



بنك الخليج المتحد ش.م.ب.  
United Gulf Bank B.S.C.

## Basel III, Pillar 3

# Risk Management and Capital Adequacy Disclosures

30<sup>th</sup> June 2016





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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 III Capital Adequacy Framework effective 1 January 2015. This is in accordance with the Central Bank of Bahrain’s (“the CBB”) Basel III guidelines.

The Risk Management and Capital Adequacy Disclosures fulfill the Pillar 3 requirements of the Basel III 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’.

The disclosures have been provided in accordance with the Public Disclosures (“PD”) module of the CBB’s Rulebook volume 1. They meet the requirements of Basel III (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 updated and approved by the Board of Directors on 13 August 2015.

The CET 1, Tier 1 and Total consolidated capital adequacy ratios of UGB as at 30th June 2016 were over the CBB’s thresholds of 9.0%, 10.5% and 12.5% (including Capital Conservation Buffer “CCB” of 2.5%) respectively. UGB’s consolidated CET 1 ratio was 9.40%, Tier 1 ratio was 11.14% and Total Capital ratio was 15.11% as of 30 June 2016, with total risk weighted assets being US\$ 2,266 million. This comprises 91% for credit risk 3% for operational risk and 6% for market risk.

All figures in this report are as at 30 June 2016 (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. 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 of investment and commercial banking. Investment banking include 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\$ 33.3 billion as of 30 June 2016. The Group has substantial ownership interests in a portfolio of over 60 companies operating across 24 countries. KIPCO's main sector focus is financial services, media, real estate and manufacturing. Through its core companies, subsidiaries and affiliates, KIPCO also has interests in education and medical sectors.

The ownership of the Bank as at 30 June 2016 can be summarized as follows:

	<b>No. of shares</b>	<b>Percentage</b>
Kuwait Projects (Holding) KSC	797,883,143	95.6%
Directors	762,700	0.1%
Public Shareholders	16,502,317	2.0%
Treasury shares	19,454,135	2.3%
<b>Total</b>	<b>834,602,295</b>	<b>100%</b>



## **1. INTRODUCTION TO THE BASEL III FRAMEWORK**

The new capital adequacy module of the Central Bank of Bahrain (CBB) rulebook volume 1 was introduced with effect from 1 January 2015. The transitional arrangements (which end on 31<sup>st</sup> December 2018) for implementing the new standards help to ensure that the banking sector can meet the higher capital standards through reasonable earnings retention and capital raising, while still supporting lending to the economy.

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

- |                 |   |
|-----------------|---|
| <b>Pillar 1</b> | Minimum capital requirements for credit, market and operational risks, defining eligible capital instruments and prescribing rules for calculating RWA.   |
| <b>Pillar 2</b> | 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. |
| <b>Pillar 3</b> | Market discipline through public disclosures that are designed to provide transparent information on capital structures and risk management. It allows market participants to assess the risk and capital profiles of banks.  |

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 III 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 III capital adequacy framework.



## 1 INTRODUCTION TO THE BASEL III 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. Basel III transitional capital requirements became effective on 1 January 2015 with a transition period of up to 2018 for full implementation. There are three categories of risk-based capital under Basel III transitional arrangements: Core Equity Tier 1 Capital (CET 1), Tier 1 Capital and Total Capital. Banks incorporated in Bahrain are required to maintain regulatory minimum ratios of 6.5% CET 1, 8.0% Tier 1, and 10.0% Total Capital. There is also a requirement for banks to maintain a Capital Conservation Buffer (CCB) of 2.5%. Therefore, the required CARs including CCB for CET 1, Tier 1 and Total Capital are 9.0%, 10.5% and 12.5% respectively.

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 III 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 III FRAMEWORK (continued)**

### **1.2 Pillar 2 – Supervisory Review Process (“SRP”)**

The second pillar of Basel III 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; and
- 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 III Accord, imposes certain disclosure requirements with an objective 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 material subsidiaries are included within the Group structure. No additional disclosures are required due to listing requirements of the Group's subsidiaries. The principal subsidiaries for capital adequacy purposes are as follows:

<i><b>Name of the subsidiary</b></i>	<i><b>Country of incorporation</b></i>	<i><b>Legal ownership</b></i>		<i><b>Year of incorporation</b></i>
		<i><b>30 June 2016</b></i>	<i><b>31 December 2015</b></i>	
<i><b>Held directly</b></i>				
FIMBank Group [FIMBank]	Malta	<b>61%</b>	61%	1994
KAMCO Investment Company K.S.C.P. [KAMCO]	Kuwait	<b>86%</b>	86%	1998
Hatoon Real Estate Company	Kuwait	<b>98%</b>	98%	2008
Syria Gulf Investment Company	Syria	<b>99%</b>	99%	2007
Takaud Saving & Pensions Company	Bahrain	<b>50%</b>	50%	2011
United Gulf Financial Services Company-North Africa	Tunisia	<b>85%</b>	85%	2008
United Gulf Realty International, Ltd	British Virgin Islands	<b>100%</b>	100%	2012
<i><b>Held through KAMCO</b></i>				
Al Dhiyafa United Real Estate Company W.L.L.	Kuwait	<b>100%</b>	100%	2007
Al Jazi Money Market Fund	Kuwait	<b>48%</b>	17%	2016
KAMCO Mena Plus Fixed Income Fund	Kuwait	<b>65%</b>	44%	2009
Al Zad Real Estate W.L.L.	Kuwait	<b>99%</b>	99%	2007
Kamco GCC Opportunistic Fund	Kuwait	<b>100%</b>	87%	2013
Kuwait Private Equity Opportunity Fund	Kuwait	<b>71%</b>	71%	2004
North Africa Real Estate Co.	Kuwait	<b>100%</b>	100%	2014
Orange Real Estate Co. W.L.L.	Kuwait	<b>100%</b>	100%	2005
<i><b>Held through FIMBank</b></i>				
India Factoring and Finance Solutions Private Limited	India	<b>79%</b>	79%	2010
CIS Factors Holdings B.V.	Russia	<b>100%</b>	100%	2009
FIM Holdings (Chile) S.p.a.	Chile	<b>100%</b>	100%	2014
First Factors S.A.	Chile	<b>51%</b>	51%	2014
London Forfaiting Company Limited	Kingdom	<b>100%</b>	100%	2009
London Forfaiting International Limited	Kingdom	<b>100%</b>	100%	2009
London Forfaiting do Brasil Ltd.	Brazil	<b>100%</b>	100%	2009
FIM Factors B.V.	Netherlands	<b>100%</b>	100%	2009
FIM Business Solutions Limited	Malta	<b>100%</b>	100%	2009
FIM Property Investment Limited	Malta	<b>100%</b>	100%	2010
Emerging Market Trade Finance Fund	Malta	<b>100%</b>	100%	2013
Menafactors Limited	United Arab Emirates	<b>100%</b>	100%	2009
London Forfaiting Americas Inc.	United States of America	<b>100%</b>	100%	2009



## **2 GROUP STRUCTURE AND OVERALL RISK MANAGEMENT PROCESSES (continued)**

### **2.1 Group Structure (continued)**

Significant minority investments in financial entities that form part of the regulatory adjustments are as follows:

- Manafae Investment Company – Kuwait;
- Syria Gulf Bank – Syria;
- Al Sharq Financial Brokerage Co.;
- Brasilfactors;
- Global Banking Corp.; and
- Burgan Bank

The total amount of deductions resulting from the above was US\$ 190.8 million.

In addition to the above, the Bank's investments in United Real Estate Company and North Africa Holding Company, both commercial entities, attract risk weights of 800%.

The total amount being risk weighted at 800% resulting from the above was US\$ 20.0 million.

### **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.



## **2 GROUP STRUCTURE AND OVERALL RISK MANAGEMENT PROCESSES (continued)**

### **2.2 Risk Management Structure and Processes (continued)**

The Investment Committee comprising the Acting Chief Executive Officer 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 Acting 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.

The Nominating & Remuneration Committee (NRC), comprising of three board members, assists the Board in assessing the skill sets of Board members and ensures that there is an appropriate mix of eminent persons having an independent standing in their respective field/profession and who can effectively contribute to UGB's business and policy decisions. The NRC also recommends / reviews the remuneration policies for the Board Directors and senior management.

The IT Steering Committee, headed by the Acting Chief Executive Officer and members include the Chief Financial Officer and other senior management team members, is responsible for assisting the Board in the supervision of IT related activities. It ensures that it minimizes the risks associated with UGB's investment in information technology and that it contributes to the attainment of technology related corporate objectives.

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.

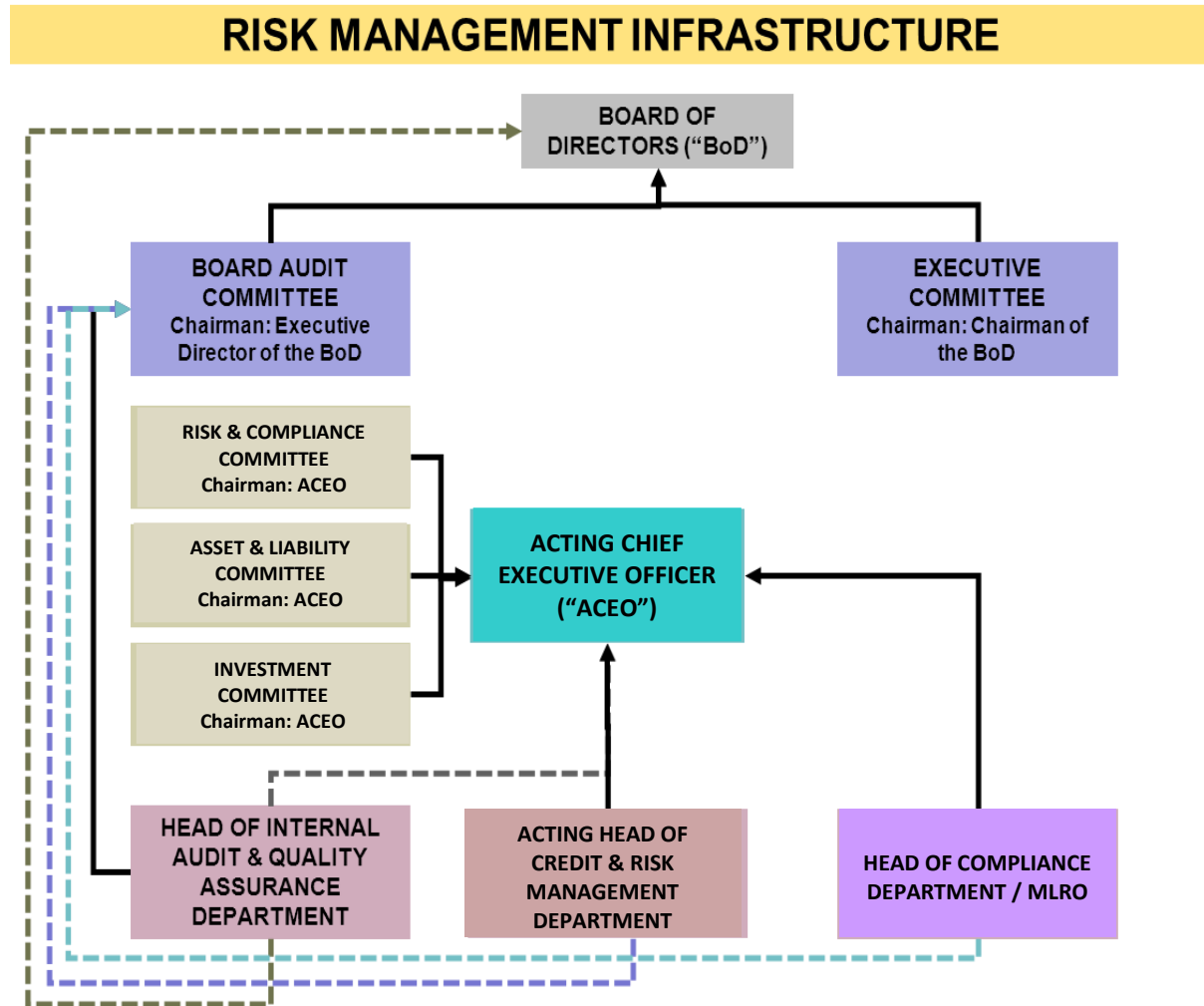
The Internal Audit and Quality Assurance Department provides the Board Audit Committee and Senior Management with an ongoing process of independent and objective assessment and assurance on effectiveness and quality of controls.

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.

**2 GROUP STRUCTURE AND OVERALL RISK MANAGEMENT PROCESSES (continued)**

Corporate Governance report for the year ended 31 December 2015 has been prepared by the Bank and is available on the Bank’s website [www.ugbbah.com](http://www.ugbbah.com).

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 30 June 2016 can be summarized as follows:

	<b>Gross Exposures US\$ 000</b>
<b>Funded</b>	
Demand and call deposits with banks	199,981
Placements with banks	218,753
Non-trading investments	114,578
Loans and receivables	1,189,729
Other assets	93,821
	<u>1,816,862</u>
<b>Unfunded</b>	
Letters of credit	66,059
Letters of guarantee	3,889
Derivative financial assets	462
	<u>70,410</u>
	<u>1,887,272</u>

The period-end position of the gross credit exposure is the representative of the Groups risk position during the period and accordingly the average gross credit exposure of the Group for the period ended 30 June 2016 is not disclosed.

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.



## 2 GROUP STRUCTURE AND OVERALL RISK MANAGEMENT PROCESSES (continued)

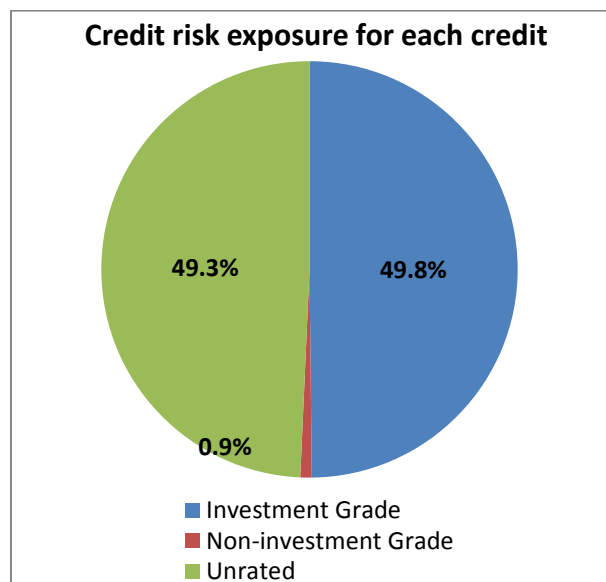
### 2.4 Risks under Pillar 1 (continued)

#### Risk Category/Issuer Rating

Whenever available, UGB uses ratings assigned by the CBB accredited rating, which mainly include Moody's, Standard and Poor's and Fitch. 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 30 June 2016 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 the 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**

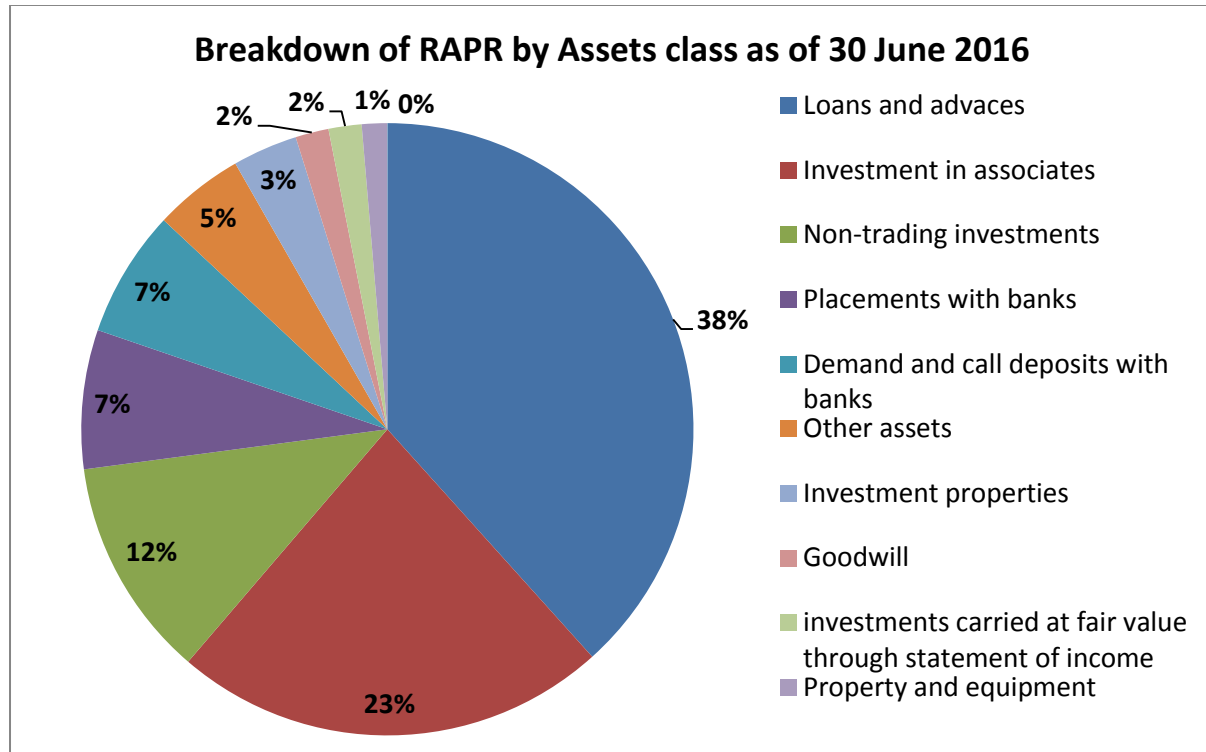
The asset class of the investment is usually determined by its ability to be sold or traded i.e. the extent of liquidity. If pricing is identical for the same risk but offered in a variety of asset classes, UGB's risk policy recommends its investment in a tradable security as opposed to a loan, for which 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 30 June 2016.



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 these disclosures.

#### **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)**

#### **iii) Operational Risk (Continued)**

UGB's ability to properly identify, assess, manage, measure, monitor and report risk is critical to its financial strength and profitability. A comprehensive set of risk management policies, processes and limits are in place to provide guidelines and parameters. They are continually updated with the objective of incorporating best practices, changes in market factors and changes in the regulatory environment.

In accordance with the Basel guidelines, UGB has developed a comprehensive operational risk framework, whereby all activities and processes of the Bank are analysed, residual risks identified, measured and reported as appropriate.

Exception and excess exposure reporting is done by the Credit and Risk Management Department, succession planning, business continuity planning, reliable management reporting and supervision by the Internal Audit Department and the Board Audit Committee is also adhered to by the Bank.

The management of operational risk is the responsibility of every employee. The operational risk framework is built around a comprehensive Risk Control Self-Assessment (RCSA) that identifies all major risks stemming from activities of each department of the Bank. The Risk and Compliance Committee periodically reviews the results of the RCSA. UGB has further enhanced its Operational Risk Framework, supported by a fully automated Operational Risk System. The system comprises of modules for loss database, RCSA, key risk indicators and exposure monitoring.



## **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 30 June 2016, the liquidity ratio of the Bank was 70.4%. This is strictly monitored to ensure that it remains above the regulatory level of 25 percent at all times.



## **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 re-pricing 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) 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 using 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 (and its main subsidiaries) overall minimum capital requirement of 12.5% and capital adequacy position under Pillar 1 as of 30 June 2016.

#### **Total Minimum Capital Requirement**

	<b>Consolidated</b>	<b>KAMCO</b>	<b>FIMBank</b>
	<b>US\$ 000</b>	<b>US\$ 000</b>	<b>US\$ 000</b>
Credit Risk (Standardized)	258,171	35,201	96,118
Operational Risk (Basic Indicator)	8,362	5,016	9,583
Market Risk (Standardized)	16,744	6	9,781
<b>Total required Capital</b>	<b>283,277</b>	<b>40,224</b>	<b>115,483</b>
<b>Total Available Capital</b>	<b>342,529</b>	<b>113,972</b>	<b>123,830</b>
<b>Excess Capital Over Minimum Capital Requirement</b>	<b>59,252</b>	<b>73,748</b>	<b>8,347</b>

### **3.1 Capital Structure and capital adequacy**

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.



### 3. CAPITAL ADEQUACY (continued)

The total regulatory capital (CET 1, Tier 1 and Tier 2) calculated in accordance with the CBB guidelines are as follows:

	CET 1 US\$ 000	AT 1 US\$ 000	T 2 US\$ 000
<b>Tier 1 Capital</b>			
<b>Common Equity Tier 1 (CET1)</b>			
Issued and fully paid ordinary shares	208,651		
Less: Employee stock incentive program funded by the bank (outstanding) Treasury Shares	18,131		
General reserves	80,373		
Legal / Statutory reserves	99,888		
Share premium	11,460		
Retained earnings	80,497		
Current interim cumulative net income / losses	4,235		
Accumulated other comprehensive income and losses (and other reserves)	(71,602)		
<b>Total CET1 capital before minority interest</b>	<b>395,371</b>		
Total minority interest in banking subsidiaries given recognition in CET1 capital	79,853		
<b>Total CET1 capital prior to regulatory adjustments</b>	<b>475,224</b>		
Less:			
Goodwill	52,321		
Intangibles other than mortgage servicing rights	1,946		
Deferred tax assets	16,608		
Cash flow hedge reserve	(93)		
<b>Total CET 1 capital after the regulatory adjustments above (CET1 a)</b>	<b>404,442</b>		
Less: Investment in financial entities where ownership is < 10% of the issued common share capital (amount above 10% CET1a)	-		
<b>Total Common Equity Tier 1 capital after the regulatory adjustments above (CET1 b)</b>	<b>404,442</b>		
Less: Non-common equity Invest. in financial entities where ownership is >10% of the issued common share capital	-		
<b>Total Common Equity Tier 1 capital after the regulatory adjustments above (CET1 C)</b>	<b>404,442</b>		
Less:			
Significant investments in the common stock of financial entities (amount above 10% of CET1c)	189,861		
Aggregated amount of exceeding the 15% of CET1c	115,439		
Positive or negative adjustments due to aggregation of CET1	113,916		
<b>Total Common Equity Tier 1 capital after the regulatory adjustments above (CET1 d)</b>	<b>213,058</b>		
<b>Other Capital (AT1 &amp; T 2)</b>			
Instruments issued by parent company		33,000	64,694
Instruments issued by banking subsidiaries to third parties		6,368	14,379
General loan loss provisions		-	11,030
<b>Total Available AT1 &amp; T2 Capital</b>		<b>39,368</b>	<b>90,103</b>
<b>Deduction from AT1 &amp; T2 before additional deduction to absorb deficiency in Tier 2</b>		-	-
<b>Total AT1 &amp; T2 Deductions</b>		-	-
<b>Net Available Capital after regulatory adjustments before Applying Haircut</b>		<b>39,368</b>	<b>90,103</b>
<b>Net Available Capital after Applying Haircut</b>	<b>213,058</b>	<b>39,368</b>	<b>90,103</b>
<b>Total Tier 1</b>		<b>252,426</b>	
<b>Total Capital</b>			<b>342,529</b>



### 3. CAPITAL ADEQUACY (continued)

#### Composition of Capital – Reconciliation Requirements:

Step 1: Disclose the reported balance sheet under the regulatory scope of consolidation

	Balance sheet as in published financial statements	Consolidated PIR data
	30-Jun-16	30-Jun-16
	US\$ 000	US\$ 000
<b>Assets</b>		
Cash and balances with central banks	199,981	6,863
Due from banks and other financial institutions	218,753	411,872
Investments at fair value through statement of income	51,950	51,950
Loans and advances to customers	1,141,754	1,152,784
Non-trading investments	346,414	819,330
Investments in associated companies	683,604	263,008
Interest receivable and other assets	141,929	142,312
Investment properties	102,148	102,148
Property and equipment	39,581	39,581
Goodwill	52,321	-
Assets of disposal group classified as held for sale	382	-
<b>Total assets</b>	<b>2,978,817</b>	<b>2,989,848</b>
<b>Liabilities</b>		
Due to banks and other financial institutions	725,053	725,054
Deposits from Customers	882,060	882,060
Term borrowings	650,051	650,051
Subordinated debt	123,470	-
Interest payable and other liabilities	62,069	62,287
Liabilities of disposal group classified as held for sale	218	-
<b>Total liabilities</b>	<b>2,442,921</b>	<b>2,319,452</b>
<b>Equity</b>		
Share capital	208,651	190,520
Treasury shares	(18,131)	-
Share premium	11,459	11,460
Statutory reserve	99,888	99,888
General reserve	80,373	80,373
Treasury shares reserve	14,248	-
Cumulative changes in fair values	(53,681)	(53,682)
Foreign currency translation adjustments	(32,260)	(32,260)
Retained earnings	84,731	98,979
Collective impairment provision	-	11,030
Subordinated debts	-	123,470
<b>Attributable to the owners of the Bank</b>	<b>395,278</b>	<b>529,778</b>
Non-controlling interests	107,618	107,618
Perpetual Tier 1 capital facility	33,000	33,000
<b>Total equity</b>	<b>535,896</b>	<b>670,396</b>
<b>Total Liabilities and equities</b>	<b>2,978,817</b>	<b>2,989,848</b>



**Step 2: Expand the lines of the regulatory Balance sheet to display all of the components used in the definition of capital disclosure template**

	Balance sheet as in published financial statements	Consolidated PIR data	Ref.
	30-Jun-2016	30-Jun-2016	
	US\$ 000	US\$ 000	
<b>Assets</b>			
Cash and balances with central banks	199,981	6,863	
Due from banks and other financial institutions	218,753	411,872	
Investments at fair value through statement of income	51,950	51,950	
Loans and advances to customers	1,141,754	1,152,784	
of which specific provisions	(36,945)	(36,945)	
of which loans and advances (gross of provisions)	1,178,699	1,189,729	
Non-trading investments	346,414	819,330	
of which related to equity investments in financial entities	38,331	38,331	
of which related to CET1	38,331	23,378	a
of which related to Tier 1	-	-	
of which related to Tier 2	-	-	
of which related to other AFS investments	308,083	308,083	
of which equity investments in financial entities	-	487,870	b
Investments in associated companies	683,604	263,008	
of which equity investments in financial entities	500,143	12,273	c
of which other investments	183,461	198,414	
of which Goodwill	-	52,321	d
Interest receivable and other assets	141,929	142,312	
of which deferred tax assets due to temporary differences	23,560	23,560	
of which Interest receivable and other assets	118,369	118,752	e
Investment properties	102,148	102,148	
Property and equipment	39,581	39,581	
Goodwill	52,321	-	
Assets of disposal group classified as held for sale	382	-	
<b>Total assets</b>	<b>2,978,817</b>	<b>2,989,848</b>	





Step 2: Expand the lines of the regulatory Balance sheet (continued)

	Balance sheet as in published financial statements	Consolidated PIR data	Ref.
	30-Jun-2016	30-Jun-2016	
	US\$ 000	US\$ 000	
<b>Liabilities</b>			
Due to banks and other financial institutions	725,053	725,054	
Deposits from Customers	882,060	882,060	
Term borrowings	650,051	650,051	
Subordinated debt	123,470	-	
Interest payable and other liabilities	62,069	62,287	
Liabilities of disposal group classified as held for sale	218	-	
<b>Total liabilities</b>	<b>2,442,921</b>	<b>2,319,452</b>	
<b>Equity</b>			
Share capital (net of Treasury shares)	190,520	190,520	
of which amount eligible for CET 1	190,520	190,520	f
of which amount eligible for AT 1	-	-	
Share premium	11,459	11,460	g
Statutory reserve	99,888	99,888	h
General reserve	80,373	80,373	i
Treasury shares reserve	14,248	-	
Cumulative changes in fair values	(53,681)	(53,682)	
of which unrealized gains and losses on available for sale financial instruments	841	841	j
of which gains and losses on derivatives held as cash flow hedges	(93)	(93)	k
of which unrealized gains and losses from fair valuing equities	(54,429)	(54,430)	l
Foreign currency translation adjustments	(32,260)	(32,260)	m
Retained earnings	84,731	98,979	
of which Treasury shares reserve	-	14,248	n
of which Retained earnings	84,731	84,731	o
Collective impairment provision	-	11,030	p
Subordinated debts	-	123,470	
of which Tier 2 capital instruments	-	64,694	q
<b>Attributable to the owners of the Bank</b>	<b>395,278</b>	<b>529,778</b>	
Non-controlling interests	107,618	107,618	
Perpetual Tier 1 capital facility	33,000	33,000	
<b>Total equity</b>	<b>535,896</b>	<b>670,396</b>	
<b>Total Liabilities and equities</b>	<b>2,978,817</b>	<b>2,989,848</b>	



**Step 3: Map each of the components that are disclosed in Step 2 to the composition of capital disclosure templates**

		Component of regulatory capital	Source based on reference letters of the balance sheet under the regulatory scope of consolidation
<b>Common Equity Tier 1: Instruments and reserves</b>			
1	Directly issued qualifying common share capital plus related stock surplus	201,980	f+g
2	Retained earnings	84,732	o
3	Accumulated other comprehensive income and losses (and other reserves)	108,659	h+i+j+l+m+n
4	Not applicable		
5	Common shares issued by subsidiaries and held by third parties (amount allowed in group CET1)	79,853	
6	<b>Common Equity Tier 1 capital before regulatory adjustments</b>	<b>475,224</b>	
<b>Common Equity Tier 1 capital: regulatory adjustments</b>			
7	Prudential valuation adjustment		
8	Goodwill (net of related tax liabilities)	52,321	d
9	Other intangibles other than mortgage servicing rights (net of related tax liabilities)	1,946	
10	Deferred tax assets that rely on future profitability excluding those arising from temporary differences (net of related tax liabilities)	16,608	e
11	Cash flow hedge reserve	(93)	k
12	Shortfall of provisions to expected losses	-	
13	Securitization gain on sale (as set out in paragraph 562 of Basel II framework)	-	
14	Not applicable	-	
15	Defined benefit pension fund net assets	-	
16	Investments in own shares	-	
17	Reciprocal cross holdings in Common equity	-	
18	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)	-	
19	Significant investments in the common stock of banking, financial and insurance entities that are outside the scope of regulatory consolidation, net of eligible short positions (amount above 10% threshold)	189,861	
20	Mortgage servicing rights (amount above 10% of CET1c)	-	
21	Deferred tax assets arising from temporary differences (amount above 10% threshold, net of related tax liability)	-	
22	Amount exceeding the 15% threshold	115,439	
23	of which: significant investments in the common stock	107,497	
24	of which: mortgage servicing rights		
25	of which: deferred tax assets arising from temporary differences	7,942	
26	CBB specific regulatory adjustments	(113,916)	
	Regulatory Adjustments applied to Common Equity Tier 1 in respect of amounts subject to pre-2015 treatments		
	of which: Positive or negative adjustments due to aggregation of CET1	(113,916)	
27	Regulatory adjustments applied to Common Equity Tier 1 due to insufficient Additional Tier 1 and Tier 2 to cover deductions	-	
28	<b>Total regulatory adjustments to Common equity Tier 1</b>	<b>262,166</b>	
29	<b>Common Equity Tier 1 capital (CET1)</b>	<b>213,058</b>	
<b>Additional Tier 1 capital: instruments</b>			
30	Directly issued qualifying Additional Tier 1 instruments plus related stock surplus	33,000	
31	of which: classified as equity under applicable accounting standards	33,000	
32	of which: classified as liabilities under applicable accounting standards	-	
33	Directly issued capital instruments subject to phase out from Additional Tier 1	-	
34	Additional Tier 1 instruments (and CET1 instruments not included in row 5) issued by subsidiaries and held by third parties (amount allowed in group AT1)	6,368	
35	of which: instruments issued by subsidiaries subject to phase out	-	
36	<b>Additional Tier 1 capital before regulatory adjustments</b>	<b>39,368</b>	
<b>Additional Tier 1 capital: regulatory adjustments</b>			
37	Investments in own Additional Tier 1 instruments	-	
38	Reciprocal cross-holdings in Additional Tier 1 instruments	-	
39	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)	-	
40	Significant investments in the capital banking, financial and insurance entities that are outside the scope of regulatory consolidation (net of eligible short positions)	-	
41	CBB specific regulatory adjustments	-	
42	Regulatory adjustments applied to Additional Tier 1 due to insufficient Tier 2 to cover deductions	-	
43	<b>Total regulatory adjustments to Additional Tier 1 capital</b>	<b>-</b>	
44	<b>Additional Tier 1 capital (AT1)</b>	<b>39,368</b>	
45	<b>Tier capital (T1 = CET1 + AT1)</b>	<b>252,426</b>	



### 3. CAPITAL ADEQUACY (continued)

#### Step 3: Map each of the components that are disclosed in Step 2 to the composition of capital disclosure templates (continued)

		Component of regulatory capital	Source based on reference letters of the balance sheet under the regulatory scope of consolidation
<b>Tier 2 capital: instruments and provisions</b>			
46	Directly issued qualifying Tier 2 instruments plus related stock surplus	64,694	q
47	Directly issued capital instruments subject to phase out from Tier 2	-	
48	Tier 2 instruments (and CET1 and AT1 instruments not included in rows 5 or 34) issued by subsidiaries and held by third parties (amount allowed in group Tier 2)	14,379	
49	of which: instruments issued by subsidiaries subject to phase out	-	
50	Provisions	11,030	p
51	<b>Tier 2 capital before regulatory adjustments</b>	<b>90,103</b>	
<b>Tier 2 capital: regulatory adjustments</b>			
52	Investments in own Tier 2 instruments	-	
53	Reciprocal cross-holdings in Tier 2 instruments	-	
54	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)	-	
55	Significant investments in the capital banking, financial and insurance entities that are outside the scope of regulatory consolidation (net of eligible short positions)	-	
56	National specific regulatory adjustments	-	
57	Total regulatory adjustments to Tier 2 capital	-	
58	<b>Tier 2 capital (T2)</b>	<b>90,103</b>	
59	<b>Total capital (TC = T1 + T2)</b>	<b>342,529</b>	
60	<b>Total risk weighted assets</b>	<b>2,266,217</b>	
<b>Capital ratios and buffers</b>			
61	Common Equity Tier 1 (as a percentage of risk weighted assets)	9.40%	
62	Tier 1 (as a percentage of risk weighted assets)	11.14%	
63	Total capital (as a percentage of risk weighted assets)	15.11%	
64	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%	
65	of which: capital conservation buffer requirement	2.50%	
66	of which: bank specific countercyclical buffer requirement	N/A	
67	of which: G-SIB buffer requirement	N/A	
68	Common Equity Tier 1 available to meet buffers (as a percentage of risk weighted assets)	9.40%	
<b>National minima (where different from Basel III)</b>			
69	CBB Common Equity Tier 1 minimum ratio	6.50%	
70	CBB Tier 1 minimum ratio	8.00%	
71	CBB total capital minimum ratio	10.00%	
<b>Amounts below the thresholds for deduction (before risk weighting)</b>			
72	Non-significant investments in the capital of other financials	23,378	a
73	Significant investments in the common stock of financials	217,738	b+c
74	Mortgage servicing rights (net of related tax liability)	-	
75	Deferred tax assets arising from temporary differences (net of related tax liability)	16,087	e
<b>Applicable caps on the inclusion of provisions in Tier 2</b>			
76	Provisions eligible for inclusion in Tier 2 in respect of exposures subject to standardised approach (prior to application of cap)	11,030	p
77	Cap on inclusion of provisions in Tier 2 under standardised approach	25,817	
78	N/A		
79	N/A		
<b>Capital instruments subject to phase-out arrangements (only applicable between 1 Jan 2019 and 1 Jan 2023)</b>			
80	Current cap on CET1 instruments subject to phase out arrangements		
81	Amount excluded from CET1 due to cap (excess over cap after redemptions and maturities)		
82	Current cap on AT1 instruments subject to phase out arrangements		
83	Amount excluded from AT1 due to cap (excess over cap after redemptions and maturities)		
84	Current cap on T2 instruments subject to phase out arrangements		
85	Amount excluded from T2 due to cap (excess over cap after redemptions and maturities)		



### 3. CAPITAL ADEQUACY (continued)

#### Disclosure of main features of regulatory capital instruments

Disclosure of template for main features of regulatory capital instruments					
1	Issuer	United Gulf Bank	United Gulf Bank	United Gulf Bank	FIMBank, Malta
2	Unique identifier (e.g. CUSIP, ISIN or Bloomberg identifier)	Share ticker: UGB	Not listed	ISIN: XS0270878506	Not listed
3	Governing law(s) of the instrument	Laws and regulations of Kingdom of Bahrain	Laws and regulations of Kingdom of Bahrain	English Laws and Singapore Stock Exchange	Laws of Malta
	<i>Regulatory treatment</i>				
4	Transitional CBB rules	Common Equity Tier 1	Additional Tier 1	Tier 2	Tier 2
5	Post-transitional CBB rules	Common Equity Tier 1	Eligible	Eligible	Eligible
6	Eligible at solo/group/group & solo	Group and solo	Group and solo	Group and solo	Group and solo
7	Instrument type (types to be specified by each jurisdiction)	Common shares	Perpetual Subordinated Loan	Subordinated Bond	Subordinated Loan
8	Amount recognised in regulatory capital	US\$ 202 million	US\$ 33 million	US\$ 14.7 million	US\$ 50 million
9	Par value of instrument	US\$ 0.25	US\$ 33 million	US\$ 100 million	US\$ 50 million
10	Accounting classification	Shareholders' Equity	Equity	Borrowing	Borrowing
11	Original date of issuance	Various	Mar-2016	Oct-2006	Sep-2015
12	Perpetual or dated	Perpetual	Perpetual	Dated	Dated
13	Original maturity date	No maturity	No maturity	13-Oct-2016	30-Sep-2020
14	Issuer call subject to prior supervisory approval	No	Yes	Yes	Yes
15	Optional call date, contingent call dates and redemption	Not applicable	Not applicable	Not applicable	Not applicable
16	Subsequent call dates, if applicable	Not applicable	Not applicable	Not applicable	Not applicable
	<i>Coupons / dividends</i>				
17	Fixed or floating dividend/coupon	Floating dividends	Fixed coupon	Fixed coupon	Fixed coupon
18	Coupon rate and any related index	Not applicable	10.5% p.a.	3 month LIBOR +	6 month LIBOR + 3%
19	Existence of a dividend stopper	Not applicable	Yes	Not applicable	Not applicable
20	Fully discretionary, partially discretionary or mandatory	Fully discretionary	Fully discretionary	Mandatory	Mandatory
21	Existence of step up or other incentive to redeem	No	No	No	No
22	Noncumulative or cumulative	Noncumulative	Noncumulative	Noncumulative	Noncumulative
23	Convertible or non-convertible	Not applicable	Non-convertible	Non-convertible	Non-convertible
24	If convertible, conversion trigger (s)	Not applicable	Not applicable	Not applicable	Not applicable
25	If convertible, fully or partially	Not applicable	Not applicable	Not applicable	Not applicable
26	If convertible, conversion rate	Not applicable	Not applicable	Not applicable	Not applicable
27	If convertible, mandatory or optional conversion	Not applicable	Not applicable	Not applicable	Not applicable
28	If convertible, specify instrument type convertible into	Not applicable	Not applicable	Not applicable	Not applicable
29	If convertible, specify issuer of instrument it converts into	Not applicable	Not applicable	Not applicable	Not applicable
30	Write-down feature	No	Yes	No	No
31	If write-down, write-down trigger(s)	Not applicable	Non-Viability Event	Not applicable	Not applicable
32	If write-down, full or partial	Not applicable	Partial	Not applicable	Not applicable
33	If write-down, permanent or temporary	Not applicable	Permanent	Not applicable	Not applicable
34	If temporary write-down, description of write-up mechanism	Not applicable	Not applicable	Not applicable	Not applicable
35	Position in subordination hierarchy in liquidation (specify instrument type immediately senior to instrument)	Not applicable	Tier 2 subordinated instruments	None	None
36	Non-compliant transitioned features	None	None	None	None
37	If yes, specify non-compliant features	Not applicable	Not applicable	Not applicable	Not applicable

\* The issue of the Additional Tier 1 facility has no impact on the earnings or dividends of the Group for the six months period ended 30 June 2016.



### 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

UGB's policy is to maintain a strong capital base 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 significant subsidiaries as at 30 June 2016 were as follows:

##### Capital Adequacy Ratio

	Consolidated US\$ 000	KAMCO US\$ 000	FIMBank US\$ 000
<b>Total Eligible Capital Base</b>	<b>342,529</b>	<b>113,972</b>	<b>123,830</b>
Credit Risk Weighted Exposure	2,065,369	281,612	768,947
Operational Risk Weighted Exposure	66,898	40,132	76,665
Market Risk Weighted Exposure	133,950	46	78,251
<b>Total Risk Weighted Exposure</b>	<b>2,266,217</b>	<b>321,790</b>	<b>923,863</b>
<b>Core Equity Tier 1 (CET 1) Ratio</b>	<b>9.40%</b>	<b>35.38%</b>	<b>12.25%</b>
<b>Tier 1 Ratio</b>	<b>11.13%</b>	<b>35.38%</b>	<b>12.25%</b>
<b>Total Capital Adequacy Ratio</b>	<b>15.11%</b>	<b>35.42%</b>	<b>13.40%</b>

The CBB's minimum capital adequacy ratios for banks incorporated in Bahrain at a consolidated level are as follows:

	Minimum Ratio Required	Capital Conservation Buffer (CCB)	CARS including CCB
<b>CET 1</b>	6.5%	2.5%	9.0%
<b>Tier 1</b>	8.0%	2.5%	10.5%
<b>Total Capital</b>	10.0%	2.5%	12.5%

#### 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 III capital adequacy framework as 'standard portfolios'. The primary standard portfolios are claims on sovereigns, claims on Public Sector Entities (PSEs), claims on banks, claims on corporate, investments in securities, holdings of real estate and other assets. 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 various eligible external rating agencies approved by the CBB.

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:

	<b>Total exposure</b> <b>US\$ 000</b>	<b>Risk Mitigant</b> <b>US\$ 000</b>	<b>Exposure after</b> <b>risk mitigant</b> <b>US\$ 000</b>	<b>RWA</b> <b>US\$ 000</b>	<b>Capital</b> <b>requirement</b> <b>US\$ 000</b>	<b>Rated</b> <b>exposure</b> <b>US\$ 000</b>
Cash items	13	-	13	-	-	NA
Total Claims on Sovereigns	240,682	-	240,682	7,002	875	240,682
Total Claims on Banks	311,100	57,064	254,036	123,176	15,397	280,879
Total Claims on PSEs	453,611	-	453,611	188,568	23,571	453,611
Total Claims on MDBs	7,750	-	7,750	-	-	-
Claims on Corporates including Insurance Companies & Category 3						
Investment Firms	1,029,134	-	1,029,134	607,981	75,998	1,005,206
Regulatory Retail Portfolios	10,708	-	10,708	8,031	1,004	-
Investments in Securities	546,595	-	546,595	891,170	111,396	-
Holding of Real Estate	132,392	-	132,392	212,158	26,520	-
Other Assets	43,371	-	43,371	27,284	3,411	-
<b>Total</b>	<b>2,775,356</b>	<b>57,064</b>	<b>2,718,292</b>	<b>2,065,369</b>	<b>258,171</b>	<b>1,980,378</b>

### 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 Requirement for Market Risk

	<b>RWA</b> <b>US\$ '000</b>	<b>Capital</b> <b>Requirement</b> <b>US\$ '000</b>
Equity Position Risk	46,200	5,775
Foreign Exchange Risk	87,750	10,969
<b>Total</b>	<b>133,950</b>	<b>16,744</b>



### 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 six months are as follows:

	Equity Position Risk US\$ '000	Foreign Exchange Risk US\$ '000
Minimum Values	5,775	9,655
Maximum Values	6,311	10,969

#### 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 III capital adequacy framework. The capital requirement for operational risk as at 30 June 2016 amounted to US\$ 8.4 million.

The following table summarizes the amount of exposure subject to basic indicator approach of operational risk and related capital requirements:

	Gross income		
	2015 US\$ '000	2014 US\$ '000	2013 US\$ '000
Total Gross Income	44,880	54,777	7,379
Average Gross income (US\$ '000)			35,679
Multiplier			12.5
			445,983
Eligible Portion for the purpose of the calculation			15%
Total Operational Risk Weighted Exposure			66,897



#### **4. CREDIT RISK – PILLAR 3 DISCLOSURES**

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

##### **4.1 Categories of exposure classes**

UGB's credit exposures are categorized as per the Basel III 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 are risk weighted subject to ECAI ratings with 100% used for unrated.

##### **Total Claims on Banks**

The exposure under claims on banks is risk weighted based on their external credit rating agencies. A preferential risk weight treatment is available for qualifying short-term exposures to claims on foreign banks licensed in Bahrain funded in the relevant domestic currency, i.e. BD or US\$.

##### **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 III 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 direct 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 III and the CBB norms.

##### 4.2 Categories of exposure by industry

The breakdown of the overall credit exposure by industry before taking into account collaterals held or other credit enhancements was as follows:

###### Gross credit exposure by industry

	<i>Trading and Manufacturing US\$ 000</i>	<i>Banks &amp; Other Financial Institutions US\$ 000</i>	<i>Construction and real estate US\$ 000</i>	<i>Government and public sector US\$ 000</i>	<i>Others US\$ 000</i>	<i>Total US\$ 000</i>
<b>Funded exposures</b>						
Demand and call deposits with b	-	199,981	-	-	-	199,981
Placements with banks	-	218,753	-	-	-	218,753
Non-trading investments	-	25,910	-	88,668	-	114,578
Loans and receivables	474,306	510,942	71,332	44,515	88,634	1,189,729
Other assets	-	53,759	1,244	401	38,417	93,821
<b>Unfunded exposures</b>						
Letters of credit	48,950	17,109	-	-	-	66,059
Letters of guarantee	-	3,889	-	-	-	3,889
Derivative financial assets	-	462	-	-	-	462
<b>Total</b>	<b>523,256</b>	<b>1,030,805</b>	<b>72,576</b>	<b>133,584</b>	<b>127,051</b>	<b>1,887,272</b>



#### 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 European Union Countries. The breakdown of the overall credit exposure by geography before taking into account collaterals held or other credit enhancements was as follows:

	Gulf Co- operation Council countries (G.C.C.) US\$ 000	Middle East and North Africa (excluding G.C.C.) US\$ 000	Europe US\$ 000	Americas US\$ 000	Asia US\$ 000	Others * US\$ 000	Total US\$ 000
Bank demand and call deposits	34,132	5,098	133,071	26,858	356	466	199,981
Placements with banks	99,187	-	117,606	-	1,960	-	218,753
Non-trading investments	3,072	-	24,898	78,858	7,750	-	114,578
Loans and advance	132,619	42,419	571,714	148,708	62,974	231,295	1,189,729
Other assets	76,809	4	8,204	4,810	3,994	-	93,821
Letters of credit	15,674	7,342	5,871	1,831	4,953	30,388	66,059
Letters of guarantee	1,162	2,280	257	-	-	190	3,889
Derivative financial assets	462	-	-	-	-	-	462
Total	363,117	57,143	861,621	261,065	81,987	262,339	1,887,272

\* Others mainly comprise of exposures in Africa (excluding North Africa).



#### 4. CREDIT RISK – PILLAR 3 DISCLOSURES (continued)

##### 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 (i.e. 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	<i>Up to 3 months US\$ 000</i>	<i>3 months to 1 year US\$ 000</i>	<i>1 to 5 years US\$ 000</i>	<i>5 to 10 years US\$ 000</i>	<i>10 to 20 years US\$ 000</i>	<i>Total US\$ 000</i>
Demand and call deposits with banks	199,107	-	874	-	-	199,981
Placements with banks	218,753	-	-	-	-	218,753
Non-trading investments	-	114,578	-	-	-	114,578
Loans and receivables	762,207	280,899	92,138	54,485	-	1,189,729
Other assets	-	93,821	-	-	-	93,821
Letters of credit	28,576	19,621	17,862	-	-	66,059
Letters of guarantee	-	3,889	-	-	-	3,889
Derivative financial assets	-	462	-	-	-	462
<b>Total</b>	<b>1,208,643</b>	<b>513,270</b>	<b>110,874</b>	<b>54,485</b>	<b>-</b>	<b>1,887,272</b>

##### 4.5 Categories of exposure by related parties

The related party exposures including off statement of financial position items are transacted at commercial terms that are mutually agreed between the counterparties.

##### Gross credit exposure by related party breakdown

	<i>Parent US\$ 000</i>	<i>Associates US\$ 000</i>	<i>Other related parties US\$ 000</i>	<i>Total US\$ 000</i>
Demand and call deposits with banks	-	6,139	573	6,712
Placements with banks	-	60,200	15,412	75,612
Non-trading investments	-	8,003	14,941	22,944
Loans and receivables	-	55,309	8,177	63,486
Other assets	1,797	46,383	10,269	58,449



#### 4. CREDIT RISK – PILLAR 3 DISCLOSURES (continued)

##### 4.6 Specific and collective impairment 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:

	<i>Loans</i>	<i>Investments</i>	<i>Other Assets and off- Balance Sheet</i>	<i>Collective impairment provision</i>
	<i>US\$ 000</i>	<i>US\$ 000</i>	<i>US\$ 000</i>	<i>US\$ 000</i>
At beginning of the year	34,079	21,502	157	10,082
Amounts written off		-	-	-
Write backs / cancellation due to improvement	4,325	-	-	3,335
Additional provisions made	7,107	1,700	-	3,890
Exchange adjustment and other movements	84	-	(49)	393
<b>Balance at reporting date</b>	<b>36,945</b>	<b>23,202</b>	<b>108</b>	<b>11,030</b>

An industry-wise movement in specific provisions for losses of loans is as follows:

	At beginning of the year	Write backs	Provisions for the period	Other movements	Closing balance
	<i>US\$ 000</i>	<i>US\$ 000</i>	<i>US\$ 000</i>	<i>US\$ 000</i>	<i>US\$ 000</i>
Trading & manufacturing	17,527	779	5,612	(214)	22,147
Banks & other financial institutions	14,827	3,439	782	323	12,494
Construction & real estate	98	-	16	(1)	112
Others	1,627	107	699	(24)	2,192
	<b>34,079</b>	<b>4,325</b>	<b>7,109</b>	<b>84</b>	<b>36,945</b>



#### 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 30 June 2016, were almost US\$ 20.95 million of restructured loans, comprising 1.76% of the Group's gross loans and advances portfolio. As of 30 June 2016, there were provisions of US\$ 12.74 million against restructured loans.

##### 4.8 Past due and impaired loans

The past due and impaired loans, net as of 30 June 2016 amounted to USD 91.4 million (31 December 2015: USD 46.8 million). A collective provision of USD 11.0 million (31 December 2015: USD 10.1 million) remains against the total loan portfolio.

	Past due or impaired loans US\$ 000	Past due				Collective provision US\$ 000	Specific provision US\$ 000
		90-365 days US\$ 000	1-3 years US\$ 000	3 years or more US\$ 000	Total US\$ 000		
Trading & manufacturing	45,015	23,818	13,751	7,446	45,015	-	22,147
Banks & other financial institutions	36,376	25,219	9,817	1,340	36,376	-	12,494
Construction & real estate	753	-	702	51	753	-	112
Others	9,286	3,820	2,296	3,170	9,286	-	2,192
	91,430	52,857	26,566	12,007	91,430	11,030	36,945

##### Past due and impaired loans for geographical area

	Past due or impaired loans US\$ 000	Past due				Collective provision US\$ 000	Specific provision US\$ 000
		90-365 days US\$ 000	1-3 years US\$ 000	3 years or more US\$ 000	Total US\$ 000		
GCC	30,687	22,746	6,186	1,755	30,687	-	10,843
MENA (excluding GCC)	3,337	2,321	1,016	-	3,337	-	1,202
European Union	19,331	1,874	13,268	4,189	19,331	-	10,964
Others	38,075	25,916	6,095	6,064	38,075	-	13,936
	91,430	52,857	26,565	12,008	91,430	11,030	36,945

Others mainly comprises of past due or impaired exposures in India.



#### **4. CREDIT RISK – PILLAR 3 DISCLOSURES (continued)**

##### **4.9 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.

The following exposures were risk weighted at 800% in arriving at credit risk weighted assets:

	<b>US\$ 000</b>
Exposure to corporates exceeding 15% of Total Capital	1,446
Equity investments exceeding 15% of Total Capital	20,001

##### **4.10 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 recognized 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.

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.



#### 4. CREDIT RISK – PILLAR 3 DISCLOSURES (continued)

##### 4.10 Equity position in banking book (continued)

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	Trading Book US\$ '000	Banking Book US\$ '000	Capital Requirement	
			Trading Book US\$ '000	Banking Book US\$ '000
Debt Securities	<b>11,626</b>	<b>114,578</b>	<b>2,907</b>	<b>14,322</b>
Listed	11,626	114,578	2,907	14,322
Unlisted	-	-	-	-
Equity Securities and Mutual Funds	<b>11,476</b>	<b>621,072</b>	<b>2,869</b>	<b>82,211</b>
Listed	11,476	547,835	2,869	68,479
Unlisted	-	73,237	-	13,732
Managed Funds	-	<b>71,395</b>	-	<b>12,684</b>
Listed	-	11,237	-	1,405
Unlisted	-	60,158	-	11,280
Total Investments in Financial Instruments	<b>23,102</b>	<b>807,045</b>	<b>5,776</b>	<b>109,218</b>
Investment Properties				
Cost		102,148		
Market Value		102,148		
Interest in Consolidated Subsidiaries and Associated Companies		263,008		
				<b>US\$ 000</b>
Cumulative realized gains arising from sale or liquidation during the period				2,295
Unrealised gains recognized in the balance sheet but not through profit or loss				241
Unrealised losses recognized in the balance sheet but not through profit or loss				(1,214)

All unrealized gains and losses are recognized in Common Equity Tier 1 capital of the Group.



#### **4. CREDIT RISK – PILLAR 3 DISCLOSURES (continued)**

##### **4.11 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 comprise of cash margins, charges over real estate properties, inventory, trade receivables, and bank guarantees.

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.

Counterparty credit risk exposure covered by collateral is disclosed in section 3.3.

#### **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 III 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 BALANCE SHEET STATEMENT OF FINANCIAL POSITION EXPOSURE**

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

- 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 statement financial position notional amounts into an equivalent on statement of financial position 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 statement of financial position items is disclosed in Note 9 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 are included in section 8.2.

### 8.2 Disclosure concerning interest rate risk in the banking book

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 30 June 2016.

Currency	<i>Increase in basis points</i>	<i>Sensitivity of net interest income</i>
		US\$ '000
KD	200	(4,244)
USD	200	(7,939)
EUR	200	(873)
GBP	200	47
Others	200	2,086

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 30 June 2016, 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 (Continued)**

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

	<b>Upto 3 months</b>	<b>3 months to 1 year</b>	<b>Over 1 year</b>	<b>Non-interest rate sensitive</b>	<b>Total</b>
	<b>US\$ 000</b>	<b>US\$ 000</b>	<b>US\$ 000</b>	<b>US\$ 000</b>	<b>US\$ 000</b>
<b>Assets</b>					
Bank demand and call deposits	199,107	-	874	-	<b>199,981</b>
Placements with banks	218,753	-	-	-	<b>218,753</b>
Investments, carried at fair value through statement of income	-	-	-	51,950	<b>51,950</b>
Non-trading investments	-	111,506	3,072	231,836	<b>346,414</b>
Investment in associated companies	-	-	-	683,604	<b>683,604</b>
Loans and advance	754,552	273,362	113,543	297	<b>1,141,754</b>
Investment properties	-	-	-	102,148	<b>102,148</b>
Interest receivable and other assets	-	-	-	141,929	<b>141,929</b>
Properties and equipment	-	-	-	39,581	<b>39,581</b>
Goodwill	-	-	-	52,321	<b>52,321</b>
Assets of disposal group classified as held for sale	-	-	-	382	<b>382</b>
<b>Total assets</b>	<b>1,172,412</b>	<b>384,868</b>	<b>117,489</b>	<b>1,304,048</b>	<b>2,978,817</b>
<b>Liabilities:</b>					
Due to banks and other financial institutions	685,037	40,000	-	16	<b>725,053</b>
Deposits from customers	330,153	76,546	51,563	423,798	<b>882,060</b>
Long term loans	328,932	193,454	116,313	11,351	<b>650,050</b>
Sub Debt	-	80,200	43,270	-	<b>123,470</b>
Interest payable and other liabilities	-	-	-	62,069	<b>62,069</b>
Liabilities of disposal group classified as held for sale	-	-	-	219	<b>219</b>
Minority Interest	-	-	-	107,618	<b>107,618</b>
Perpetual Tier 1 facility	-	-	33,000	-	<b>33,000</b>
Shareholders Equity	-	-	-	395,278	<b>395,278</b>
<b>Total liabilities and shareholders' Equity</b>	<b>1,344,122</b>	<b>390,200</b>	<b>244,146</b>	<b>1,000,349</b>	<b>2,978,817</b>
On balance sheet gap	(171,710)	(5,332)	(126,657)	303,699	-
Cumulative gap	(171,710)	(177,042)	(303,699)	-	-
<b>Off balance sheet items</b>					
Interest rate Swaps	50,000	30,000	145,000	-	<b>225,000</b>
Forward foreign exchange contracts	1,120,835	46,839	-	-	<b>1,167,674</b>



## **8. PILLAR 2 RISKS (continued)**

### **8.3 Concentration Risk**

Concentration Risk is captured in UGB's framework using 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 30 June 2016, the exposures that exceeded 15% of the capital base are:

	<b>Current exposure US\$ 000</b>	<b>RWA US\$ 000</b>	<b>Percentage of regulatory capital</b>
Counterparty A	585,134	358,105	170.8%
Counterparty B	84,831	-	24.8%
Counter Party C	83,480	-	24.4%
Counter Party D	67,258	178,411	19.6%
Counter Party E	65,375	30,389	19.1%
Counter Party F	63,901	22,500	18.7%
Counter Party G	55,502	84,363	16.2%
Total	<u>1,005,481</u>	<u>673,767</u>	

## **9. INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS**

ICAAP is requirement of Pillar II norms of Basel III, 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. 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 and the Central Bank of Bahrain directives, nor of the Memorandum and Articles of Association of the Bank have occurred during the period ended 30th June 2016. 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 2016.

In addition, we also confirm to the best of our knowledge and belief, that there are no material pending legal cases outstanding as at 30 June 2016.

## **11. CONCLUSION**

The Risk Management and Capital Adequacy Disclosures focus solely on the Pillar 3 requirements of the Basel III Accord. Further information on the Bank and its salient subsidiaries and associates, is available in the Annual Report and the Corporate Governance Report for the year ended 31 December 2015. Both documents are available in the Financial Section of the Bank’s website [www.ugbbah.com](http://www.ugbbah.com)

\*\*\* END \*\*\*