بنك الخليج المتحد ش.م.ب.

United Gulf Bank B.S.C.

Basel II, Pillar 3

Risk Management and Capital Adequacy Disclosures

31 December 2011

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EXECUTIVE SUMMARY

As a bank incorporated in the Kingdom of Bahrain, United Gulf Bank B.S.C. ("UGB" or "the Bank") has complied with the Basel II Capital Adequacy Framework effective 1 January 2008. This is in accordance with the Central Bank of Bahrain's ("the CBB") Basel II guidelines.

The Risk Management and Capital Adequacy Disclosures fulfill the Pillar 3 requirements of the Basel II Accord. The objective of implementing Pillar 3 is to improve market discipline through effective public disclosure and to complement the reporting templates under Pillar 1 and Pillar 2. The spirit of market discipline can be summed up in the phrase 'accountability through transparency'. Accountability is based on the premise that the Bank's management acts in the best interests of its external stakeholders – mainly the current and prospective holders of its equity and debt. Transparency is evident when the Bank discloses sufficient information so as to allow the stakeholders to make informed judgments as to whether the bank is acting in their best interests.

The disclosures have been provided in accordance with the Public Disclosures ("PD") module of the CBB's Rulebook volume I. They meet the requirements of Basel II (Pillar 3) and International Financial Reporting Standard ("IFRS") 7. The PD module sets out required disclosures to allow market participants to assess key pieces of information on the scope of application, capital structure, risk exposures, risk assessment processes, and the capital adequacy of the financial institution. The information provided in this document, is also in line with UGB's Disclosure Policy that was approved by the Board of Directors in 2008 and updated in 2011.

The Tier 1 and Total consolidated capital adequacy ratios of UGB as at 31 December 2011 are well over the CBB's threshold of 12% with an additional 0.5% as a prudent measure. UGB's consolidated capital adequacy ratio for the year ended December 2011 was 18.2%, with total risk weighted assets being US$ 2,322 million. This comprises 91% for credit risk 7% for market risk and 2% for operational risk.

All figures in this report are as at 31 December 2011 (unless otherwise stated), and have been reported using IFRS, that are applicable at the consolidated level of UGB and its subsidiaries. Agreed upon procedures have been performed on the Public Disclosures by Ernst & Young (UGB's external auditors) in accordance with PD module issued by the CBB.

Figures contained in these disclosures are subject to rounding adjustments and in certain instances, the sum of the numbers in a column or a row in tables contained in this document may not conform exactly to the total figure given for that column/row or cross referred with numbers in financial statements or annual report.

BACKGROUND

United Gulf Bank B.S.C. is a joint stock company incorporated in the Kingdom of Bahrain in 1980, under Commercial Registration (CR) number 10550. It is listed on the Bahrain Bourse and the Kuwait Stock Exchange. The Bank's registered office is UGB Tower, Diplomatic Area, P.O. Box 5964, Manama, Kingdom of Bahrain.

The Bank operates in Bahrain under a Wholesale Banking License issued by the CBB. The principal activities of the Bank and its subsidiaries ('the Group') comprise asset management, investment banking and commercial banking. Investment banking includes asset portfolio management; corporate finance; advisory; investment in quoted and private equity funds; real estate; capital markets; international banking and treasury functions. Commercial banking includes extending loans and other credit facilities; accepting deposits and current accounts from corporate and institutional customers.

The Bank's parent and ultimate holding company is Kuwait Projects Company (Holding) K.S.C. ("KIPCO"), a company incorporated in the State of Kuwait and listed on the Kuwait Stock Exchange. The KIPCO Group is one of the biggest diversified holding companies in the Middle East and North Africa, with assets worth around US$ 20.8 billion under management or control. The Group has substantial ownership interests in a portfolio of over 60 companies operating across 26 countries. KIPCO's main sector focus is financial services, insurance and media. Through the subsidiaries and affiliates of its core companies, KIPCO also has interests in real estate, industrial, education, and management advisory sectors.

The ownership of the Bank as at 31 December 2011 can be summarized as follows:

	No of shares	Percentage
Kuwait Projects (Holding) KSC	800,594,257	95.93%
Directors	636,000	0.08%
Management	436,116	0.05%
Public Shareholders	21,838,257	2.62%
Treasury shares	11,056,255	1.32%
Total	834,560,885	100%

The Group operates an equity-settled, share-based Employee Stock Option Plan (ESOP). Under the terms of the plan, share options are granted to permanent employees, which are exercisable in a future period. The Executive / Senior Management and other staff were granted 36.5 million share options under the Bank's Employee Stock Option Plan, as approved at the extra ordinary general meeting (EGM) held on 24 March 2004. The options vest at various dates and are expensed over the vesting period.

1. INTRODUCTION TO THE BASEL II FRAMEWORK

The new capital adequacy module of the Central Bank of Bahrain (CBB) rulebook volume 1 was introduced with effect from 1 January, 2008. Its objectives are to strengthen capital levels across banks, provide a more risk sensitive approach to the assessment of risk and the calculation of regulatory capital, and strengthen risk management practices and processes within the financial industry.

The CBB's Basel II Framework can be summarized as follows:

Pillar 1	Calculation of the capital adequacy ratio based on the charges for credit, market and operational risks stemming from its operations.
Pillar 2	The supervisory review process including the Internal Capital Adequacy Assessment Process ("ICAAP") to assess risks not covered under Pillar 1, identify capital relating to these risks and ensuring that the Bank has sufficient capital (generated from internal / external resources), to cover the relevant risks.
Pillar 3	Market discipline through public disclosures that are designed to provide transparent information on capital structures, risk exposures, risk mitigation and the risk assessment process.

The three pillars are designed to be mutually reinforcing and are meant to ensure a capital base that corresponds to the overall risk profile of the Bank.

1.1 Pillar 1 – Minimum Capital Requirements

Pillar 1 of the Basel II Accord published by the Bank of International Settlements, covers the minimum regulatory capital requirement that a bank is expected to maintain to cover credit, market and operational risks stemming from its operations. It sets out the basis for the consolidation of entities for capital adequacy reporting requirements, the definition and calculations of risk weighted assets and the various options given to banks to calculate these risk weighted assets.

The following table summarizes the approaches available for calculating risk weighted assets for each risk type, in accordance with the CBB's Basel II capital adequacy framework.

1 INTRODUCTION TO THE BASEL II FRAMEWORK (continued)

Methodologies available for determining regulatory capital requirements

Credit Risk	Market Risk	Operational Risk
Standardized approach	Standardized Approach	Basic Indicator Approach
Foundation Internal Ratings Based Approach (FIRB)	Internal Models Approach	Standardized Approach / Alternative Standardized Approach
Advanced Internal Ratings Based Approach (AIRB)		Advanced Measurement Approach

On a group-wide basis, UGB's capital management framework is intended to ensure that there is sufficient capital to support the underlying risks of the Bank's business activities, and to maintain a "well-capitalized" status under the CBB's regulatory requirements. The minimum consolidated capital adequacy ratio ("CAR") for banks incorporated in Bahrain is 12% compared to the Basel Committee's minimum ratio of 8%. There is also a requirement for banks to maintain a buffer of 0.5% above the minimum threshold. In the event that the capital adequacy ratio falls below 12.5%, additional prudential reporting requirements apply, and a formal action plan setting out the measures to be taken to restore the ratio above the target level, has to be submitted to the CBB. The CAR needs to be reported on a regular basis, until such time as the ratio exceeds the threshold.

UGB assesses its capital adequacy relative to the risks underlying its business activities and takes proactive measures to ensure that it operates above these. The approach adopted by the Bank for each type of risk is as follows:

i) **Credit Risk** – UGB uses the standardized approach for determining the charge for credit risk. The standardized approach incorporates the use of external ratings to determine risk factors. Financial collaterals are used wherever applicable in order to mitigate the underlying risk. The risk weighted assets are determined by multiplying the credit exposure (less specific provisions) by a risk weight factor (determined in accordance with CBB regulations), that is a function of the type of counterparty, and the counterparty's external rating. A risk weight factor of 100% is used for all unrated exposures.

ii) **Market Risk** – For regulatory reporting purposes, UGB uses the standardized approach. This incorporates a charge for general risk and specific risk on its equities, funds, and foreign exchange exposures.

iii) **Operational Risk** – Under the CBB's Basel II framework, it is mandated that all banks incorporated in Bahrain, use the basic indicator approach for operational risk. The only exception is when specific approval is granted by the CBB to use the standardized or alternative standardized approach. UGB determines its capital charge for operational risk, by applying an alpha coefficient of 15% to the average gross income for the preceding three financial years. Figures for any year in which annual gross income is negative or zero is excluded from both the numerator and denominator when calculating the average.

1 INTRODUCTION TO THE BASEL II FRAMEWORK (continued)

1.2 Pillar 2 – Supervisory Review Process ("SRP")

The second pillar of Basel II is aimed at encouraging financial institutions to develop self-control processes that enable them to:

- Identify any risks not previously considered in Pillar 1
- Identify capital relating to these risks
- Ensure that the business has sufficient capital (generated from internal / external resources), to cover the relevant risks.

Pillar 2 encompasses two processes – namely, the ICAAP and a Supervisory Review and Evaluation Process. The ICAAP involves appropriate identification, assessment and measurement of residual risks, and ensures that the Bank has sufficient capital resources available to meet regulatory and internal capital requirements, even during periods of intensive economic or financial stress. Considerable work has been done by UGB to fulfill the requirements under Pillar 2.

1.3 Pillar 3 – Market Discipline

Pillar 3 of the Basel II Accord, imposes certain disclosure requirements which are extremely comprehensive. The objective of this is to ensure that there is greater transparency on the transactions and the risk strategy of a bank. It is assumed that the reactions of market participants (shareholders, creditors, counterparties and external rating agencies amongst others) will have a disciplining effect in terms of their assessment about the bank's risk profile and the level of capitalization. Under the current regulations, qualitative and quantitative analysis, need to be presented to comply with the prudential disclosure guidelines.

2 GROUP STRUCTURE AND OVERALL RISK MANAGEMENT PROCESSES

The objective of this section is to set out the consolidation principles and the capital base of UGB for the purpose of disclosure with the Pillar 1 guidelines. It also describes the policies and the corporate governance processes that are applicable in the management and control of risk and capital.

2.1 Group Structure

The full legal name of the top corporate entity to which the disclosure requirements apply is United Gulf Bank B.S.C. The Group produces consolidated financial statements. These are prepared and published on a full consolidation basis, with all principal subsidiaries being consolidated in accordance with IFRS. The bank maintains an up to date checklist of all applicable IFRS and disclosure requirements. For capital adequacy purposes, all subsidiaries are included within the Group structure. However, the CBB's capital adequacy methodology accommodates both normal and aggregation forms of consolidation.

As mentioned in Note 2 to the Group's consolidated financial statements for the year ended 31 December 2011, the principal subsidiaries for capital adequacy purposes are as follows:

		Effective ownership as at		
Name of the subsidiary	***Country of incorporation***	***31 December 2011***	*31 December 2010*	***Year of incorporation***
Held directly				
KIPCO Asset Management Company [KAMCO]	Kuwait	**86%**	86%	1998
United Gulf Bank Securities Company *	Bahrain	**-**	96%	1998
Hatoon Real Estate Company	Kuwait	**98%**	98%	2008
Syria Gulf Investment Company	Syria	**99%**	99%	2007
United Gulf Financial Services Company-North Africa	Tunisia	**77%**	77%	2008
Held through KAMCO				
Al-Nuzoul Holding Company K.S.C. (Closed)	Kuwait	**60%**	60%	2005
Al-Janah Holding Company K.S.C. (Closed)	Kuwait	**60%**	60%	2005
KAMCO Real Estate Company S.P.C.	Bahrain	**100%**	100%	2005
Al Zad Real Estate W.L.L.	Kuwait	**100%**	100%	2007
Al Dhiyafa United Real Estate Company W.L.L.	Kuwait	**100%**	100%	2007
First North Africa Real Estate Co. W.L.L.	Kuwait	**100%**	100%	2007
Al Raya Real Estate Projects Company W.L.L.	Kuwait	**100%**	100%	2007
Orange Real Estate Co. W.L.L.	Kuwait	**100%**	100%	2005
Al Rawabi International Real Estate Co. W.L.L.	Kuwait	**96%**	99%	2009
First Homes Real Estate Co. W.L.L.	Kuwait	**99%**	99%	2009

* Liquidated during 2011.

2 GROUP STRUCTURE AND OVERALL RISK MANAGEMENT PROCESSES (continued)

2.1 Group Structure (continued)

The investments in significant minority investments in banking, securities and other financial entities that are deducted from the Group's regulatory capital are as follows:

- Manafae Investment Company – Kuwait;
- Takaud Savings and Pensions Company B.S.C. (c) – Bahrain;
- Royal Capital PJSC – U.A.E; and
- Syria Gulf Bank – Syria.

2.2 Risk Management Structure and Processes

UGB's risk management framework and governance structure are intended to provide comprehensive controls and ongoing management of the major risks inherent in the Bank's business activities. Its philosophy is based on the principles that reiterate:

- A sound knowledge base, experience and judgment of Senior Management and Risk Management staff, are the cornerstone of a successful risk mitigation program;
- Vigilance, discipline and attention to detail are mandatory; and
- Policies and procedures must be clear, well communicated, understood and implemented in letter and spirit.

The Board of Directors (Board) of UGB is the ultimate authority for setting overall strategy, risk parameters, limits, capital adequacy ratios and tolerances, within which the Bank operates. The Board reviews the Bank's overall risk profile, significant risk exposures as well as the policies, procedures and controls that have been incorporated in accordance with the regulations. The Board has delegated day to day decision making to the Executive Committee (EC) that comprises four directors. The EC meets in between Board meetings to approve all proposals that exceed the threshold of the Investment Committee. The Board Audit Committee assists the Board in carrying out its responsibilities regarding internal controls, internal and external audit, compliance with laws, financial reporting practices, accounting policies, corporate governance and the review of UGB's strategy and business plans.

The Investment Committee comprising the Acting Chief Executive Officer, the Head of Asset Management and Investment Banking and the Chief Financial Officer, is responsible for approving or recommending approval to the EC, limits for individual exposures, investments and concentrations towards banks, countries, industries, risk rating classes or other special risk asset categories. The Head of Credit and Risk Management is the Secretary of this Committee and participates in meetings as a non-voting member.

Apart from the above, the Bank has a Risk and Compliance Committee that is responsible for the monitoring and assessment of risks facing the Bank, the review of compliance with internal and external guidelines, the review of risk frameworks and methodologies, and the assessment of the impact on the Bank from new regulatory requirements.

2 GROUP STRUCTURE AND OVERALL RISK MANAGEMENT PROCESSES (continued)

2.2 Risk Management Structure and Processes (continued)

The Assets and Liabilities Committee (ALCO) provides a forum for the review of assets and liabilities on UGB's statement of financial position. It monitors the tenor and cost / yield profiles of the various components, and evaluates the Bank's statement of financial position both from interest rate sensitivity and liquidity points of view. Corrective adjustments based on perceived trends and market conditions, liquidity and foreign exchange exposures and positions are recommended.

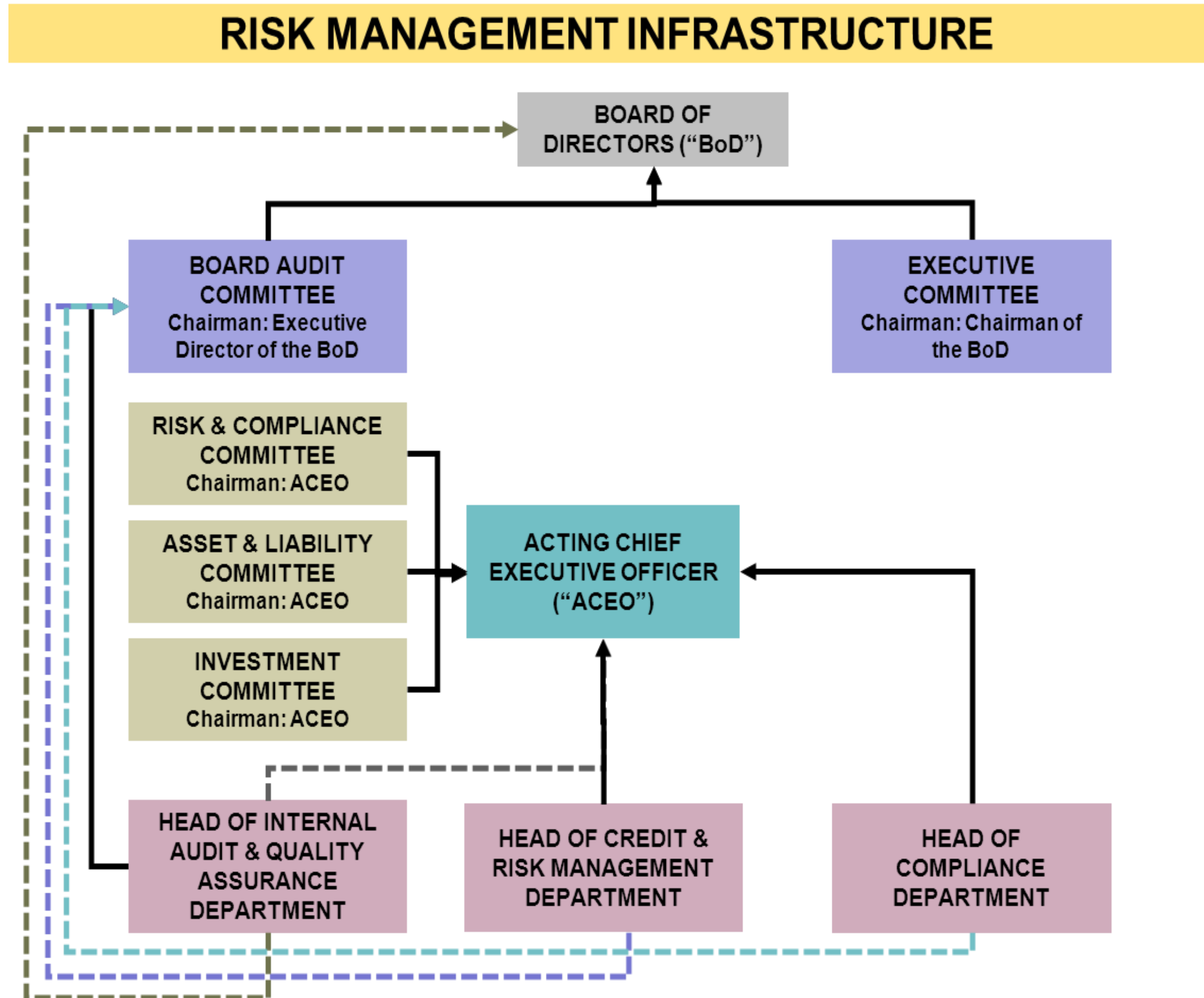
The Internal Audit and Quality Assurance Department provides the Board Audit Committee and Senior Management with an ongoing process of independent and objective assessment and assurance on effectiveness and quality of controls.

With the introduction of the Key Persons Policy by the Bahrain Bourse, the Insider Trading Committee of the Board of Directors was disbanded effective October 2010.

On 15 March 2010, the Ministry of Commerce and Industry of the Kingdom of Bahrain introduced a Corporate Governance Code (the Code) applicable to the Group. The Code is based upon nine core Principles of Corporate Governance that adhere to international best practices. The Code includes recommendations to apply the Principles, as well as recommendations which support the implementation of good corporate governance. The Code is issued in a "comply or explain" framework, which means companies should comply with the recommendations, or give an explanation in the case of non-compliance. A detailed Corporate Governance report has been prepared by the Bank and is available on the Bank's website www.ugbbah.com.

2 GROUP STRUCTURE AND OVERALL RISK MANAGEMENT PROCESSES (continued)

The governance structure for risk management can be depicted as follows:



2.3 Types of Risk

The major types of risk that UGB is primarily exposed to include credit, market, operational, liquidity, funding and interest rate risks, concentration and legal/reputational risks. The first three comprise part of the Pillar 1 assessment, while the latter four are considered under Pillar 2.

2 GROUP STRUCTURE AND OVERALL RISK MANAGEMENT PROCESSES (continued)

2.4 Risks under Pillar 1

i) Credit Risk is defined as the risk that UGB's clients or counterparties will be unable or unwilling to pay interest, repay the principal or other dues to fulfill their contractual obligations under loan agreements or other credit facilities. UGB adopts the standardized approach for calculating credit risk weighted assets. These are determined by multiplying the exposure by a risk weight factor that is a function of the counterparty's external rating issued by accredited external credit rating agencies approved by the CBB. The overall credit exposures as at 31 December 2011 can be summarized as follows:

	Gross Exposures US$ 000	*Risk Weighted Exposures US$ 000*
Demand and call deposits with banks	17,857	3,571
Time deposits with banks	102,282	19,840
Non-trading investments	13,153	6,577
Loans and advances	27,942	30,683
Other assets	31,948	31,948
Letters of credit	18,984	18,984
Letters of guarantee	50,951	50,951
Derivative financial assets	5,341	1,068
	268,458	163,622

The year-end position of gross credit exposure is representative of the average gross credit exposure of the Group for the year ended 31 December 2011.

Assigning risk ratings to an individual risk exposure is a subjective process. The factors that are considered while determining the rating are:

- Risk category / Issuer rating
- Investment size (per name or risk category)
- Industry sector
- Asset class (liquid-illiquid)
- Country / region
- Maturity / expected maturity
- Yield / Interest rate (fixed / floating, coupon / non-coupon bearing)

Although some of these criteria are more important than others, each is an integral part of the decision-making process for asset allocation.

A brief analysis of each category relative to UGB's Risk Asset Portfolio is as follows:

2 GROUP STRUCTURE AND OVERALL RISK MANAGEMENT PROCESSES (continued)

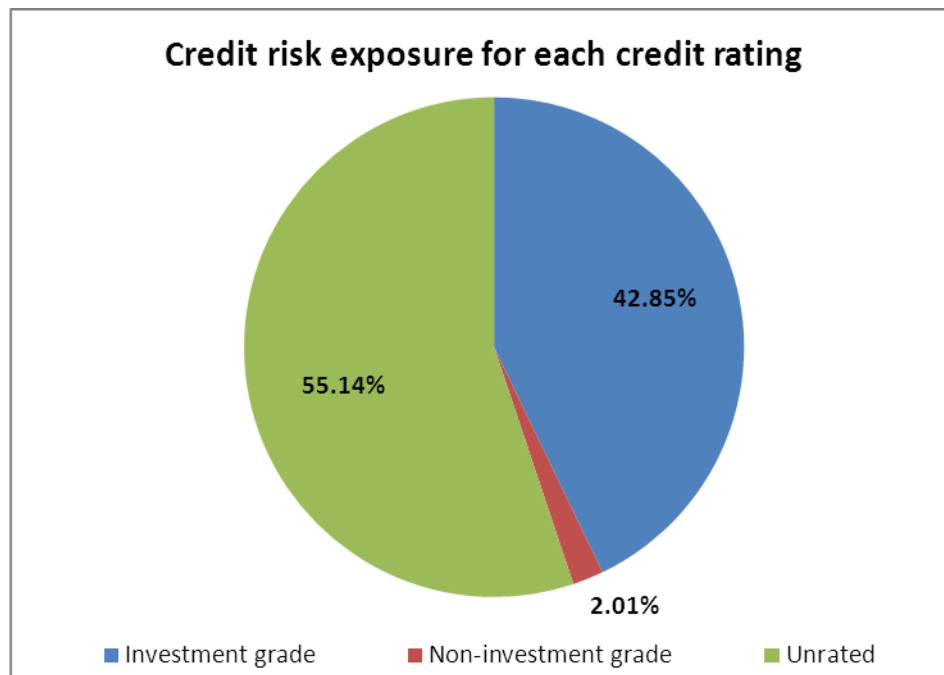
2.4 Risks under Pillar 1 (continued)

Risk Category/Issuer Rating

Whenever available, UGB uses ratings assigned by CBB accredited rating agencies – namely Moody's / Standard & Poor's / Fitch / Capital Intelligence. For unrated exposures, an internal rating is assigned based on subjective evaluation by the originating department, in consultation with Credit and Risk Management. However, internally assigned ratings are indicative and are not considered for capital adequacy purposes.

The rating system classifies ratings BBB- or greater as "Investment Grade", i.e. higher quality credits with AAA being of undoubted credit worthiness. Ratings ranging from BB+ to B / CCC/ D are designated as "Non-Investment Grade", with D representing a default investment. The individual rating influences the approval matrix, portfolio mix and diversification, the capital allocation to the business groups (ensuring the proper risk-return balance) and the investment review cycle.

Breakdown of the Risk Asset Portfolio by rating as at 31 December 2011 is presented below.



2 GROUP STRUCTURE AND OVERALL RISK MANAGEMENT PROCESSES (continued)

2.4 Risks under Pillar 1 (continued)

Investment Size

The absolute exposure per issuer is determined by the CBB's guidelines on maximum exposure limits, that stipulate that aggregate outstanding to an individual counterparty or a group of closely related counterparties, should not exceed 15% of the bank's consolidated capital base. In accordance with CBB rules, the Bank has a Large Exposure policy (approved by the Board), which stipulates guidelines for monitoring all existing large exposures. Further details on large exposures are disclosed in Section 8.3.

Industry Sector

UGB's risk policies and procedures define twelve industry groups that have been established for classifying its portfolio. These twelve categories represent a distillation of the Moody's standard industry classification guide. The emphasis on industry diversification is to ensure that UGB avoids undue concentration in any one or more industry groups that could be vulnerable to an economic downturn or a structural shift – "cyclical" industry sectors. The Bank's strategy also aims at achieving a wide balance across the industry category spectrum, based on the premise that more industries are better than a few. The Bank also avoids certain sectors that are historically known for a greater extent of volatility (e.g. airlines, shipbuilding, early stage high technology and venture capital—unless on a diversified fund basis). This is primarily because these industries are exposed to structural difficulties, an absence of industry comparisons, or cannot be adequately analyzed in terms of resident analytical expertise. Investments in sensitive industries like gambling and armaments are not permissible under the Bank's risk policy.

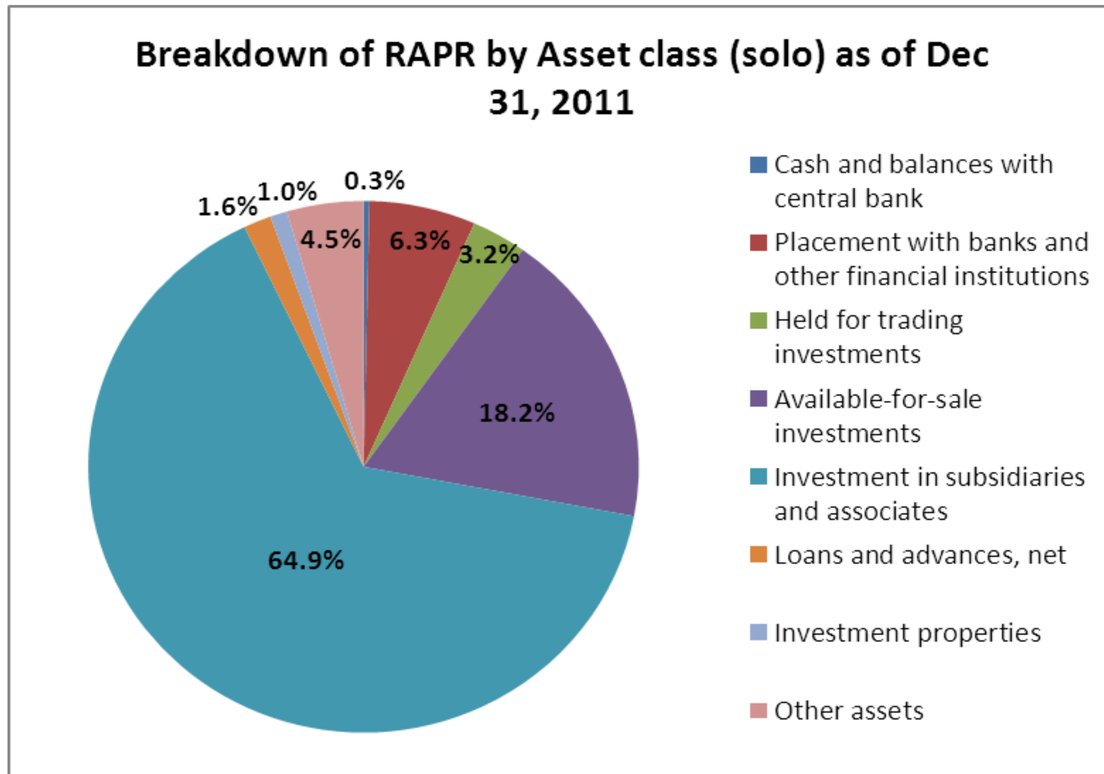
Asset Class

The asset class of the investment is usually determined by its ability to be sold or traded i.e. the extent of liquidity. If pricing is identical for the same risk but offered in a variety of asset classes, UGB's risk policy recommends its investment in a tradable security as opposed to a loan, for which an imperfect secondary market usually exists. In further defining this criterion, risk assets are categorized in terms of "liquid / marketable" and "illiquid". Liquid / marketable assets normally comprise publicly quoted debt securities and quoted equities that have the ability to be sold promptly at minimal or no price discount within 48 hours. A further sub-category of liquid / marketable is defined as "highly liquid". These assets comprise US Treasury bills and certain AAA Corporate bonds that can be sold "on the wire" i.e. instantly with little / no price discount risk. All other risk assets such as commercial customer loans, private subordinated debt, unquoted equities, private equity funds & direct investments and real estate are defined as illiquid. These assets are not readily traded or marketable other than over a long period of time and at a potential discount.

2 GROUP STRUCTURE AND OVERALL RISK MANAGEMENT PROCESSES (continued)

2.4 Risks under Pillar 1 (continued)

The following graph illustrates the breakdown of the Risk Asset Portfolio Report (RAPR) by assets as at 31 December 2011.



Where appropriate, UGB seeks to minimize its credit risk using a variety of techniques including, but not limited to:

- Operating under a sound credit and investment approval process;
- Maintaining appropriate credit administration, measurement and monitoring;
- Ensuring adequate controls over the credit risk process;
- Seeking third party guarantees of the counterparty's obligations;
- Procuring collateral against the investment or facility; and
- Entering into netting agreements.

UGB actively manages and monitors credit risk in accordance with well-defined policies and procedures that have been approved by the Board. Limits are set on the amount of risk that the Bank is willing to accept against individual counterparties, related parties and geographical and industry concentrations.

2 GROUP STRUCTURE AND OVERALL RISK MANAGEMENT PROCESSES (continued)

2.4 Risks under Pillar 1 (continued)

Continuous monitoring of the Bank's assets through various reports and reviews is key to timely and accurate identification of any impairment. A monthly risk asset review report is produced by the Credit and Risk Management Department in which all assets are assessed based on rating, industry, and geographic exposure in addition to a number of other parameters. The purpose of this report is also to ensure compliance with both external regulatory requirements and internal risk policy guidelines. Additionally, a semiannual review of all assets is prepared detailing performance and outlining recent developments and future outlook.

Detailed information on the Bank's credit risk exposures including geographical distribution, industry/sector allocation, details of collateral and other credit enhancements and bifurcation based on internal ratings has been provided in Note 4 of this Disclosure.

ii) Market Risk

Market risk is defined as the loss of the value of a financial instrument or a portfolio of financial instruments due to an adverse change in market prices or rates. Market Risk within UGB arises from the trading of equities and investment activities.

The categories of market risk to which UGB is exposed to are as follows:

- Equity risk that arises from exposures to changes in the price and volatility of individual equities or funds. UGB's equity risk principally arises from its trading activities which are largely focused on the Kuwait and the U.S. equity markets.

- Foreign exchange risks those results from exposure to change in the price and volatility of currency spot and forward rates.

UGB's policy guidelines for market risk have been vetted by the Board in compliance with the rules and guidelines provided by the CBB. The Bank seeks to manage the market risks it faces, through diversification of exposures across dissimilar markets, industries and products. In order to effectively manage market risk exposures in addition to the exercise of business judgment and management experience, the Bank utilizes limit structures including those relating to asset classes, capital markets and industry sectors.

iii) Operational Risk

Operational Risk is defined as the risk of loss arising from inadequate or failed internal processes, people, systems or external events. It is an inherent risk faced by all banks and covers various incidents including business interruption and systems failures, internal and external fraud, transaction execution and process management, employment practices and workplace safety, customer and business practices and damage to physical assets.

2 GROUP STRUCTURE AND OVERALL RISK MANAGEMENT PROCESSES (continued)

2.4 Risks under Pillar 1 (continued)

In a bid to mitigate operational risk, UGB has introduced internal controls and processes based on the principle of checks and balances and segregation of duties. The intention is to minimize the risk by ensuring that there is a culture of strong control throughout the organization. The management of operational risk in the Bank is the responsibility of every employee.

2.5 Risks under Pillar 2

In accordance with the ICAAP process, UGB assesses risks that are not part of the calculation of the regulatory capital adequacy ratio. Chief among these are:

i) Liquidity Risk

Liquidity risk stems from the inability to procure sufficient cash flow to meet UGB's financial obligations as and when they fall due. The risk arises due to the timing differences between the maturity profile of the Bank's assets and liabilities. In the wake of the global crises, liquidity risk has been of concern to regulators and financial institutions. This is evident when entities are forced to sell assets much below their intrinsic value/market price, their inability to raise deposits and their requirement to borrow funds at excessively high rates.

In order to ensure that the Bank can meet its financial obligations as they fall due, there is a close monitoring of UGB's assets and liabilities position. Besides other functions, an ALCO evaluates the statement of financial position from a structural, liquidity and sensitivity point of view. The whole process is aimed at ensuring availability of sufficient liquidity to fund the Bank's ongoing business activities, effectively managing maturity mismatches between assets and liabilities, managing market sensitivities, and ensuring that the Bank has the capacity to fund its obligations as they fall due. Daily, weekly and monthly reports are generated to monitor key liquidity ratios and to ensure the maintenance of a diversified funding base in terms of individual loans, and maturities.

UGB has established a funding strategy that provides effective diversification in the sources and the tenor of funding. It maintains an ongoing presence in its chosen funding markets. Strong relationships are also maintained with funds providers to promote the effective diversification of funding resources. As at year end 2011, the liquidity ratio of the Bank was 47.2 percent. This is strictly monitored to ensure that a cushion over the regulatory level of 25 percent is maintained at all times.

Additionally, since September 2008, with the onset of the credit crisis, UGB has received significant group support in terms of deposits placed with the Bank both on a short term and a medium term basis. During 2011, Burgan Bank S.A.K. (as associate) has converted short term borrowings of US$ 240 million into a medium term loan. The Bank's parent, KIPCO, has constituted an ALCO which meets on periodic basis to discuss pertinent issues and recommends action with the objective of managing liquidity at the Group level. This Committee comprises CEOs, Treasurers, CFOs and Risk Managers of all major KIPCO financial institutions.

2 GROUP STRUCTURE AND OVERALL RISK MANAGEMENT PROCESSES (continued)

2.5 Risks under Pillar 2 (continued)

ii) Interest Rate Risk in the Banking Book.

Interest rate risk on the banking book arises as a result of mismatches in the repricing or maturity of interest rate sensitive financial assets and liabilities. This is also known as re-pricing risk. Additionally, UGB is exposed to basis value risk which results from a change in the relationship between the yields/yield curves of long and short positions with the same maturity in different financial instruments. This in effect means that the long and short positions no longer fully hedge each other.

UGB identifies the sources of interest rate risk and the interest rate risk sensitive products and activities. It proactively measures and monitors the interest rate risk in the banking book. The Bank also periodically carries out stress testing to assess the effect of extreme movements in interest rates that could expose the Bank to high risks. A conscious effort is also made to match the amount of floating rate assets with floating rate liabilities in the banking book. UGB also enters into certain transactions in order to hedge exposures arising from day-to-day banking and investment activities. These hedge transactions may be instruments such as interest rate swaps (IRS) and floating rate notes (FRN), to convert a floating rate asset/liability into a fixed rate one or vice-versa. The Bank continuously monitors the effectiveness of the hedges.

iii) Concentration Risk

Concentration of exposures in credit portfolios is an important aspect of credit risk that is monitored separately by UGB. This risk can be considered from either a micro (idiosyncratic) perspective or a macro (systemic) perspective. The first type - name concentration, relates to imperfect diversification of risk in the portfolio either because of its small size or because of large exposures to specific individual obligors. The second type - sector concentration, relates to imperfect diversification across systemic components of risk, namely industry sectorial factors.

Concentration risk is captured in UGB's framework through the use of internal and external regulations that cap the maximum exposure to any single obligor. There are established limits in place that set thresholds for aggregate industry, asset classes and geography. The actual levels of exposure are monitored against approved limits and regularly reviewed by Senior Management and the Board.

2 GROUP STRUCTURE AND OVERALL RISK MANAGEMENT PROCESSES (continued)

2.5 Risks under Pillar 2 (continued)

iv) Legal Risk

Legal risk is defined as the loss that may arise as a result of the inability to enforce contracts and agreements that the Bank has entered into with its counterparties. In order to mitigate this risk, UGB uses industry standard master agreements whenever available. Expert legal advice is sought on legal structures and arrangements to which the Bank is a party. Proper execution and completion of all legal contracts is ensured prior to committing funds to the transactions. All legal documents are reviewed on a periodic basis to ensure their ongoing enforceability. These are also maintained under dual custody.

2.6 Monitoring and Reporting

The monitoring and reporting of risk is conducted on a timely basis. The regular forums, in which risk related issues are highlighted and discussed, are the weekly Management meetings, the quarterly Risk and Compliance Committee Meetings and the semi-annual investment reviews.

3. CAPITAL ADEQUACY

UGB's overall capital requirements under Pillar 1, is calculated by aggregating:

- the credit risk charge using the standardized approach;
- the market risk charge using the standardized approach; and
- the operational risk charge using the basic indicator approach.

The following table shows the Bank's overall minimum capital requirement and capital adequacy position under Pillar 1 as at 31 December 2011.

Total Minimum Capital Requirements	**US$**
Credit Risk (standardized)	252,474
Operational Risk (basic indicator)	6,783
Market Risk (standardized)	19,401
Total required capital	278,658
Total available capital	422,794
Excess capital over minimum regulatory capital requirements	144,136

3. CAPITAL ADEQUACY (continued)

3.1 Capital Structure and capital adequacy

The Bank maintains an actively managed capital base to cover risks inherent in the business. The adequacy of the Bank's capital is monitored using the rules and ratios established by the Basel Committee on Banking Supervision ("BCBS rules/ratios") and adopted by the CBB.

The primary objectives of the Group's capital management are to ensure that the Group complies with capital requirements of the CBB and that the Group maintains strong credit ratings and healthy capital ratios in order to support its business and to maximize shareholders' value. In order to maintain or adjust the capital structure, the Bank may adjust the amount of dividend payment to shareholders, or issue capital securities.

The total eligible capital (Tier 1 and 2) calculated in accordance with CBB guidelines are as follows:

	Tier 1 Capital US$ 000	Tier 2 Capital US$ 000	Total US$ 000
Issued and fully paid ordinary shares and perpetual non-cumulative preference shares	195,915	-	195,915
Disclosed reserves	-	-	-
General reserves	76,002	-	76,002
Legal / statutory reserves	95,517	-	95,517
Share premium	11,459	-	11,459
Retained profit brought forward	140,860	-	140,860
Others	54,148	-	54,148
Current interim profits	-	1,471	1,471
Unrealized gains arising from fair valuing equities	-	11,851	11,851
Subordinated term debt	-	80,000	80,000
Excess of total eligible provisions over total expected loss	-	-	-
Minority interest in consolidated subsidiaries	41,311	-	41,311
Less:			
Goodwill	56,781	-	56,781
Unrealized gross losses arising from fair valuing equity securities	36,465	-	36,465
Reciprocal cross-holdings of bank capital	-	-	-
	521,966	**93,322**	**615,288**
Deduction			
Significant minority investments in banking, securities and other financial entities unless pro-rata consolidated	42,097	42,097	84,194
Excess amount over maximum permitted large exposure limit	54,150	54,150	108,300
Additional deduction from Tier 1 to absorb deficiency in Tier 2	2,925	(2,925)	-
Net Available Capital	**422,794**	**-**	**422,794**

In accordance with the CBB's Basel II capital adequacy framework, certain assets are required to be deducted from regulatory capital. As at 31 December 2011, US$ 192.5 Million was deducted from regulatory capital in relation to minority interests in banking, securities and other financial entities and excess amount over maximum permitted large exposure limit.

3. CAPITAL ADEQUACY (continued)

3.1 Capital Structure and capital adequacy

There are no impediments on the transfer of funds or regulatory capital between UGB and its subsidiaries, other than restrictions over transfers to ensure minimum regulatory capital requirements that are necessitated for subsidiary companies.

3.2 Capital adequacy ratio of consolidated group and significant subsidiaries

UGB'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 capital structure may be adjusted through the dividend payout, the issue of new equity, subordinated term finance, and Tier 1 capital securities.

The capital adequacy ratios of UGB and its principal subsidiary as at 31 December 2011, were as follows:

	Consolidated US$'000	KAMCO US$'000
Total eligible capital base	422,794	293,639
Credit risk weighted exposures	2,103,952	652,412
Market risk weighted exposures	161,675	48,022
Operational risk weighted exposures	56,526	30,532
Total risk weighted exposures	2,322,153	730,966
Total capital adequacy ratio	18.2%	40.2%
Tier 1 ratio	18.2%	40.2%

The CBB's current minimum total capital adequacy ratio for banks incorporated in Bahrain is set at a consolidated level of 12% with a buffer of 0.5%.

3.3 Capital requirements for credit risk

For regulatory reporting purposes, UGB calculates the capital requirements for credit risk based on the standardized approach. Under the standardized approach, on and off statement of financial position credit exposures are assigned to exposure categories based on the type of counterparty or underlying exposure. The exposure categories are referred to in the CBB's Basel II capital adequacy framework as 'standard portfolios'. The primary standard portfolios are claims on sovereigns, claims on banks and claims on corporate. Under the standardized approach, the risk weightings are provided by the CBB and are determined based on the counterparty's external credit rating. The external credit ratings are derived from eligible external rating agencies approved by the CBB. UGB uses ratings assigned by Standard & Poor's, Moody's, Fitch and Capital Intelligence.

3. CAPITAL ADEQUACY (continued)

3.3 Capital requirements for credit risk (continued)

An overview of the exposures, Risk Weighted Assets (RWAs) and capital requirements for credit risk analyzed by the standardized approach is presented in the table below:

	Total exposure	RWA	Capital requirement
	US$'000	US$'000	US$'000
Total Claims on Sovereigns	546	-	-
Total Claims on Banks	120,445	24,263	2,912
Claims on Corporates including Insurance Companies & Category 3 Investment Firms	115,867	115,867	13,904
Past Due Exposure	1,995	1,995	239
Equity Investments			-
Listed	630,031	630,031	75,604
Unlisted	667,911	1,001,867	120,224
Holding of Real Estate	153,470	292,234	35,068
Other Assets and Holding of Securitization Tranches	37,695	37,695	4,523
Total	1,727,960	2,103,952	252,474

3.4 Capital requirements for market risk

The Bank uses the standardized approach to calculate the regulatory capital requirements relating to general and specific market risk. The resultant measure of market risk is multiplied by 12.5, to determine the market risk-weighted exposure on a basis that is consistent with credit risk-weighted exposure.

The RWAs and capital requirements for market risk are presented in the table below:

Capital Requirements for Market Risk	RWA	Capital requirement
	US$ 000	US$ 000
Equity position risk	48,238	5,789
Foreign exchange risk	113,438	13,613
Total	161,676	19,402

3. CAPITAL ADEQUACY (continued)

3.4 Capital requirements for Market Risk (continued)

The minimum and maximum values of capital requirements for equity position risk and foreign exchange risk over the last one year are as follows:

	Equity Position Risk US$ 000	**Foreign Exchange Risk US$ 000**
Minimum values	48,688	105,825
Maximum values	64,975	232,850

3.5 Capital requirements for operational risk

For regulatory reporting purposes, the capital requirement for operational risk is calculated according to the basic indicator approach. Under this approach, the Group's average gross income over the preceding three financial years is multiplied by a fixed alpha coefficient. The alpha coefficient has been set at 15 per cent in the CBB's Basel II capital adequacy framework. The capital requirement for operational risk as at 31 December 2011 amounted to US$ 6.8 million.

4. CREDIT RISK – PILLAR 3 DISCLOSURES

This section provides detailed disclosures on credit risk in accordance with the CBB's Basel II framework in relation to Pillar 3 requirements:

4.1 Categories of exposure classes

UGB's credit exposures are categorized as per the Basel II capital adequacy framework for the standardized approach for credit risk. The appropriate risk weights are used to derive the risk weighted assets.

Total Claims on PSEs

Public Sector Entities were risk weighted at 100% as none of these were rated.

Total Claims on Banks

The exposure under claims on banks is risk weighted based on their external credit ratings assigned by Standard & Poor's, Moody's and Fitch and Capital Intelligence.

Total Claims on Corporates

Claims on corporates are risk weighted according to their external credit ratings. A 100% risk weightage is assigned to all exposure pertaining to unrated corporates.

Total Claims on Investment Firms

The exposure under claims on investment firms, are risk weighted based on their external credit ratings.

Past Due Exposures

The Bank defines non-performing facilities as the facilities that are overdue for a period of 90 days or more. These exposures are placed on a non-accrual status with income being recognized to the extent that it is actually received. It is the Bank's policy that when an exposure is overdue for a period of 90 days or more, the whole financing facility extended is considered as past due, not only the overdue installments/payments.

All past due loan exposures are assigned a risk weighting of either 100% or 150%, depending on the level of provisions maintained against them. The weightage is on the outstanding loan amount, net of provisions and interest in suspense.

Equity Investments

In accordance with CBB Basel II guidelines, all equity exposures are categorized into listed and unlisted categories, with corresponding risk weights of 100% or 150% for the purposes of determining the capital charge.

4. CREDIT RISK – PILLAR 3 DISCLOSURES (continued)

4.1 Categories of exposure classes (continued)

Holding of Real Estate

All real estate related exposures are risk weighted at 200% for the purposes of calculating the capital charge. These include direct or indirect exposures to real estate/real estate related development and management companies.

Other Assets

Other assets are risk weighted at 100% as per Basel II and the CBB norms.

4.2 Categories of exposure by industry

The breakdown of the overall credit exposure by industry was as follows:

Gross credit exposure by industry	*Trading and manufacturing*	*Banks and other financial institutions*	*Construction and real estate*	*Individual*	*Others*	*Total*
	US$ 000	*US$ 000*	*US$ 000*	*US$ 000*	*US$ 000*	*US$ 000*
Demand and call deposits with banks	-	17,857	-	-	-	17,857
Time deposits with banks	-	102,282	-	-	-	102,282
Non-trading investments	-	13,153	-	-	-	13,153
Loans and advances	-	3,008	2,740	19,019	3,175	27,942
Other assets	-	5,898	-	18	26,032	31,948
Letters of credit	-	500	-	-	18,484	18,984
Letters of guarantee	-	18,309	-	-	32,642	50,951
Derivative financial assets	-	5,341	-	-	-	5,341
Total	-	166,348	2,740	19,037	80,333	268,458

4. CREDIT RISK – PILLAR 3 DISCLOSURES (continued)

4.3 Categories of exposure by geography and region

Given the Bank's track record, geographical exposures of UGB are limited to a strong focus on assets issued/incorporated in the GCC (in particular Kuwait) , Middle East and North Africa and a small exposure to European Union Countries.

	Gulf Co-operation Council countries (G.C.C.) US$ 000	*Middle East and North Africa (excluding G.C.C.) US$ 000*	*European Union countries US$ 000*	*North America US$ 000*	*Others US$ 000*	*Total US$ 000*
Demand and call deposits with banks	14,471	529	277	2261	319	17,857
Time deposits with banks	92,406	9,876	-	-	-	102,282
Non-trading investments	13,153	-	-	-	-	13,153
Loans and advances	4,678	2,742	16,514	4008	-	27,942
Other assets	27,341	4,303	14	288	2	31,948
Letters of credit	18,484	500	-	-	-	18,984
Letters of guarantee	50,951	-	-	-	-	50,951
Derivative financial assets	1,393	-	3,948	-	-	5,341
Total	222,877	17,950	20,753	6,557	321	268,458

4.4 Categories of exposure by maturity

The Bank strives to construct a portfolio that is well-balanced in terms of anticipated cash flows originating from redemptions, maturities and exits. A disproportionate number of redemptions in any given fiscal year are discouraged in a view to avoid reinvestment risk (ie cash flows being reinvested in a different interest rate environment) and price volatility risk. The latter increases with a longer-term portfolio, as the longer the term of a security the more volatile the price. The Bank also tracks expected maturities vs actual maturities as part of its normal risk management strategies.

Gross credit exposure by maturity	*Up to 3 months US$ 000*	*3 months to 1 year US$ 000*	*1 to 5 years US$ 000*	*5 to 10 years US$ 000*	*10 to 20 years US$ 000*	*Total US$ 000*
Demand and call deposits	17,539	-	-	-	318	17,857
Time deposits with banks	102,282	-	-	-	-	102,282
Non-trading investments	-	-	13,153	-	-	13,153
Loans and advances	18,355	8,826	761	-	-	27,942
Other assets	338	31,610	-	-	-	31,948
Letter of credit	-	18,984	-	-	-	18,984
Letter of guarantee	-	50,951	-	-	-	50,951
Derivative financial assets	-	5,341	-	-	-	5,341
Total financial assets	138,514	115,712	13,914	-	318	268,458

4. CREDIT RISK – PILLAR 3 DISCLOSURES (continued)

4.5 Categories of exposure by related parties

The related party exposures including off statement of financial position items are transacted at commercial terms on an arm's length basis.

Gross credit exposure by related party breakdown

	Major shareholders *US$ 000*	*Associates* *US$ 000*	*Other related parties* *US$ 000*	*Total 2011* *US$ 000*
Demand and call deposits with banks	-	9,446	536	9,982
Time deposits with banks	-	1,077	9,827	10,904
Investments carried at fair value				-
through statement of income	1,752	2,046	2,536	6,334
Investments, carried at fair value				-
through statement of income ,				-
in funds managed by related party	-	-	12,036	12,036
Non-trading investments	-	-	12,378	12,378
Loans and advances	-	2,741	8,849	11,590
Other assets	995	19,812	7,771	28,578
Letters of credit	-	500	18,485	18,985
Guarantees	-	18,309	32,642	50,951

4.6 Specific and general provisions

The movement in provisions for losses of loans, non-trading investments (available for sale investments), and other assets and off balance sheet items and collective impairment provision is as follows:

	Loans *US$ 000*	*Investments* *US$ 000*	*Other Assets and Off-Balance Sheet Items* *US$ 000*	*Collective impairment provision* *US$ 000*
At beginning of the year	1,697	55,395	8,497	1,010
Amounts written off	-	9,514	-	-
Write backs / cancellation due to improvement	79	3,868	-	-
Additional provisions made	-	23,961	468	8
Exchange adjustment and other movements	93	-	74	-
Balance at reporting date	1,711	65,974	9,039	1,018

4. CREDIT RISK – PILLAR 3 DISCLOSURES (continued)

4.7 Restructured loans

Where possible, the Group seeks to restructure loans rather than to take possession of collateral. This may involve extending the payment arrangements and the agreement of new loan conditions. Once the terms have been renegotiated, the loan is no longer considered past due. The carrying amounts of the loans, whose terms have been renegotiated as at 31 December 2011, were not material.

Past due and impaired loans are US$ 2 million against which a provision of US$ 1.7 million has been provided as at 31 December 2011.

4.8 Exposure over the individual obligor limits

Under the CBB's rules governing maximum single exposure, banks incorporated in Bahrain are required to obtain the regulator's approval for any planned exposure to a single counterparty or group of connected counterparties that exceed 15% of the regulatory capital base.

4.9 Disclosure requirement for equity position in banking book

UGB's business model is focused on offering investment banking and commercial banking services through a network of financial services entities spread across the Middle East North Africa (MENA) region. These entities are treated as strategic assets of the Bank held with long term perspective, and contribute significantly towards the Bank's bottom line.

These strategic assets if treated as an associate are initially recognized at cost and adjusted thereafter for the post acquisition change in the Group's share of net assets of the investee, using the equity method. The Group recognizes in the consolidated statement of income, its share of the total recognized profit or loss of the associate from the date that influence or ownership effectively commences, until the date that it effectively ceases. Distributions received from an associate reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for changes in the Group's share in the associate arising from changes in its equity that have not been recognised in the associate's profit or loss. The Group's share of those changes is recognized directly in equity. Unrealized gains on transactions with an associate are eliminated to the extent of the Group's share in the associate.

An assessment of an associate is performed when there is an indication that the asset has been impaired, or that impairment losses recognized in prior years no longer exist. Whenever the impairment requirements of IAS 36 indicate that investment in an associate may be impaired, the entire carrying amount of investment is tested by comparing its recoverable amount with its carrying value. The recoverable amount of an asset or a cash–generating unit is the higher of its fair value less costs to sell and its value in use. Goodwill is included in the carrying amount of an investment in associate and is therefore not separately tested for impairment.

4. CREDIT RISK – PILLAR 3 DISCLOSURES (continued)

4.9 Disclosure requirement for equity position in banking book (continued)

The reporting dates of the associate and the Group are identical and the associate's accounting policies conform to those used by the Group for like transactions and events in similar circumstances.

Additionally, the Bank also has a portfolio of opportunistic direct investments held in the banking book. These investments are held for medium to short term and mostly include private equity and fund of hedge funds. For accounting purposes these are classified as investments available for sale and investments held to maturity.

The Group classifies investments as held to maturity if the requirements of IAS 39 are met and in particular the Group has the intention and ability to hold these investments to maturity. After initial recognition, investments held to maturity are carried at amortized cost using the effective interest rate method, less impairment losses, if any.

Investments available for sale are those non–derivative financial assets that are designated as available for sale or are not classified as investment at fair value through the consolidated statement of income; investments held to maturity; or loans and advances. After initial recognition, investments available for sale are measured at fair value with gains and losses being recognized as a separate component of equity, until the investment is derecognized or until the investment is determined to be impaired at which time the cumulative gain or losses previously reported in equity is recognized in the consolidated statement of income. Investments whose fair value cannot be reliably measured are carried at cost less impairment losses, if any.

The breakdown of the Bank's equity, mutual funds and debt position in the banking book are as follows:

Equity position in banking book

	2011 US$ 000
Equity securities and mutual funds	**898,810**
Listed	507,177
unlisted	391,633
Managed funds	48,951
Total investments	**947,761**
INVESTMENT PROPERTIES	
Cost	16,054
Market Value	16,054
INTEREST IN UNCONSOLIDATED SUBSIDIARIES AND ASSOCIATED COMPANIES	**-**
INTEREST IN SUBSIDIARIES AND ASSOCIATED COMPANIES	**539,158**

4. CREDIT RISK – PILLAR 3 DISCLOSURES (continued)

4.9 Disclosure requirement for equity position in banking book (continued)

Movements in fair value of non-trading investments are as follows:

	Available for sale
	US$ 000
At beginning of the year	(11,520)
Exchange adjustment and other movements	7,354
Net unrealized gains / (losses)	(4,166)
Transfer to income statement:	
Impairment	(23,960)
Realized	30,478
Balance at reporting date	(10,684)

The gains on trading investments are as follows:

	US$ 000
Net gain on trading investments	4,814

4.10 Collateral

The amount and type of collateral required depends on an assessment of the credit risk of the counterparty. Guidelines are implemented regarding the acceptability of types of collateral and valuation parameters.

The main types of collateral obtained are as follows:

- For commercial lending, cash margins, charges over real estate properties, inventory, trade receivables, bank guarantees; and
- For retail lending, mortgages over residential properties, claim over employees' end of service benefits etc.

The Group also obtains guarantees from companies for loans to their subsidiaries. The Bank monitors the market value of collateral and requests additional collateral in accordance with the underlying agreement, during its review of the adequacy of the allowance of impairment losses.

There were no loans to highly leveraged and other high risk counterparties.

5. MARKET RISK – PILLAR 3 DISCLOSURES

Market risk is defined as the loss of the value of a financial instrument or a portfolio of financial instruments due to an adverse change in market prices or rates. This has the impact of a potential reduction in net income, or decrease in the value of UGB's financial statement. The Bank's trading activities principally comprise trading equity securities, and foreign exchange. There are limits in place to monitor positions, volumes, concentrations, maturities and allowable losses.

As mentioned in Section 3.4, the Bank uses the standardized approach to determine the charge for market risk.

6. OPERATIONAL RISK – PILLAR 3 DISCLOSURES

UGB's Operational Risk Framework incorporates suitable risk management policies and procedures to enable the Bank to identify, assess, monitor and control/mitigate operational risk. It transcends from best industry practices and Basel II regulatory requirements, and provides a means to develop key risk indicators (KRIs) and includes mapping of processes into lines of business. The Policy also provides procedures and sets responsibilities for day to day tracking and monitoring of operational risks, and outlines minimum reporting and analysis requirements.

UGB has automated its Operational Risk Framework through the implementation of a robust system. This system consists of three key modules – namely the operational loss database, risk and control self-assessments and key risk indicators. The system allows the Bank to monitor, mitigate and report its operational risk exposures on a real time basis.

7. OFF STATEMENT OF FINANCIAL POSITION EXPOSURE

UGB's non-funded exposure for the purposes of determining credit risk weighted assets for the Basle II framework comprise:

- Credit related contingent items: These are mainly guarantees, letters of credit and undrawn commitments to investments. For credit related contingent items, the nominal value is converted into an exposure at default using the appropriate credit conversion factor (CCF). The CCF factors range from 50% to 100% depending on the type of contingent item and its maturity. The objective is to convert off balance sheet notional amounts into an equivalent on balance sheet exposure, in order to capture risks relating to counterparty credit and/or liquidity.

- Derivative and foreign exchange instruments: These include forward contracts and interest rate swaps which have been used to hedge UGB's underlying positions.

Further information on off balance sheet items is disclosed in Note 29 of the Financial Statements.

8. PILLAR 2 RISKS

8.1. Liquidity Risk

Liquidity risk stems from the inability to procure sufficient cash flow to meet UGB's financial obligations as and when they fall due. The risk arises due to the timing differences between the maturity profile of the Bank's assets and liabilities. Positions are monitored on a daily basis and proactive measures are taken to ensure that there is adequate liquidity at all times. Further details on the maturity profile of assets and liabilities are included in Note 31 (d) of the consolidated financial statements.

The following table demonstrates the sensitivity to a reasonable possible change in interest rates, with all other variables held constant, of the Group's consolidated statement of income based on the consolidated statement of financial position as of 31 December 2011.

8.2 Interest Rate Risk in the Banking Book

Currency	***Increase in basis points 2011***	***Sensitivity of net interest income 2011***
		US$ 000
Kuwaiti Dinar	+ 200	(7,632)
United States Dollar	+ 200	(6,640)
Euro	+ 200	(104)
Pound Sterling	+ 200	8
Others	+ 200	(912)

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

The sensitivity of the consolidated statement of income is the effect of the assumed changes in interest rates on the net interest income for one year, based on the floating rate financial assets and financial liabilities held at 31 December 2011, including the effect of hedging instruments.

There are no material interest bearing securities in non-trading investments and hence no sensitivity of equity has been disclosed.

8. PILLAR 2 RISKS (continued)

8.2. Disclosure concerning interest rate risk in the banking book

The details of interest rate sensitive assets, liabilities and off balance sheet exposures are as follows:

	Upto 3 months US$ 000	3 months to 1 year US$ 000	Over 1 year US$ 000	Non-interest rate sensitive US$ 000	Total US$ 000
Assets					
Bank demand and call deposits	17,539	-	318	-	17,857
Time deposits	102,282	-	-	-	102,282
Securities held for trading	-	-	-	24,233	24,233
Funds held for trading	-	-	-	48,950	48,950
Investments available for sale	-	-	13,152	421,876	435,028
Investment in associated companies	-	-	-	1,002,939	1,002,939
Loans and advance, net	18,356	8,825	761	-	27,942
Investment properties	-	-	-	16,054	16,054
Interest receivable and other assets	-	-	-	37,491	37,491
Properties and equipment	-	-	-	946	946
Goodwill	-	-	-	56,782	56,782
Total assets	138,177	8,825	14,231	1,609,271	1,770,504
Liabilities:					
Due to banks and other financial institutions	211,795	-	-	-	211,795
Deposits from customers	80,349	-	-	-	80,349
Long term loans	509,501	221,683	-	-	731,184
Subordinated debt	100,000	-	-	-	100,000
Interest payable and other liabilities	-	-	-	44,022	44,022
Minority Interest	-	-	-	41,311	41,311
Shareholders Equity	-	-	-	561,843	561,843
Total liabilities and shareholders' Equity	901,645	221,683	-	647,176	1,770,504
On balance sheet gap	(763,468)	(212,858)	14,231	962,095	-
Cumulative gap	(763,468)	(976,326)	(962,095)	-	-
Off balance sheet items					
Interest rate Swaps	-	200,000	-	-	200,000
Forward foreign exchange contracts	-	-	406,412	1,147,759	1,554,171

8. PILLAR 2 RISKS (continued)

8.3. Concentration Risk

Concentration Risk is captured in UGB's framework through the use of internal and external regulations that cap the maximum exposure to any single obligor. There are established limits in place that set thresholds for aggregate industry, name lending and geography. Under the CBB's rules governing maximum single exposure, banks incorporated in Bahrain are required to obtain the regulator's approval for any planned exposure to a single counterparty or group of connected counterparties that exceed 15% of the regulatory capital base. As at 31 December 2011, the exposures that exceeded 15% of the capital base are:

	Current exposure US$ 000	RWA US$ 000	Percentage of regulatory capital
Counterparty A	470,698	468,392	88%
Counterparty B	155,376	310,752	29%
Counter Party C	113,294	113,294	21%
Counter Party D	93,475	93,475	17%
Total	832,843	985,913	

9. INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS

ICAAP is requirement of Pillar II norms of Basel II, and involves appropriate identification and measurement of risks, and maintaining an appropriate level of internal capital in alignment with the Bank's overall risk profile and business plan. The objective of the Bank's ICAAP is to ensure that adequate capital is retained at all times to support the risks the Bank undertakes in the course of its business.

The Bank recognizes that its earnings are the first line of defense against losses arising from business risks, and that capital is one of the tools to address such risks. Also important, are establishing and implementing documented procedures; defining and monitoring internal limits on the Bank's activities/ exposures; strong risk management, compliance and internal control processes; as well as adequate provisions for credit, market and operational losses. However, since capital is vital to ensure continued solvency, the Bank's objective is to maintain sufficient capital such that a buffer above regulatory capital adequacy requirement is available to meet risks arising from fluctuations in asset values, revenue streams, business cycles, and expansion and future requirements. The Bank's ICAAP identifies risks that are material to the Bank's business and the capital that is required to be set aside for such risks.

9. INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS (continued)

The Bank seeks to achieve the following goals by implementing an effective capital management framework:

- Meet the regulatory capital adequacy requirement and maintain a prudent buffer;
- Generate sufficient capital to support overall business strategy;
- Integrate capital allocation decisions with the strategic and financial planning process;
- Enhance Board and Senior Management's ability to understand how much capital flexibility exists to support the overall business strategy;
- Enhance the Bank's understanding on capital requirements under different stress scenarios; and
- Build and support the link between risks and capital and tie performance to both of them.

10. DISCONTINUED OPERATIONS

At an EGM of United Gulf Bank Securities Company B.S.C. (c) (UGBS) (96% owned subsidiary) held on 27 October 2010, shareholders of UGBS had resolved to voluntarily liquidate the Company. As a result, UGBS was officially liquidated in 2011 with the approval of the CBB and the Ministry of Industry and Commerce

11. PENALTIES

We confirm to the best of our knowledge and belief, that no violation of Bahrain Commercial Companies Law, nor Central Bank of Bahrain and Financial Institutions Law, nor of the Memorandum and Articles of Association of the Bank have occurred during the year ended 31 December 2011. Accordingly, the Bank has complied with all the terms of its banking license and no penalties have been levied by any of regulatory authorities during 2011.

In addition, we also confirm to the best of our knowledge and belief, that there are no material pending legal cases outstanding as at 31 December 2011.

12. CONCLUSION

The Risk Management and Capital Adequacy Disclosures focus solely on the Pillar 3 requirements of the Basel II Accord. Further information on the Bank and its salient subsidiaries and associates, is available in the Annual Report for the year ended 31 December 2011. Both documents are available in the Financial Section of the Bank's website www.ugbbah.com

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