactions with shareholders*

| | Six months ended 30 June 2011 |
|---|---|
| Fee Income | 463 |

| | As at 30 June 2011 |
|---|---|
| Funds under management | 35,676 |
| Deposits | - |

The Group has banking relationships, makes deposits and placements and has un-utilized credit facilities with certain of its shareholders that are local banks.