



Gulf International Bank B.S.C.

CONSOLIDATED FINANCIAL STATEMENTS

For the year ended 31st December 2012

CONSOLIDATED FINANCIAL STATEMENTSFor the year ended 31st December 2012**TABLE OF CONTENTS****Independent auditors' report to the shareholders**

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INDEPENDENT AUDITORS' REPORT TO THE SHAREHOLDERS

7 February 2013

Gulf International Bank B.S.C.

Manama, Kingdom of Bahrain

Report on the consolidated financial statements

We have audited the accompanying consolidated financial statements of Gulf International Bank B.S.C. (the "Bank") and its subsidiaries (together the "Group"), which comprise the consolidated statement of financial position as at 31 December 2012, and the consolidated statements of income, comprehensive income, changes in equity and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Responsibility of the board of directors for the consolidated financial statements

The board of directors of the Bank is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as the board of directors determines is necessary to enable the preparation of the consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Group as at 31 December 2012, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards.

Report on other regulatory requirements

As required by the Bahrain Commercial Companies Law and the Central Bank of Bahrain (CBB) Rule Book (Volume 1), we report that: the Bank has maintained proper accounting records and the consolidated financial statements are in agreement therewith; the financial information contained in the chairman's statement is consistent with the consolidated financial statements; we are not aware of any violations of the Bahrain Commercial Companies Law, the Central Bank of Bahrain and Financial Institutions Law, the CBB Rule Book (Volume 1 and applicable provisions of Volume 6), CBB directives, or the terms of the Bank's memorandum and articles of association having occurred during the year that might have had a material adverse effect on the business of the Bank or on its financial position; and satisfactory explanations and information have been provided to us by the management in response to all our requests.

Consolidated statement of financial position

	<i>Note</i>	<u>At 31.12.12</u> US\$ millions	<u>At 31.12.11</u> US\$ millions
ASSETS			
Cash and other liquid assets	5	1,107.4	858.7
Securities purchased under agreements to resell	6	1,010.8	280.0
Placements	7	4,479.7	5,394.0
Trading securities	8	100.5	83.7
Investment securities	9	3,560.1	3,151.7
Loans and advances	10	7,110.3	6,751.8
Other assets	11	336.0	269.0
Total assets		17,704.8	16,788.9
LIABILITIES			
Deposits from banks	13	2,222.4	1,549.3
Deposits from customers	13	9,471.9	8,520.3
Securities sold under agreements to repurchase	14	597.7	283.3
Other liabilities	15	372.1	305.1
Senior term financing	16	2,432.7	3,690.3
Subordinated term financing	17	477.8	477.8
Total liabilities		15,574.6	14,826.1
EQUITY			
Share capital	18	2,500.0	2,500.0
Reserves	19	328.2	246.0
Retained earnings		(698.0)	(783.2)
Total equity		2,130.2	1,962.8
Total liabilities & equity		17,704.8	16,788.9

The consolidated financial statements were approved by the Board of Directors on 7th February 2013 and signed on its behalf by:-

Jammaz bin Abdullah Al-Suhaimi
Chairman

Abdullah bin Hassan Al-Abdul-Gader
Chairman of Board Audit Committee

Yahya bin Abdullah Alyahya
Chief Executive Officer

The notes on pages 6 to 46 form part of these consolidated financial statements.

Consolidated statement of income

	<i>Note</i>	Year ended 31.12.12 US\$ millions	Year ended 31.12.11 US\$ millions
Interest income	21	289.0	273.9
Interest expense	21	139.6	130.1
Net interest income		149.4	143.8
Fee and commission income	22	56.7	48.5
Foreign exchange income	23	21.3	10.3
Trading income	24	14.3	7.3
Other income	25	13.3	17.0
Total income		255.0	226.9
Staff expenses		91.0	77.7
Premises expenses		10.8	9.9
Other operating expenses		34.3	32.2
Total operating expenses		136.1	119.8
Net income before provisions and tax		118.9	107.1
Provisions for investment securities	9	11.3	(4.8)
Provisions for loans and advances	10	(9.0)	6.7
Net income before tax		121.2	109.0
Taxation charge on overseas activities		(3.3)	(4.5)
Net income		117.9	104.5
<i>Earnings per share</i>	38	<i>US\$0.05</i>	<i>US\$0.04</i>

Jammaz bin Abdullah Al-Suhaimi
Chairman

Abdullah bin Hassan Al-Abdul-Gader
Chairman of Board Audit Committee

Yahya bin Abdullah Alyahya
Chief Executive Officer

The notes on pages 6 to 46 form part of these consolidated financial statements.

Consolidated statement of comprehensive income

	Year ended 31.12.12	Year ended 31.12.11
	US\$ millions	US\$ millions
Net income	117.9	104.5
Other comprehensive income:-		
Cash flow hedges:		
- net changes in fair value	0.4	0.5
- net amount transferred to consolidated statement of income	(2.5)	(3.3)
Investment securities:		
- net changes in fair value of equity investments classified as fair value through other comprehensive income	(11.9)	-
- net changes in fair value of investments classified as available-for-sale	-	(61.3)
- net amount transferred to consolidated statement of income	-	4.4
- realised losses on equity investments classified as fair value through other comprehensive income	(0.1)	-
Total other comprehensive income	(14.1)	(59.7)
Total comprehensive income	103.8	44.8

The notes on pages 6 to 46 form part of these consolidated financial statements.

Consolidated statement of changes in equity

	<i>Note</i>	Share capital US\$ millions	Reserves US\$ millions	Retained earnings US\$ millions	Total US\$ millions
At 1st January 2012		2,500.0	246.0	(783.2)	1,962.8
Transition adjustment on adoption of IFRS 9	2	-	78.4	(14.8)	63.6
At 1st January 2012 - restated		2,500.0	324.4	(798.0)	2,026.4
Net income for the year		-	-	117.9	117.9
Other comprehensive income for the year		-	(14.0)	(0.1)	(14.1)
Total comprehensive income for the year		-	(14.0)	117.8	103.8
Transfer from retained earnings		-	17.8	(17.8)	-
At 31st December 2012		2,500.0	328.2	(698.0)	2,130.2
At 1st January 2011		2,500.0	288.7	(870.7)	1,918.0
Net income for the year		-	-	104.5	104.5
Other comprehensive income for the year		-	(59.7)	-	(59.7)
Total comprehensive income for the year		-	(59.7)	104.5	44.8
Transfer from retained earnings		-	17.0	(17.0)	-
At 31st December 2011		2,500.0	246.0	(783.2)	1,962.8

The notes on pages 6 to 46 form part of these consolidated financial statements.

Consolidated statement of cash flows

	<i>Note</i>	Year ended 31.12.12 US\$ millions	Year ended 31.12.11 US\$ millions
OPERATING ACTIVITIES			
Net income after tax		117.9	104.5
Adjustments to reconcile net income to net cash inflow from operating activities:			
Provisions for investment securities		(11.3)	4.8
Provisions for loans and advances		9.0	(6.7)
Realised profits on debt investment securities		(0.4)	(5.0)
Amortisation of investment securities		21.1	20.7
Net (increase) / decrease in statutory deposits with central banks		(32.2)	15.2
Net increase in securities purchased under agreements to resell		(730.8)	(100.0)
Net decrease / (increase) in placements		914.3	(1,817.7)
Net increase in trading securities		(16.8)	(4.0)
Net (increase) / decrease in loans and advances		(367.5)	765.0
Increase in accrued interest receivable		(10.6)	(8.5)
Increase in accrued interest payable		1.9	8.5
Net decrease / (increase) in other net assets		2.3	(4.6)
Net increase / (decrease) in deposits from banks		673.1	(675.1)
Net increase in deposits from customers		951.6	2,041.1
Net cash inflow from operating activities		1,521.6	338.2
INVESTING ACTIVITIES			
Purchase of investment securities		(1,341.8)	(982.7)
Sale and maturity of investment securities		979.9	836.2
Net cash outflow from investing activities		(361.9)	(146.5)
FINANCING ACTIVITIES			
Net increase / (decrease) in securities sold under agreements to repurchase		314.4	(662.2)
Net (decrease) / increase in senior term financing		(1,257.6)	513.7
Net decrease in subordinated term financing		-	(33.2)
Net cash outflow from financing activities		(943.2)	(181.7)
Increase in cash and cash equivalents		216.5	10.0
Cash and cash equivalents at 1st January		814.2	804.2
Cash and cash equivalents at 31st December	5	1,030.7	814.2

The notes on pages 6 to 46 form part of these consolidated financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS for the year ended 31st December 2012

1. Incorporation and registration

The parent company of the Group (the Group), Gulf International Bank B.S.C. (the Bank), is a Bahraini Shareholding Company incorporated in the Kingdom of Bahrain by Amiri Decree Law No. 30 dated 24th November 1975 and is registered as a conventional wholesale bank with the Central Bank of Bahrain. The registered office of the Bank is located at Al-Dowali Building, 3 Palace Avenue, Manama, Kingdom of Bahrain.

The Group is principally engaged in the provision of wholesale commercial and investment banking services. The Group operates through subsidiaries, branch offices and representative offices located in six countries worldwide. The total number of staff employed by the Group at the end of the financial year was 565.

2. Significant accounting policies

The principal accounting policies adopted in the preparation of the consolidated financial statements are set out below:-

2.1 Basis of preparation

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) and in conformity with the Bahrain Commercial Companies Law and the Central Bank of Bahrain and Financial Institutions Law. The consolidated financial statements have been prepared under the historical cost convention as modified by the revaluation of trading securities, equity investment securities, and derivative financial instruments as explained in more detail in the following accounting policies. Recognised assets and liabilities that are hedged by derivative financial instruments are also stated at fair value in respect of the risk that is being hedged. The accounting policies have been consistently applied by the Bank and its subsidiaries and are consistent with those of the previous year, except for the early adoption of IFRS 9 Financial Instruments: Recognition and Measurement with effect from 1st January 2012 as referred to below.

IFRS 9 Financial Instruments: Recognition and Measurement

The Group has adopted IFRS 9 Financial Instruments: Recognition and Measurement (IFRS 9) in advance of its compulsory effective date. The Group has chosen 1st January 2012 as the date of initial application, i.e. the date on which the Group has assessed the classification and measurement of its existing financial assets and financial liabilities. The Group has voluntarily early adopted this standard, as it is considered to result in the recognition and measurement of financial instruments on a basis that more appropriately reflects the operations and performance of the Group.

The standard has been applied retrospectively and, as permitted by IFRS 9, comparative amounts have not been restated. The impact of the early adoption of IFRS 9 at 1st January 2012 has been recognised in retained earnings and the investment securities revaluation reserve at that date, and eliminates the existing IAS 39 categories of held-to-maturity, available-for-sale and loans and receivables.

IFRS 9 specifies how an entity should classify and measure its financial assets and financial liabilities. IFRS 9 requires all financial assets to be classified in their entirety on the basis of the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial assets. The classification bases are set out in note 2.4.

The Group's existing financial assets at the date of the initial application of IFRS 9 on 1st January 2012 have been reviewed and assessed, and as a result:-

- the Group's investments in debt instruments meeting the required criteria have been classified as financial assets at amortised cost;
- the Group's equity investments not held for trading have been designated as fair value through other comprehensive income (FVTOCI); and
- the Group's remaining investments in equity and debt instruments have been designated as fair value through the profit or loss (FVTPL).

Financial liabilities previously measured at amortised cost under IAS 39 have been classified and measured under IFRS 9 at amortised cost using the effective interest rate method. There have been no changes in the classification and measurement of financial liabilities on the adoption of IFRS 9.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

2. Significant accounting policies (continued)

2.1 Basis of preparation (continued)

The impact of this change in accounting policy as at 1st January 2012 has been to decrease retained earnings by US\$14.8 million, and to increase the investment securities revaluation reserve by US\$78.4 million as follows:-

	Retained earnings	Investment securities revaluation reserve
	US\$ millions	US\$ millions
<u>Due to reclassification of financial assets:</u>		
Financial assets measured at FVTOCI	(14.8)	14.8
Financial assets measured at amortised cost	-	63.6
	(14.8)	78.4

If IFRS 9 had not been adopted, the consolidated statement of income for the year ended 31st December 2012 would have been impacted by a decrease in net income of US\$0.1 million resulting from the recognition of realised losses on equity investments that have been accounted for in retained earnings in accordance with IFRS 9.

Additional disclosures, reflecting the revised classification and measurement of financial assets of the Group as a result of adopting IFRS 9, are shown in notes 9 and 19 to the consolidated financial statements.

The table below illustrates the classification and measurement of financial assets under IAS 39 and IFRS 9 at the date of initial application on 1st January 2012:-

	<u>Original measurement category, IAS 39</u>	<u>New measurement category, IFRS 9</u>	<u>Original carrying amount</u>	<u>New carrying amount</u>
			US\$ millions	US\$ millions
Cash and other liquid assets:				
- Liquid assets	Held-to-maturity	Financial assets at amortised cost	763.9	763.9
- Cash and balances with banks	Loans and receivables	Financial assets at amortised cost	94.8	94.8
Securities purchased under agreements to resell	Held-to-maturity	Financial assets at amortised cost	280.0	280.0
Placements	Held-to-maturity	Financial assets at amortised cost	5,394.0	5,394.0
Trading securities	Held-for-trading	Financial assets at FVTPL	83.7	83.7
Investment securities:				
- Debt securities	Available-for-sale	Financial assets at amortised cost	2,848.8	2,912.4
- Equities	Available-for-sale	Financial assets at FVTOCI	302.9	302.9
Loans and advances	Loans and receivables	Financial assets at amortised cost	6,751.8	6,751.8
Other assets:				
- Interest and other assets	Loans and receivables	Financial assets at amortised cost	154.0	154.0
- Positive fair value of derivatives	Financial assets at FVTPL	Financial assets at FVTPL	81.1	81.1

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS for the year ended 31st December 2012

2. Significant accounting policies (continued)

2.2 Consolidation principles

The consolidated financial statements include the accounts of Gulf International Bank B.S.C. and its subsidiaries. Subsidiary undertakings are companies and other entities, including special purpose entities, in which the Bank holds, directly or indirectly, more than one half of the voting rights, or otherwise has the power to exercise effective control over the financial and operating policies of the entity. All intercompany balances and transactions, including unrealised gains and losses on transactions between Group companies, have been eliminated.

2.3 Foreign currencies

Items included in the consolidated financial statements of the Bank and its principal subsidiaries are measured based on the currency of the primary environment in which the entity operates (the functional currency). The consolidated financial statements are presented in US Dollars, representing the Group's functional and presentation currency. Transactions in foreign currencies are converted to US Dollars at the rate of exchange prevailing at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into US Dollars at market rates of exchange prevailing at the balance sheet date. Realised and unrealised foreign exchange gains and losses are included in trading income.

2.4 Financial assets and liabilities

Financial assets and liabilities comprise all assets and liabilities reflected in the statement of financial position, although excluding investments in subsidiaries, associated companies and joint ventures, employee benefit plans, property and equipment, deferred taxation and taxation payable.

a) Initial recognition and measurement

The Group recognises financial assets and liabilities in the consolidated statement of financial position when, and only when, the Group becomes party to the contractual provisions of the instrument.

Financial instruments are classified at inception into one of the following categories, which then determine the subsequent measurement methodology:-

Financial assets are classified into one of the following three categories:-

- financial assets at amortised cost
- financial assets at fair value through other comprehensive income (FVTOCI)
- financial assets at fair value through the profit or loss (FVTPL)

Financial liabilities are classified into one of the following two categories:-

- financial liabilities at amortised cost
- financial liabilities at fair value through the profit or loss (FVTPL)

Financial assets are initially recognised at fair value, including transaction costs that are directly attributable to the acquisition of the financial asset.

Financial liabilities are initially recognised at fair value, representing the proceeds received net of premiums, discounts and transaction costs that are directly attributable to the financial liability.

All regular way purchases and sales of financial assets and liabilities classified as FVTPL are recognised on the trade date, i.e. the date on which the Group commits to purchase or sell the financial asset or liability. All regular way purchases and sales of other financial assets and liabilities are recognised on the settlement date, i.e. the date on which the asset or liability is received from or delivered to the counterparty. Regular way purchases or sales are purchases or sales of financial assets that require delivery within the time frame generally established by regulation or convention in the market place.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

2. Significant accounting policies (continued)

2.4 Financial assets and liabilities (continued)

b) Subsequent measurement

Subsequent to initial measurement, financial assets and liabilities are measured at either amortised cost or fair value. The classification and the basis for measurement are subject to the Group's business model for managing the financial assets and the contractual cash flow characteristics of the financial assets, as detailed below:-

Financial assets at amortised cost

Financial assets are measured at amortised cost using the effective interest rate method if:

- i) the assets are held within a business model whose objective is to hold assets in order to collect contractual cash flows; and
- ii) the contractual terms of the financial assets give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

If either of these two criteria is not met, the financial assets are classified and measured at fair value, either through the profit or loss (FVTPL) or through other comprehensive income (FVTOCI).

Additionally, even if a financial asset meets the amortised cost criteria, the entity may choose to designate the financial asset at FVTPL. Such an election is irrevocable and applicable only if the FVTPL classification significantly reduces a measurement or recognition inconsistency.

Financial assets at fair value through other comprehensive income (FVTOCI)

At initial recognition, the Group can make an irrevocable election to classify an equity investment that is not held for trading as FVTOCI.

For this purpose, a financial asset is deemed to be held for trading if the equity investment meets any of the following conditions:

- i) it has been acquired principally for the purpose of selling in the near term;
- ii) on initial recognition, it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short term profitability; or
- iii) it is a derivative and not designated and effective as a hedging instrument or a financial guarantee.

The irrevocable election is on an instrument-by-instrument basis. If an equity investment is designated as FVTOCI, all gains and losses, except for dividend income, are recognised in other comprehensive income and are not subsequently included in the consolidated statement of income.

Financial assets at fair value through the profit or loss (FVTPL)

Financial assets not otherwise classified above are classified as FVTPL.

Financial liabilities at amortised cost

All financial liabilities, other than those classified as financial liabilities at FVTPL, are classified as financial liabilities at amortised cost and are measured at amortised cost using the effective interest rate method as described in note 2.7(a).

Financial liabilities at fair value through the profit or loss

Financial liabilities not otherwise classified above are classified as financial liabilities at FVTPL. This classification includes derivatives that are liabilities measured at fair value.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS for the year ended 31st December 2012

2. Significant accounting policies (continued)

2.4 Financial assets and liabilities (continued)

c) Derecognition of financial assets and liabilities

Financial assets are derecognised and removed from the consolidated statement of financial position when the right to receive cash flows from the assets has expired; the Group has transferred its contractual right to receive the cash flows from the assets, and substantially all the risks and rewards of ownership; or where control is not retained. Financial liabilities are derecognised and removed from the consolidated statement of financial position when the obligation is discharged, cancelled, or expires.

2.5 Impairment of financial assets

Only financial assets that are measured at amortised cost are tested for impairment. A provision for impairment is established where there is objective evidence that the Group will not collect all amounts due, including both principal and interest, in accordance with the contractual terms of the credit facility. Objective evidence that a financial asset is impaired may include a breach of contract, such as default or delinquency in interest or principal payments, the granting of a concession that, for economic or legal reasons relating to the borrower's financial difficulties, would not otherwise be considered, indications that it is probable that the borrower will enter bankruptcy or other financial reorganisation, the disappearance of an active market, or other observable data relating to a group of assets such as adverse changes in the payment status of borrowers or issuers in the group, or economic conditions that correlate with defaults in the group.

Provisions for impairment are determined based on the difference between the net carrying amount and the recoverable amount of the financial asset. The recoverable amount is measured as the present value of expected future cash flows, including amounts recoverable from guarantees and collateral, discounted based on the interest rate at the inception of the credit facility or, for debt instruments, at the current market rate of interest for a similar financial asset.

Provisions for impairment are also measured and recognised on a collective basis in respect of impairments that exist at the balance sheet date but which will only be individually identified in the future. Future cash flows for financial assets that are collectively assessed for impairment are estimated based on contractual cash flows and historical loss experiences for assets with similar credit risk characteristics. Historical loss experience is adjusted, based on current observable data, to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based.

Provisions for impairment are recognised in the consolidated statement of income and are reflected in an allowance account against loans and advances and investment securities.

Financial assets are written off after all restructuring and collection activities have taken place and the possibility of further recovery is considered to be remote. Subsequent recoveries are included in other income.

Provisions for impairment are released and transferred to the consolidated statement of income where a subsequent increase in the recoverable amount is related objectively to an event occurring after the provision for impairment was established.

Financial assets which have been renegotiated are no longer considered to be past due and are replaced on performing status when all principal and interest payments are up to date and future payments are reasonably assured. Financial assets subject to individual impairment assessment and whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired or should be considered past due.

2.6 Offsetting financial assets and liabilities

Financial assets and financial liabilities are only offset and the net amount reported in the consolidated statement of financial position when there is a legally enforceable right to set off the recognised amounts and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously.

2.7 Revenue recognition

a) Interest income and interest expense

Interest income and interest expense for all interest-bearing financial assets and liabilities except those classified as FVTPL are recognised using the effective interest rate method. The effective interest rate method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense over the expected life of the asset or liability. The effective interest rate is the rate that exactly discounts estimated future cash flows through the expected life of the financial asset or liability or, where appropriate, a shorter period, to the net carrying amount of the financial asset or liability. The application of the effective interest rate method has the effect of recognising interest income and interest expense evenly in proportion to the amount outstanding over the period to maturity or repayment. In calculating the effective interest rate, cash flows are estimated taking into consideration all contractual terms of the financial asset or liability but excluding future credit losses. Fees, including loan origination fees and early redemption fees, are included in the calculation of the effective interest rate to the extent that they are considered to be an integral part of the effective interest rate.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

2. Significant accounting policies (continued)

2.7 Revenue recognition (continued)

a) Interest income and interest expense (continued)

Interest income is suspended when either interest or principal on a credit facility is overdue by more than 90 days whereupon all unpaid and accrued interest is reversed from income. Interest on non-accrual facilities is included in income only when received. Credit facilities are restored to accrual status only after all delinquent interest and principal payments have been brought current and future payments are reasonably assured.

b) Fees and commissions

Fees and commissions that are integral to the effective interest rate of a financial asset or liability are included in the calculation of the effective interest rate.

Other fees and commissions are recognised as the related services are performed or received, and are included in fee and commission income.

c) Trading income

Trading income arises from earnings generated from customer business and market making, and from changes in fair value resulting from movements in interest and exchange rates, equity prices and other market variables. Changes in fair value and gains and losses arising on the purchase and sale of trading instruments are included in trading income, together with the related interest income, interest expense and dividend income.

d) Dividend income

Dividend income is recognised as follows:-

- dividends from equity instruments classified as FVTPL are recognised when the right to receive the dividend is established and are included in trading income.
- dividends from equity instruments classified as FVTOCI are recognised when the right to receive the dividend is established and are included in other income.

2.8 Securities financing arrangements

Securities purchased under agreements to resell (reverse repurchase agreements) and securities sold under agreements to repurchase (repurchase agreements) are treated as collateralised lending and borrowing transactions and are recorded in the consolidated statement of financial position at the amounts the securities were initially acquired or sold. Interest earned on reverse repurchase agreements and interest incurred on repurchase agreements are included in interest income and interest expense respectively.

2.9 Premises and equipment

Land is stated at cost. Other premises and equipment are stated at cost less accumulated depreciation. The residual values and useful lives of premises and equipment are reviewed at each balance sheet date, and adjusted where appropriate. Where the carrying amount of premises or equipment is greater than the estimated recoverable amount, the carrying amount is reduced to the recoverable amount.

Generally, costs associated with the maintenance of existing computer software are recognised as an expense when incurred. However, expenditure that enhances and extends the benefits of computer software programs beyond their original specifications and lives is recognised as a capital improvement and capitalised as part of the original cost of the software.

2.10 Other provisions

Other provisions are recognised when the Group has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

2. Significant accounting policies (continued)

2.11 Derivative financial instruments and hedge accounting

Derivative financial instruments are contracts, the value of which is derived from one or more underlying financial instruments or indices, and include futures, forwards, swaps and options in the interest rate, foreign exchange, equity and credit markets.

Derivative financial instruments are recognised in the consolidated statement of financial position at fair value. Fair values are derived from prevailing market prices, discounted cash flow models or option pricing models as appropriate. In the consolidated statement of financial position, derivative financial instruments with positive fair values (unrealised gains) are included in other assets and derivative financial instruments with negative fair values (unrealised losses) are included in other liabilities.

The changes in the fair values of derivative financial instruments entered into for trading purposes or to hedge other trading positions are included in trading income.

The recognition of changes in the fair values of derivative financial instruments entered into for hedging purposes is determined by the nature of the hedging relationship. For the purposes of hedge accounting, derivative financial instruments are designated as a hedge of either: (i) the fair value of a recognised asset or liability (fair value hedge), or (ii) the future cash flows attributable to a recognised asset or liability or a firm commitment (cash flow hedge).

The Group's criteria for a derivative financial instrument to be accounted for as a hedge include:-

- the hedging instrument, the related hedged item, the nature of the risk being hedged, and the risk management objective and strategy must be formally documented at the inception of the hedge,
- it must be clearly demonstrated that the hedge is expected to be highly effective in offsetting the changes in fair values or cash flows attributable to the hedged risk in the hedged item,
- the effectiveness of the hedge must be capable of being reliably measured, and
- the hedge must be assessed on an ongoing basis and determined to have actually been highly effective throughout the financial reporting period.

Changes in the fair values of derivative financial instruments that are designated, and qualify, as fair value hedges and that prove to be highly effective in relation to the hedged risk, are included in trading income together with the corresponding change in the fair value of the hedged asset or liability that is attributable to the risk that is being hedged. Unrealised gains and losses arising on hedged assets or liabilities which are attributable to the hedged risk are adjusted against the carrying amounts of the hedged assets or liabilities in the consolidated statement of financial position. If the hedge no longer meets the criteria for hedge accounting, any adjustment to the carrying amount of a hedged interest-bearing financial instrument is amortised to income over the remaining period to maturity.

Changes in the fair values of derivative financial instruments that are designated, and qualify, as cash flow hedges and that prove to be highly effective in relation to the hedged risk, are recognised in other comprehensive income. Unrealised gains or losses recognised in other comprehensive income are transferred to the consolidated statement of income at the same time that the income or expense of the corresponding hedged item is recognised in the consolidated statement of income and are included in the same income or expense category as the hedged item. Unrealised gains or losses on any ineffective portion of cash flow hedging transactions are included in trading income.

The interest component of derivatives that are designated, and qualify, as fair value or cash flow hedges is included in interest income or interest expense relating to the hedged item over the life of the derivative instrument.

Hedge accounting is discontinued when the derivative hedging instrument either expires or is sold, terminated or exercised, or no longer qualifies for hedge accounting. Gains and losses arising on the termination of derivatives designated as cash flow hedges are recognised in interest income or interest expense over the original tenor of the terminated hedge transaction.

Some hybrid instruments contain both a derivative and non-derivative component. In such cases, the derivative is categorised as an embedded derivative. If the host contract is accounted for under IFRS 9 then the hybrid financial instrument is holistically assessed as to whether it should be measured at amortised cost or as fair value. If the host contract is not accounted for under IFRS 9 and the economic characteristics and risks of the embedded derivative are not closely related to those of the host contract, and the overall contract itself is not carried at fair value, the embedded derivative is bifurcated and measured at fair value. If it is not practically possible to bifurcate the embedded derivative, the entire hybrid instrument is categorised as a financial asset at FVTPL and measured at fair value. Changes in fair value are included in trading income.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS for the year ended 31st December 2012

2. Significant accounting policies (continued)

2.12 Financial guarantees

Financial guarantees are contracts that require the Group to make specified payments to reimburse the holder for a loss it incurs because a specific debtor fails to make payment when due in accordance with the terms of a debt instrument. Financial guarantees are issued to financial institutions and other counterparties on behalf of customers to secure loans, overdrafts and other banking facilities, and to other parties in relation to the performance of customers under obligations related to contracts, advance payments made by other parties, tenders and retentions.

Financial guarantees are initially recognised at fair value on the date the guarantee is issued. The guarantee liability is subsequently measured at the higher of the initial measurement, less amortisation to recognise the fee income earned over the period, or the present value of any expected financial obligation arising as a result of an anticipated non-recoverable payment under a guarantee. Any increase in a liability relating to guarantees is recognised in the consolidated statement of income. In the consolidated statement of financial position, financial guarantees are included in other liabilities.

2.13 Post retirement benefits

The majority of the Group's employees are eligible for post retirement benefits under either defined benefit or defined contribution pension plans which are provided through separate trustee-administered funds or insurance plans. The Group also pays contributions to Government defined contribution pension plans in accordance with the legal requirements in each location.

The Group's contributions to defined contribution pension plans are expensed in the year to which they relate.

The pension costs for defined benefit pension plans are assessed using the projected unit credit method. The cost of providing pensions is charged to income so as to spread the regular cost of pensions over the service lives of the employees, in accordance with the advice of an independent qualified actuary who conducts a full valuation of the plan every three years. The pension obligation is measured as the present value of the estimated future cash flows using interest rates of government securities which have terms to maturity approximating the terms of the related liability.

Actuarial gains and losses are recognised in income when the net cumulative unrecognised actuarial gain or loss at the end of the previous financial year exceeds 10 per cent of the higher of: (i) the fair value of the plan assets, or (ii) the present value of the fund obligations. That portion of the net cumulative unrecognised actuarial gain or loss is recognised in income over the expected average remaining working lives of the employees participating in the plan. Otherwise, the actuarial gain or loss is not recognised.

2.14 Taxation

a) Current tax

Current taxation is the expected tax payable on the taxable income for the year, using tax rates enacted at the balance sheet date, and includes any adjustments to tax payable in respect of previous years.

b) Deferred tax

Deferred tax is provided, using the liability method, for temporary differences arising between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. A deferred tax asset is recognised only to the extent that it is probable that future taxable income will be available against which the unutilised tax losses and credits can be utilised. Currently enacted tax rates are used to determine deferred taxes.

2.15 Cash and cash equivalents

In the consolidated statement of cash flows, cash and cash equivalents comprise cash and other liquid assets, excluding statutory deposits with central banks.

2.16 Segment reporting

An operating segment is a distinguishable component of the Group that is engaged in business activities from which revenues are earned and expenses are incurred, including revenues and expenses that relate to transactions with any of the Group's other operating segments. All segments have discrete financial information which is regularly reviewed by the Group's Management Committee, being the Group's chief operating decision maker, to make decisions about resources allocated to the segment and to assess its performance.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS for the year ended 31st December 2012

2. Significant accounting policies (continued)

2.17 Fiduciary activities

The Group administers and manages assets owned by clients which are not reflected in the consolidated financial statements. Asset management fees are earned for providing investment management services and for managing mutual fund products. Asset administration fees are earned for providing custodial services. Fees are recognised as the services are provided and are included in fee and commission income.

2.18 Dividends

Dividends on issued shares are recognised as a liability and deducted from equity when they are approved by the Bank's shareholders.

2.19 Comparatives

Where necessary, comparative figures have been adjusted to conform with changes in presentation in the current year.

2.20 Future accounting developments

The International Accounting Standards Board (IASB) have issued a number of new standards, amendments to standards, and interpretations that are not yet effective and have not been applied in the preparation of the consolidated financial statements for the year ended 31st December 2012. The relevant new standards, amendments to standards, and interpretations, are as follows:-

- IAS 19 - Employee Benefits (revised). The amendments to the existing standard are effective for financial years beginning on or after 1st January 2013. The standard amends the methodology for recognising actuarial gains and losses, the current corridor method will be eliminated and all actuarial gains and losses will be immediately recognised in other comprehensive income. The revised standard also amends the calculation methodology for the reported expected returns. The Group is currently evaluating the potential effect of this revision.
- IFRS 10 - Consolidated Financial Statements. The new standard is effective for financial years beginning on or after 1st January 2013. The standard supersedes SIC 12 and elements of IAS 27 and introduces a new approach to determine which investees should be consolidated as part of the Group. The Group is currently evaluating the potential effect of this new standard and the minor revisions to the remaining elements of IAS 27 - Separate Financial Statements (2012).
- IFRS 12 - Disclosure of Interests in Other Entities. The new standard is effective for financial years beginning on or after 1st January 2013. The new standard contains the disclosure requirements for organisations that have interests in subsidiaries, associates or other unconsolidated entities. The Group is currently evaluating the potential impact on presentation that this standard could require.
- IFRS 13 - Fair Value Measurement. The new standard is effective for financial years beginning on or after 1st January 2013. The new standard provides a single source of fair value measurement guidance. The standard does not introduce new measurement requirements but does provide new techniques on how to measure fair value and the related disclosures. The adoption of this standard is not expected to have any material impact on the consolidated financial statements.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012****3. Accounting estimates and assumptions**

The preparation of the consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of certain financial assets, liabilities, income and expenses.

The use of estimates and assumptions is principally limited to the determination of provisions for impairment, the valuation of financial instruments, and the valuation of the Group's defined benefit pension plan as explained in more detail below:-

Provisions for impairment

Financial assets are evaluated for impairment on the basis set out in note 2.5.

In determining provisions for impairment, judgement is required in the estimation of the amount and timing of future cash flows.

In addition to provisions for impairment against specific assets, the Group also maintains provisions that are measured and recognised on a collective basis. Key assumptions included in the measurement of the portfolio provisions include data on the probability of default and the eventual recovery amount in the event of a forced sale or write off. These assumptions are based on observed historical data and updated as considered appropriate to reflect current conditions. The accuracy of the portfolio provisions would therefore be affected by unexpected changes in these assumptions.

Fair value of financial assets and liabilities

Where the fair value of financial assets and liabilities cannot be derived from active markets, they are determined using a variety of valuation techniques that include the use of mathematical models. The input to these models is derived from observable markets where available, but where this is not feasible, a degree of judgement is required in determining assumptions used in the models. Changes in assumptions used in the models could affect the reported fair value of financial assets and liabilities.

Retirement benefit obligations

Management, in coordination with an independent qualified actuary, are required to make assumptions regarding the defined benefit pension plan, changes in which could affect the reported liability, service cost and expected return on pension plan assets. The principal actuarial assumptions for the defined benefit pension plan are set out in note 12 and include assumptions on the discount rate, expected return on pension plan assets, mortality, future salary increases, and inflation. Changes in the assumptions could affect the reported asset, service cost and expected return on pension plan assets.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

4. Classification of assets and liabilities

The classification of assets and liabilities by accounting categorisation was as follows:-

	Financial assets at amortised cost	Financial assets at FVTPL	Financial assets at FVTOCI	Financial liabilities at amortised cost	Non- financial assets & liabilities	Total
	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions
At 31st December 2012						
Cash and other liquid assets	1,107.4	-	-	-	-	1,107.4
Securities purchased under agreements to resell	1,010.8	-	-	-	-	1,010.8
Placements	4,479.7	-	-	-	-	4,479.7
Trading securities	-	100.5	-	-	-	100.5
Investment securities	3,269.9	-	290.2	-	-	3,560.1
Loans and advances	7,110.3	-	-	-	-	7,110.3
Other assets	181.9	122.9	-	-	31.2	336.0
Total assets	17,160.0	223.4	290.2	-	31.2	17,704.8
Deposits from banks	-	-	-	2,222.4	-	2,222.4
Deposits from customers	-	-	-	9,471.9	-	9,471.9
Securities sold under agreements to repurchase	-	-	-	597.7	-	597.7
Other liabilities	-	181.4	-	121.7	69.0	372.1
Senior term financing	-	-	-	2,432.7	-	2,432.7
Subordinated term financing	-	-	-	477.8	-	477.8
Equity	-	-	-	-	2,130.2	2,130.2
Total liabilities & equity	-	181.4	-	15,324.2	2,199.2	17,704.8

	Held-to- maturity	Loans and receivables	Held-for- trading	Available- for-sale	Financial liabilities at amortised cost	Non- financial assets & liabilities	Total
	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions
At 31st December 2011							
Cash and other liquid assets	763.9	94.8	-	-	-	-	858.7
Securities purchased under agreements to resell	280.0	-	-	-	-	-	280.0
Placements	5,394.0	-	-	-	-	-	5,394.0
Trading securities	-	-	83.7	-	-	-	83.7
Investment securities	-	-	-	3,151.7	-	-	3,151.7
Loans and advances	-	6,751.8	-	-	-	-	6,751.8
Other assets	-	154.0	81.1	-	-	33.9	269.0
Total assets	6,437.9	7,000.6	164.8	3,151.7	-	33.9	16,788.9
Deposits from banks	-	-	-	-	1,549.3	-	1,549.3
Deposits from customers	-	-	-	-	8,520.3	-	8,520.3
Securities sold under agreements to repurchase	-	-	-	-	283.3	-	283.3
Other liabilities	-	-	112.5	-	122.9	69.7	305.1
Senior term financing	-	-	-	-	3,690.3	-	3,690.3
Subordinated term financing	-	-	-	-	477.8	-	477.8
Equity	-	-	-	-	-	1,962.8	1,962.8
Total liabilities & equity	-	-	112.5	-	14,521.0	2,155.4	16,788.9

The financial assets at FVTPL (2011: held-for-trading) include the fair values of derivatives designated as fair value and cash flow hedges.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

5. Cash and other liquid assets

	<u>31.12.12</u>	<u>31.12.11</u>
	US\$ millions	US\$ millions
Cash and balances with banks	502.3	50.3
Certificates of deposit	301.9	604.3
Government bills	<u>226.5</u>	<u>159.6</u>
Cash and cash equivalents	1,030.7	814.2
Statutory deposits with central banks	<u>76.7</u>	<u>44.5</u>
Cash and other liquid assets	<u>1,107.4</u>	<u>858.7</u>

6. Securities purchased under agreements to resell

The Group enters into collateralised lending transactions (reverse repurchase agreements) in the ordinary course of its operating activities. The collateral is in the form of highly rated debt securities. The collateralised lending transactions are conducted under standardised terms that are usual and customary for such transactions.

7. Placements

Placements at 31st December 2012 included placements with central banks amounting to US\$318.4 million (2011: US\$1,008.8 million). The placements with central banks represented the placement of surplus liquid funds.

8. Trading securities

	<u>31.12.12</u>	<u>31.12.11</u>
	US\$ millions	US\$ millions
Debt securities	61.7	56.9
Managed funds	<u>38.8</u>	<u>26.8</u>
	<u>100.5</u>	<u>83.7</u>

Debt securities comprise investments in debt securities issued by emerging market governments, quasi-government entities, and government-owned entities.

Managed funds comprise funds placed for investment with specialist managers.

9. Investment securities

a) Composition

The credit rating profile of investment securities, based on the lowest rating assigned by the major international rating agencies, was as follows:-

	<u>31.12.12</u>		<u>31.12.11</u>	
	US\$ millions	%	US\$ millions	%
AAA to A- / Aaa to A3	2,901.3	88.7	2,610.1	91.6
BBB+ to BBB- / Baa1 to Baa3	349.3	10.7	163.6	5.8
Other debt securities	19.3	0.6	75.1	2.6
Total debt securities	<u>3,269.9</u>	<u>100.0</u>	<u>2,848.8</u>	<u>100.0</u>
Equity investments	<u>290.2</u>		<u>302.9</u>	
	<u>3,560.1</u>		<u>3,151.7</u>	

Investment securities principally comprise investment-grade rated debt securities issued by major international financial institutions and government-related entities. The Group did not have any direct exposure to troubled European government debt impacted by the eurozone crisis at either 31st December 2012 or 31st December 2011.

At 31st December 2012, 88.7 per cent of debt securities were rated A- / A3 or above (2011: 91.6 per cent).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

9. Investment securities (continued)

b) Classification

Investment securities were classified in accordance with IFRS 9 (2011: in accordance with IAS 39) as follows:-

	<u>31.12.12</u> US\$ millions	<u>31.12.11</u> US\$ millions
Debt securities:		
- At amortised cost	3,269.9	-
- Available-for-sale	-	2,848.8
Equity investments:		
- At FVTOCI	290.2	-
- Available-for-sale	-	302.9
	<u>3,560.1</u>	<u>3,151.7</u>

As referred to in note 2, the Group adopted IFRS 9 at 1st January 2012. This resulted in a change in the Group's accounting policy for the classification and measurement of financial assets. This change in accounting policy has been applied retrospectively and, as permitted by IFRS 9, comparative amounts have not been restated.

At 31st December 2012, the fair value of debt securities classified under IFRS 9 as financial assets at amortised cost was US\$3,305.0 million. If IFRS 9 had not been adopted in 2012, a net fair value gain of US\$98.7 million would have been recorded in the consolidated statement of comprehensive income for the year ended 31st December 2012. Other income characteristics of the debt securities remain unchanged.

c) Provisions for impairment

The movements in the provisions for the impairment of investment securities were as follows:-

	<u>2012</u> US\$ millions	<u>2011</u> US\$ millions
At 1 st January	71.9	67.8
Transition adjustment on adoption of IFRS 9	(52.9)	-
At 1 st January - restated	19.0	67.8
Exchange rate movements	-	(0.1)
Amounts utilised	-	(0.6)
(Release) / Charge for the year	(11.3)	4.8
At 31 st December	<u>7.7</u>	<u>71.9</u>

On the adoption of IFRS 9 at 1st January 2012, all specific provisions against equity investments were applied against the original cost of the investments. At 31st December 2012, the provisions for the impairment of investment securities entirely comprised non-specific provisions for debt investment securities determined on a collective basis.

d) Impaired securities

Impaired securities represent securities for which there is objective evidence that the Group will not collect all amounts due, including both principal and interest, in accordance with the contractual terms of the security.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

9. Investment securities (continued)

d) Impaired securities (continued)

Impaired investment securities and the related specific provisions for impairment were as follows:-

	<u>Gross</u>	<u>Impairment</u>	<u>31.12.12</u>	<u>Gross</u>	<u>Impairment</u>	<u>31.12.11</u>
	<u>US\$ millions</u>	<u>provisions</u>	<u>Carrying</u>	<u>US\$ millions</u>	<u>provisions</u>	<u>Carrying</u>
	<u>US\$ millions</u>	<u>US\$ millions</u>	<u>amount</u>	<u>US\$ millions</u>	<u>US\$ millions</u>	<u>amount</u>
Equity investments	-	-	-	74.5	58.2	16.3
Non-specific / portfolio provisions		7.7			13.7	
Total provisions for impairment		7.7			71.9	

There were no past due debt securities at 31st December 2012 or 31st December 2011.

10. Loans and advances

	<u>31.12.12</u>	<u>31.12.11</u>
	<u>US\$ millions</u>	<u>US\$ millions</u>
Gross loans and advances	7,736.0	7,371.0
Provisions for impairment	(625.7)	(619.2)
Net loans and advances	7,110.3	6,751.8

a) Industrial classification

The classification of loans and advances by industry was as follows:-

	<u>31.12.12</u>	<u>31.12.11</u>
	<u>US\$ millions</u>	<u>US\$ millions</u>
Energy, oil and petrochemical	2,339.3	2,791.6
Financial	1,424.9	1,277.5
Trading and services	1,348.4	1,002.5
Transportation	885.5	782.5
Manufacturing	649.5	546.3
Construction	466.5	308.5
Communication	301.3	329.1
Real estate	143.8	191.5
Government	5.0	21.7
Other	171.8	119.8
	7,736.0	7,371.0
Provisions for impairment	(625.7)	(619.2)
	7,110.3	6,751.8

The classification of loans and advances by industry reflects the Group's historical strategic focus on project and structured finance in the Gulf Cooperation Council (GCC) states.

Gross loans at 31st December 2012 included Shariah-compliant transactions amounting to US\$1,865.0 million (2011: US\$1,011.9 million).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

10. Loans and advances (continued)

b) Provisions for impairment

The movements in the provisions for the impairment of loans and advances were as follows:-

	<u>2012</u>			<u>2011</u>		
	<u>Specific</u>	<u>Non-specific</u>	<u>Total</u>	<u>Specific</u>	<u>Non-specific</u>	<u>Total</u>
	<u>US\$ millions</u>	<u>US\$ millions</u>	<u>US\$ millions</u>	<u>US\$ millions</u>	<u>US\$ millions</u>	<u>US\$ millions</u>
At 1 st January	409.2	210.0	619.2	397.3	245.0	642.3
Exchange rate movements	0.2	-	0.2	(0.1)	-	(0.1)
Amounts utilised	(2.7)	-	(2.7)	(16.3)	-	(16.3)
Amounts reallocated	21.0	(21.0)	-	35.0	(35.0)	-
Charge / (Release) for the year	9.0	-	9.0	(6.7)	-	(6.7)
At 31 st December	436.7	189.0	625.7	409.2	210.0	619.2

The level of non-specific loan provisions reflect the application of stressed probabilities of default in the calculation of provisions for impairment measured on a collective basis. Stressed probabilities of default are anticipated to result from the impact of the global recession on the regional economic environment. The probabilities of default applied in the calculation of the collective provisions of impairment equate to a speculative-grade mean default rate of 13.9 per cent, exceeding the previous historical high corporate default levels witnessed in July 1991.

Non-specific provisions at 31st December 2012 represented 2.7% of non-specifically provisioned loans (2011: 3.1%).

The gross amount of specifically provisioned loans at 31st December 2012 was US\$718.9 million (2011: US\$686.0 million). Total specific provisions at 31st December 2012 represented 60.7 per cent of loans against which a specific provision had been made (2011: 59.7 per cent).

Amounts utilised during the years ended 31st December 2012 and 31st December 2011 represented provisions utilised on the settlement or sale of the related loans. No incremental losses arose on the settlement or sale of the loans.

Provision releases during the years ended 31st December 2012 and 31st December 2011 arose on the repayment of the related loans.

c) Past due loans

The gross and carrying amounts of loans for which either principal or interest was over 90 days past due were as follows:-

	<u>31.12.12</u>		<u>31.12.11</u>	
	<u>Gross</u>	<u>Carrying amount</u>	<u>Gross</u>	<u>Carrying amount</u>
	<u>US\$ millions</u>	<u>US\$ millions</u>	<u>US\$ millions</u>	<u>US\$ millions</u>
Corporates	293.7	127.5	382.4	240.5
Financial institutions	169.2	32.3	200.1	61.3
	462.9	159.8	582.5	301.8

Corporates include loans extended for investment purposes.

The overdue status of gross past due loans based on original contractual maturities was as follows:-

	<u>31.12.12</u>		<u>31.12.11</u>	
	<u>Past due but not impaired</u>	<u>Past due and impaired</u>	<u>Past due but not impaired</u>	<u>Past due and impaired</u>
	<u>US\$ millions</u>	<u>US\$ millions</u>	<u>US\$ millions</u>	<u>US\$ millions</u>
Less than 1 year	17.3	-	146.7	67.2
Years 2 to 5	100.3	345.3	86.8	281.8
	117.6	345.3	233.5	349.0

At 31st December 2012 interest-in-suspense on past due loans amounted to US\$98.3 million (2011: US\$79.1 million).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

10. Loans and advances (continued)

d) Restructured loans

There were no restructured loans during the year ended 31st December 2012. During the year ended 31st December 2011, the Group restructured two loans amounting to US\$100.2 million due to a deterioration in the borrowers' financial position and where the Group made concessions that it would not have otherwise considered. In addition, during the years ended 31st December 2012 and 31st December 2011 a number of other loans were restructured on improved terms.

e) Collateral

During the years ended 31st December 2012 and 31st December 2011, no collateral was used by the Group. During the year ended 31st December 2010, the Group took possession of listed equities received in settlement of a secured past due loan. The equities are classified as investment securities. At 31st December 2012, the carrying amount of the equities was US\$143.4 million (2011: US\$148.6 million).

11. Other assets

	<u>31.12.12</u>	<u>31.12.11</u>
	US\$ millions	US\$ millions
Derivative financial instruments	122.9	81.1
Accrued interest, fees and commissions	96.2	85.6
Premises and equipment	31.2	33.9
Prepaid pension cost	19.2	17.9
Prepayments	16.3	8.9
Deferred items	3.1	3.1
Other, including accounts receivable	47.1	38.5
	<u>336.0</u>	<u>269.0</u>

Derivative financial instruments represent the positive fair values of derivative financial instruments entered into for trading purposes, or designated as fair value or cash flow hedges. An analysis of the fair value of derivative financial instruments is set out in note 31(d).

An analysis of the prepaid pension cost is set out in note 12.

12. Post retirement benefits

The Group contributes to defined benefit and defined contribution pension plans which cover substantially all of its employees.

The Bank maintains defined contribution pension plans for the majority of its employees. Contributions are based on a percentage of salary. The amounts to be paid as retirement benefits are determined by reference to the amounts of the contributions and investment earnings thereon. The total cost of contributions to defined contribution pension plans for the year ended 31st December 2012 amounted to US\$5.7 million (2011: US\$4.8 million).

The Bank's principal subsidiary, Gulf International Bank (UK) Limited (GIBUK), maintains a defined benefit pension plan for a number of its employees. The assets of the plan are held independently of the subsidiary's assets in a separate trustee administered fund. The pension costs are charged to income so as to spread the regular cost of the pensions over the service lives of the employees, in accordance with the advice of an independent qualified actuary who conducts a full valuation of the plan every three years using the projected unit credit method. In the intervening years the calculation is updated based on information received from the actuary. The latest full actuarial valuation was carried out at 1st January 2010.

a) The amount recognised in the consolidated statement of financial position is analysed as follows:-

	<u>31.12.12</u>	<u>31.12.11</u>
	US\$ millions	US\$ millions
Fair value of plan assets	176.8	157.1
Present value of fund obligations	180.1	151.5
Plan (deficit) / surplus	<u>(3.3)</u>	5.6
Unrecognised actuarial loss	22.5	12.3
Net asset in the consolidated statement of financial position	<u>19.2</u>	<u>17.9</u>

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

12. Post retirement benefits (continued)

b) The movements in the fair value of plan assets were as follows:-

	<u>2012</u>	<u>2011</u>
	US\$ millions	US\$ millions
At 1 st January	157.1	148.0
Expected return on plan assets	8.3	9.5
Contributions paid by the Group	1.5	1.6
Benefits paid by the plan	(3.2)	(5.4)
Actuarial gains	5.5	4.0
Exchange rate movements	7.6	(0.6)
At 31 st December	<u>176.8</u>	<u>157.1</u>

The plan assets at 31st December 2012 comprise equity and debt securities in the ratio of 22 per cent and 78 per cent respectively (2011: 26 per cent and 74 per cent respectively). Cash holdings within the plan assets are included in debt securities.

The expected and actual returns on the plan assets for the year ended 31st December 2012 were US\$8.3 million and US\$13.7 million respectively (2011: US\$9.5 million and US\$13.5 million respectively). The overall expected rate of return on the plan assets is determined based on market prices, applicable to the period over which the obligation is to be settled. The expected return is determined separately for equity and debt securities.

c) The movements in the present value of fund obligations were as follows:-

	<u>2012</u>	<u>2011</u>
	US\$ millions	US\$ millions
At 1 st January	151.5	152.5
Current service cost	0.9	0.8
Interest cost	7.8	8.8
Actuarial losses / (gains)	15.4	(4.6)
Benefits paid by the plan	(3.2)	(5.4)
Exchange rate movements	7.7	(0.6)
At 31 st December	<u>180.1</u>	<u>151.5</u>

d) The movements in the net asset recognised in the consolidated statement of financial position were as follows:-

	<u>2012</u>	<u>2011</u>
	US\$ millions	US\$ millions
At 1 st January	17.9	16.5
Net expense included in staff expenses	(0.4)	(0.1)
Contributions paid by the Group	1.5	1.6
Exchange rate movements	0.2	(0.1)
At 31 st December	<u>19.2</u>	<u>17.9</u>

The Group paid US\$1.5 million in contributions to the plan during 2012 and expects to pay US\$1.5 million during 2013.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

12. Post retirement benefits (continued)

e) The amounts recognised in the consolidated statement of income were as follows:-

	<u>2012</u>	<u>2011</u>
	US\$ millions	US\$ millions
Current service cost	0.9	0.8
Interest cost	7.8	8.8
Expected return on plan assets	(8.3)	(9.5)
Net expense included in staff expenses	<u>0.4</u>	<u>0.1</u>

f) The principal actuarial assumptions used for accounting purposes were as follows:-

	<u>2012</u>	<u>2011</u>
Discount rate	4.6%	5.1%
Expected return on plan assets - equities	7.0%	6.5%
Expected return on plan assets - bonds	4.8%	4.7%
Future salary increases	4.4%	4.4%
Future increases to pensions in payment	3.2%	3.2%

g) Historical information

	<u>2012</u>	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>
	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions
Fair value of plan assets	176.8	157.1	148.0	144.8	117.5
Present value of fund obligations	180.1	151.5	152.5	149.8	101.5
Plan (deficit) / surplus	(3.3)	5.6	(4.5)	(5.0)	16.0
Experience gains on plan assets	5.7	4.5	4.8	10.0	3.2
Experience gains / (losses) on plan liabilities	15.9	(4.7)	(3.5)	(2.6)	(14.6)

13. Deposits

Deposits from customers include deposits from central banks.

The geographical composition of total deposits was as follows:-

	<u>31.12.12</u>	<u>31.12.11</u>
	US\$ millions	US\$ millions
GCC countries	8,124.3	7,387.4
Other Middle East and North Africa countries	524.1	364.3
Other countries	3,045.9	2,317.9
	<u>11,694.3</u>	<u>10,069.6</u>

GCC deposits comprise deposits from GCC country governments and central banks and other institutions headquartered in the GCC states.

At 31st December 2012, GCC deposits represented 69.5 per cent of total deposits (2011: 73.4 per cent).

The significant increase in deposits from other countries during the year ended 31st December 2012 reflected a higher level of deposit activity by the Group's London-based subsidiary, Gulf International Bank (UK) Limited.

Total deposits at 31st December 2012 included Shariah-compliant transactions amounting to US\$1,791.5 million (2011: US\$1,188.5 million). Shariah-compliant transactions comprise murabaha contracts. The increase in Shariah-compliant deposits during the year ended 31st December 2012 reflected a generally higher funding requirement associated with higher Shariah-compliant loan volumes.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

14. Securities sold under agreements to repurchase

The Group enters into collateralised borrowing transactions (repurchase agreements) in the ordinary course of its financing activities. Collateral is provided in the form of securities held within the investment securities portfolio. At 31st December 2012, the fair value of investment securities that had been pledged as collateral under repurchase agreements was US\$640.8 million (2011: US\$294.0 million). The collateralised borrowing transactions are conducted under standardised terms that are usual and customary for such transactions.

15. Other liabilities

	<u>31.12.12</u>	<u>31.12.11</u>
	US\$ millions	US\$ millions
Derivative financial instruments	181.4	112.5
Deferred items	69.0	69.7
Accrued interest	58.8	56.9
Other, including accounts payable and accrued expenses	62.9	66.0
	<u>372.1</u>	<u>305.1</u>

Derivative financial instruments represent the negative fair values of derivative financial instruments entered into for trading purposes, or designated as fair value or cash flow hedges. An analysis of the fair value of derivative financial instruments is set out in note 31(d).

16. Senior term financing

	<u>Maturity</u>	<u>31.12.12</u>	<u>31.12.11</u>
		US\$ millions	US\$ millions
Murabaha term facility	2013	100.0	100.0
Murabaha term facility	2014	300.0	300.0
Floating rate repurchase agreements	2014	64.9	64.9
Floating rate note	2015	933.2	933.2
Floating rate repurchase agreements	2015	35.4	35.4
Floating rate loan	2016	500.0	500.0
Floating rate note	2017	499.2	-
Floating rate loan	2012	-	1,173.5
Floating rate note	2012	-	533.3
Murabaha term facility	2012	-	50.0
		<u>2,432.7</u>	<u>3,690.3</u>

During the year ended 31st December 2012, the Group raised US\$499.2 million of new senior term finance (2011: US\$900.3 million).

The US\$500.0 million floating rate loan maturing in 2016 was provided by the Group's majority shareholder, the Public Investment Fund. The loan was based on market rates and standardised terms that are usual and customary for such transactions.

At 31st December 2012, the fair value of investment securities that had been pledged as collateral under term repurchase agreements was US\$143.5 million.

17. Subordinated term financing

	<u>Maturity</u>	<u>31.12.12</u>	<u>31.12.11</u>
		US\$ millions	US\$ millions
Floating rate note	2015	327.8	327.8
Floating rate loans	2016	150.0	150.0
		<u>477.8</u>	<u>477.8</u>

The subordinated term financing facilities represent unsecured obligations of the Group and are subordinated in right of payment to the claims of depositors and other creditors of the Group that are not also subordinated. The subordinated financing facilities have been approved for inclusion in tier 2 capital for capital adequacy purposes by the Bank's regulator, the Central Bank of Bahrain.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

18. Share capital

The authorised share capital at 31st December 2012 comprised 3.0 billion shares of US\$1 each (2011: 3.0 billion shares of US\$1 each). The issued share capital at 31st December 2012 comprised 2.5 billion shares of US\$1 each (2011: 2.5 billion shares of US\$1 each). All issued shares are fully paid.

19. Reserves

	Share premium	Compulsory reserve	Voluntary reserve	Cash flow hedge reserve	Investment securities revaluation reserve	Total
	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions	millions
At 1st January 2012	7.6	187.9	125.4	3.5	(78.4)	246.0
Transition adjustment on adoption of IFRS 9	-	-	-	-	78.4	78.4
At 1st January 2012 - restated	7.6	187.9	125.4	3.5	-	324.4
Net fair value gains on cash flow hedges	-	-	-	0.4	-	0.4
Net fair value losses on equity investments classified as FVTOCI	-	-	-	-	(11.9)	(11.9)
Transfers to consolidated statement of income	-	-	-	(2.5)	-	(2.5)
Net decrease	-	-	-	(2.1)	(11.9)	(14.0)
Transfers from retained earnings	-	8.9	8.9	-	-	17.8
At 31st December 2012	7.6	196.8	134.3	1.4	(11.9)	328.2
At 1st January 2011	7.6	179.4	116.9	6.3	(21.5)	288.7
Net fair value gains on cash flow hedges	-	-	-	0.5	-	0.5
Net fair value losses on investments classified as available-for-sale	-	-	-	-	(61.3)	(61.3)
Transfers to consolidated statement of income	-	-	-	(3.3)	4.4	1.1
Net decrease	-	-	-	(2.8)	(56.9)	(59.7)
Transfers from retained earnings	-	8.5	8.5	-	-	17.0
At 31st December 2011	7.6	187.9	125.4	3.5	(78.4)	246.0

In accordance with the Bank's articles of association, 10 per cent of the Bank's net profit for the year is required to be transferred to each of the compulsory and voluntary reserves. Transfers to the non-distributable compulsory reserve are required until such time as this reserve represents 50 per cent of the issued share capital of the Bank. The voluntary reserve may be utilised at the discretion of the Board of Directors.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

20. Dividends

No dividend is proposed in respect of the financial year ended 31st December 2012.

21. Net interest income

	<u>2012</u>	<u>2011</u>
	US\$ millions	US\$ millions
Interest income		
Placements and other liquid assets	43.7	37.9
Investment securities	57.4	49.4
Loans and advances	187.9	186.6
Total interest income	<u>289.0</u>	<u>273.9</u>
Interest expense		
Deposits from banks and customers	66.9	60.9
Securities sold under agreements to repurchase	6.4	6.1
Term financing	66.3	63.1
Total interest expense	<u>139.6</u>	<u>130.1</u>
Net interest income	<u>149.4</u>	<u>143.8</u>

Interest income on loans and advances includes loan origination fees that form an integral part of the effective interest rate of the loan.

Accrued but uncollected interest on impaired loans included in interest income for the year ended 31st December 2012 amounted to US\$1.4 million (2011: US\$1.6 million). There was no accrued but uncollected interest included in interest income on past due loans or past due investment securities for either the year ended 31st December 2012 or 31st December 2011.

22. Fee and commission income

	<u>2012</u>	<u>2011</u>
	US\$ millions	US\$ millions
Fee and commission income		
Commissions on letters of credit and guarantee	28.9	22.7
Investment banking and management fees	25.2	24.6
Loan commitment fees	2.5	1.2
Other fee and commission income	1.6	1.5
Total fee and commission income	<u>58.2</u>	<u>50.0</u>
Fee and commission expense	<u>(1.5)</u>	<u>(1.5)</u>
Net fee and commission income	<u>56.7</u>	<u>48.5</u>

Investment banking and management fees comprise fees relating to the provision of investment management and financial services, including asset and fund management, underwriting activities, and services relating to structured financing, privatisations, IPOs, and mergers and acquisitions.

Investment banking and management fees for the year ended 31st December 2012 included fee income relating to the Group's fiduciary activities amounting to US\$14.0 million (2011: US\$19.6 million).

Fee and commission expense principally comprises security custody fees.

23. Foreign exchange income

Foreign exchange income principally comprised customer-initiated foreign exchange contracts which have been offset in the market with matching contracts. There is no remaining market risk associated with these offset customer-related foreign exchange contracts.

Foreign exchange includes spot and forward foreign exchange contracts, and currency futures and options.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

24. Trading income

	<u>2012</u>	<u>2011</u>
	US\$ millions	US\$ millions
Debt securities	9.9	3.7
Managed funds	3.6	3.2
Interest rate derivatives	0.8	0.4
	<u>14.3</u>	<u>7.3</u>

Trading income comprises gains and losses arising both on the purchase and sale, and from changes in the fair value, of trading instruments, together with the related interest income, interest expense and dividend income. Trading income accordingly incorporates all income and expenses related to the Group's trading activities.

Interest rate derivatives includes interest rate swaps, forward rate agreements, interest rate options, interest rate futures, and credit derivatives.

An analysis of the basis used for determining the fair values of trading financial assets and liabilities classified as FVTPL is set out in note 37.

25. Other income

	<u>2012</u>	<u>2011</u>
	US\$ millions	US\$ millions
Dividend income on equity investments	11.4	7.3
Net realised profits on investment debt securities	0.4	5.0
Realised profits on repurchase of own term finance	-	4.6
Recoveries on previously written off loans	1.5	0.1
	<u>13.3</u>	<u>17.0</u>

26. Segmental information

Segmental information is presented in respect of the Group's business and geographical segments. The primary reporting format, business segments, reflects the manner in which financial information is evaluated by the Board of Directors and the Group Management Committee.

a) Business segments

For financial reporting purposes, the Group is organised into four main operating segments:-

- Wholesale banking: the provision of wholesale commercial financing and other credit facilities for corporate and institutional customers, and the provision of financial advisory services relating to structured financing, privatisations, IPOs and mergers and acquisitions.
- Treasury: the provision of a broad range of treasury and capital market products and services to corporate and financial institution clients, money market, proprietary investment and trading activities and the management of the Group's balance sheet, including funding.
- Financial markets: the provision of asset and fund management services.
- Corporate and support units: income arising on the investment of the Group's net free capital funds and expenses incurred by support units.

The results reported for the business segments are based on the Group's internal financial reporting systems, which report interest revenue and interest expense on a net basis. The accounting policies of the segments are the same as those applied in the preparation of these consolidated financial statements and are set out in note 2. Transactions between business segments are conducted on normal commercial terms and conditions. Transfer pricing between the business units is based on the market cost of funds.

Segment results, assets and liabilities comprise items directly attributable to the business segments. Liabilities reported for corporate and support units comprise senior and subordinated term finance facilities and related accrued interest, the cost of which is recharged to the relevant operating business segments.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

26. **Segmental Information** (continued)

a) **Business segments** (continued)

The business segment analysis is as follows:-

	Wholesale banking US\$ millions	Treasury US\$ millions	Financial markets US\$ millions	Corporate and support units US\$ millions	Total US\$ millions
2012					
Net interest income	42.7	63.1	-	43.6	149.4
Total income	90.4	97.6	17.6	49.4	255.0
Segment result	39.2	86.9	11.2	(16.1)	121.2
Taxation charge on overseas activities					(3.3)
Net income after tax					117.9
Segment assets	7,286.2	10,097.1	76.4	245.1	17,704.8
Segment liabilities	-	13,007.1	80.7	2,486.8	15,574.6
Total equity					2,130.2
Total liabilities and equity					17,704.8
2011					
Net interest income	49.1	41.6	-	53.1	143.8
Total income	81.1	59.6	23.2	63.0	226.9
Segment result	25.0	53.1	16.2	14.7	109.0
Taxation charge on overseas activities					(4.5)
Net income after tax					104.5
Segment assets	6,884.9	9,599.4	25.9	278.7	16,788.9
Segment liabilities	-	11,067.1	9.9	3,749.1	14,826.1
Total equity					1,962.8
Total liabilities and equity					16,788.9

b) **Geographical segments**

Although the Group's three main business segments are managed on a worldwide basis, they are considered to operate in two geographical markets: the GCC and the rest of the world.

The geographical composition of total income and total assets based on the location in which transactions are booked and income is recorded was as follows:-

	Total income US\$ millions	2012 Total assets US\$ millions	Total income US\$ millions	2011 Total assets US\$ millions
GCC	191.0	13,121.6	178.6	13,805.1
Other countries	64.0	4,583.2	48.3	2,983.8
	255.0	17,704.8	226.9	16,788.9

The geographical analyses of deposits and risk assets are set out in notes 13 and 28 respectively.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012****27. Risk management**

The principal risks associated with the Group's businesses are credit risk, market risk, liquidity risk and operational risk. The Group has a comprehensive risk management framework in place for managing these risks which is constantly evolving as the business activities change in response to credit, market, product and other developments. The risk management framework is guided by a number of overriding principles including the formal definition of risk management governance, an evaluation of risk appetite expressed in terms of formal risk limits, risk oversight independent of business units, disciplined risk assessment and measurement including Value-at-Risk (VaR) methodologies and portfolio stress testing, and risk diversification. The Board of Directors set the Group's overall risk parameters and risk tolerances, and the significant risk management policies. A Board Risk Policy Committee reviews and reports to the Board of Directors on the Group's risk profile and risk taking activities. A Management Committee, chaired by the Group Chief Executive Officer, has the primary responsibility for sanctioning risk taking activities and risk management policies within the overall risk parameters and tolerances defined by the Board of Directors. A Group Risk Committee, under the chairmanship of the Chief Risk Officer and comprising the Group's most senior risk professionals, provides a forum for the review and approval of risk measurement methodologies, risk control processes and the approval of new products. The Group Risk Committee also reviews all risk policies and limits that require the formal approval of the Management Committee. The risk management control process is based on a detailed structure of policies, procedures and limits, and comprehensive risk measurement and management information systems for the control, monitoring and reporting of risks. Periodic reviews by internal and external auditors and regulatory authorities subject the risk management processes to additional scrutiny which help to further strengthen the risk management environment.

The principal risks associated with the Group's businesses and the related risk management processes are described in detail in the Basel 2 Pillar 3 disclosure report in the Annual Report, and are summarised below together with additional quantitative analysis:-

a) Credit risk

Credit risk is the risk that counterparties will be unable to meet their obligations to the Group. Credit risk arises principally from the Group's lending and investment activities in addition to other transactions involving both on- and off-balance sheet financial instruments. Disciplined processes are in place at both the business unit and corporate level that are intended to ensure that risks are accurately assessed and properly approved and monitored. Formal credit limits are applied at the individual transaction, counterparty, country and portfolio levels. Overall exposures are also evaluated to ensure a broad diversification of credit risk. The credit management process involves the monitoring of concentrations by product, industry, single obligor, risk grade and geography, and the regular appraisal of counterparty credit quality through the analysis of qualitative and quantitative information.

Credit risk is actively managed and rigorously monitored in accordance with well-defined credit policies and procedures. Prior to the approval of a credit proposal, a detailed credit risk assessment is carried out which includes an analysis of the obligor's financial condition, market position, business environment and quality of management. The risk assessment generates an internal credit risk rating for each exposure, which affects the credit approval decision and the terms and conditions of the transaction. For cross border transactions an analysis of country risk is also conducted. The Group bases its credit decision for an individual counterparty on the aggregate Group exposure to that counterparty and all its related entities. Groupwide credit limit setting and approval authorisation requirements are conducted within Board approved guidelines, and the measurement, monitoring and control of credit exposures are done on a Groupwide basis in a consistent manner.

The Group also mitigates its credit exposures on foreign exchange and derivative financial instruments through the use of master netting agreements and collateral arrangements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

27. **Risk management** (continued)

a) **Credit risk** (continued)

Maximum exposure to credit risk

The gross maximum exposure to credit risk before applying collateral, guarantees and other credit enhancements was as follows:-

	<u>31.12.12</u> US\$ millions	<u>31.12.11</u> US\$ millions
Balance sheet items:		
Cash and other liquid assets	1,107.4	858.7
Securities purchased under agreements to resell	1,010.8	280.0
Placements	4,479.7	5,394.0
Trading securities	100.5	83.7
Investment securities	3,560.1	3,151.7
Loans and advances	7,110.3	6,751.8
Other assets, excluding derivative-related items	96.2	85.6
Total on-balance sheet credit exposure	17,465.0	16,605.5
Off-balance sheet items:		
Credit-related contingent items	4,345.1	3,569.0
Foreign exchange-related items	224.6	31.4
Derivative-related items	70.6	77.7
Total off-balance sheet credit exposure	4,640.3	3,678.1
Total gross credit exposure	22,105.3	20,283.6

Credit risk profile

The Group monitors, manages and controls credit risk exposures based on an internal credit rating system that rates individual obligors based on a rating scale from 1 to 10, subject to positive (+) and negative (-) modifiers for rating grades 2 to 6. The internal credit rating is a measure of the credit-worthiness of a single obligor, based on an assessment of the credit risk relating to senior unsecured, medium term, foreign currency credit exposure. The primary objectives of the internal credit rating system are the maintenance of a single uniform standard for credit quality measurement, and to serve as the primary basis for Board-approved risk parameters and delegated credit authority limits. The internal credit rating system also serves as a key input into the Group's risk-adjusted return on capital (RAROC) performance measurement system. Ratings are assigned to obligors, rather than facilities, and reflect a medium term time horizon, thereby rating through an economic cycle. The internal ratings map directly to the rating grades used by the international credit rating agencies as follows:-

<u>Internal rating grade</u>	<u>Internal classification</u>	<u>Historical default rate range</u> %	<u>External rating</u>	
			<u>Fitch and Standard & Poor's</u>	<u>Moody's</u>
Investment grade				
Rating grade 1	Standard	0.00 - 0.00	AAA	Aaa
Rating grade 2	Standard	0.00 - 0.03	AA	Aa
Rating grade 3	Standard	0.06 - 0.08	A	A
Rating grade 4	Standard	0.15 - 0.37	BBB	Baa
Sub-investment grade				
Rating grade 5	Standard	0.51 - 1.23	BB	Ba
Rating grade 6	Standard	2.50 - 8.64	B	B
Rating grade 7	Standard	26.82	CCC	Caa
Classified				
Rating grade 8	Substandard	26.82	CC	Ca
Rating grade 9	Doubtful	26.82	C	C
Rating grade 10	Loss	-	D	-

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

27. **Risk management** (continued)

a) **Credit risk** (continued)

Credit risk profile (continued)

The historical default rates represent the range of probability of defaults between the positive and negative modifiers for each rating grade based on Standard & Poor's one year default rates for the 31 years from 1981 to 2011 for senior unsecured obligations. The default rates represent the averages over the 31 year period and therefore reflect the full range of economic conditions over that period.

The credit risk profile, based on internal credit ratings, was as follows:-

	<u>31.12.12</u>			<u>31.12.11</u>		
	Placements, reverse repos & other liquid assets	Securities	Loans and advances	Placements, reverse repos & other liquid assets	Securities	Loans and advances
	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions
Neither past due nor impaired						
Rating grades 1 to 4-	6,582.9	3,246.0	4,368.2	6,519.7	2,776.7	4,224.1
Rating grades 5+ to 5-	15.0	85.6	2,201.5	13.0	96.6	1,809.5
Rating grades 6+ to 6-	-	-	184.5	-	32.4	281.5
Rating grade 7	-	-	-	-	-	-
Equity investments	-	329.0	-	-	313.4	-
Carrying amount	6,597.9	3,660.6	6,754.2	6,532.7	3,219.1	6,315.1
Past due but not impaired						
Rating grades 1 to 7	-	-	73.9	-	-	159.9
Carrying amount	-	-	73.9	-	-	159.9
Past due and individually impaired						
Rating grade 7	-	-	-	-	-	33.7
Rating grade 8	-	-	2.0	-	-	14.4
Rating grade 9	-	-	40.2	-	-	20.2
Carrying amount	-	-	42.2	-	-	68.3
Individually impaired but not past due						
Rating grades 1 to 7	-	-	163.0	-	-	128.3
Rating grade 9	-	-	77.0	-	-	80.2
Equity investments	-	-	-	-	16.3	-
Carrying amount	-	-	240.0	-	16.3	208.5
Total	6,597.9	3,660.6	7,110.3	6,532.7	3,235.4	6,751.8

The above analysis is reported net of the following provisions for impairment:-

Provisions for impairment	-	(7.7)	(625.7)	-	(71.9)	(619.2)
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Individually impaired financial assets represent assets for which there is objective evidence that the Group will not collect all amounts due, including both principal and interest, in accordance with the contractual terms of the obligation.

Unimpaired financial assets are stated net of allocated non-specific provisions for impairment.

The Group holds collateral against loans and advances in the form of physical assets, cash deposits, securities and guarantees. The amount and type of collateral is dependent upon the assessment of the credit risk of the counterparty. The market / fair value of the collateral is actively monitored on a regular basis and requests are made for additional collateral in accordance with the terms of the underlying agreements. Collateral is not usually held against securities or placements and no such collateral was held at either 31st December 2012 or 31st December 2011.

An analysis of the credit risk in respect of foreign exchange and derivative financial instruments is set out in note 31 while the notional and risk-weighted exposures for off-balance sheet credit-related financial instruments are set out in note 32.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

27. **Risk management** (continued)

a) **Credit risk** (continued)

Credit risk concentration

The Group monitors concentrations of credit risk by sector and by geographic location. The industrial classification of loans and advances is set out in note 10(a). The geographical distribution of risk assets is set out in note 28. An analysis of the credit risk in respect of foreign exchange and derivative financial instruments is set out in note 31.

Settlement risk

Settlement risk is the risk of loss due to the failure of a counterparty to honour its obligations to deliver cash, securities, or other assets as contractually agreed.

For certain types of transactions, the Group mitigates this risk by conducting settlements through a settlement or clearing agent to ensure that a trade is settled only when both parties have fulfilled their contractual settlement obligations. Settlement limits form part of the credit approval and limit monitoring process.

b) **Market risk**

Market risk is the risk of loss due to adverse changes in interest rates, foreign exchange rates, equity prices and market conditions, such as liquidity. The principal market risks to which the Group is exposed are interest rate risk, foreign exchange risk and equity price risk associated with its trading, investment and asset and liability management activities. The portfolio effects of holding a diversified range of instruments across a variety of businesses and geographic areas contribute to a reduction in the potential negative impact on earnings from market risk factors.

- **Trading market risk:** The Group's trading activities principally comprise trading in debt and equity securities, foreign exchange and derivative financial instruments. Derivative financial instruments include futures, forwards, swaps and options in the interest rate, foreign exchange, equity, credit and commodity markets. The Group manages and controls the market risk within its trading portfolios through limit structures of both a VaR and non-VaR nature. Non-VaR based constraints relate, inter alia, to positions, volumes, concentrations, allowable losses and maturities. VaR is a risk measurement concept which uses statistical models to estimate, within a given level of confidence, the maximum potential negative change in the market value of a portfolio over a specified time horizon resulting from an adverse movement in rates and prices. It is recognised that there are limitations to the VaR methodology. These limitations include the fact that the historical data may not be the best proxy for future price movements. The Group performs regular back testing exercises to compare actual profits and losses with the VaR estimates to monitor the statistical validity of the VaR model. VaR is calculated based on the Group's market risk exposures at the close of the business each day. Intra-day risk levels may vary from those reported at the end of the day. In addition, losses beyond the specified confidence level are not captured by the VaR methodology. VaR is not a measure of the absolute limit of market risk and losses in excess of the VaR amounts will, on occasion, arise. To manage the risk associated with extreme market movements, the Group conducts stress testing which measures the impact of simulated abnormal changes in market rates and prices on the market values of the portfolios. The composition of the debt and equity trading securities is set out in note 8. An analysis of derivative financial instruments, including the VaR of foreign exchange and derivative trading contracts, is set out in note 31.

The VaR by risk class for the Group's trading positions, as calculated in accordance with the basis set out in note 34, was as follows:-

	<u>2012</u>				<u>2011</u>			
	<u>31.12.12</u>	<u>Average</u>	<u>High</u>	<u>Low</u>	<u>31.12.11</u>	<u>Average</u>	<u>High</u>	<u>Low</u>
	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions
Interest rate risk	0.9	1.1	1.3	0.8	1.2	1.2	1.5	0.9
Foreign exchange risk	-	0.1	0.2	-	-	0.1	0.2	-
Equity risk	-	-	0.1	-	0.1	0.1	0.2	0.1
Total diversified risk	0.9	1.1	1.3	0.8	1.3	1.3	1.6	1.0

- **Non-trading market risk:** Structural interest rate risk arises in the Group's core balance sheet as a result of mismatches in the repricing of interest rate sensitive financial assets and liabilities. The associated interest rate risk is managed within VaR limits and through the use of models to evaluate the sensitivity of earnings to movements in interest rates. The repricing profile and related interest rate sensitivity of the Group's financial assets and liabilities are set out in note 30. Movements in the fair value of equity investment securities are accounted for in other comprehensive income. The Group does not maintain material foreign currency exposures. In general, the Group's policy is to match financial assets and liabilities in the same currency or to mitigate currency risk through the use of currency swaps. Details of significant foreign currency net open positions are set out in note 31(e).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

27. Risk management (continued)

b) Market risk (continued)

The more significant market risk-related activities of a non-trading nature undertaken by the Group, the related risks associated with those activities, and the types of derivative financial instruments used to manage and mitigate such risks are summarised as follows:-

<u>Activity</u>	<u>Risk</u>	<u>Risk Mitigant</u>
Management of the return on variable rate assets funded by shareholders' funds	Reduced profitability due to a fall in short term interest rates	Receive fixed interest rate swaps
Fixed rate assets funded by floating rate liabilities	Sensitivity to increases in short term interest rates	Pay fixed interest rate swaps
Investment in foreign currency assets	Sensitivity to strengthening of US\$ against other currencies	Currency swaps
Profits generated in foreign currencies	Sensitivity to strengthening of US\$ against other currencies	Forward foreign exchange contracts and purchased currency options

c) Liquidity risk

Liquidity risk is the risk that sufficient funds are not available to meet the Group's financial obligations on a punctual basis as they fall due.

Liquidity management policies are designed to ensure that funds are available at all times to meet the funding requirements of the Group, even in adverse conditions. In normal conditions the objective is to ensure that there are sufficient funds available not only to meet current financial commitments but also to facilitate business expansion. These objectives are met through the application of prudent liquidity controls. These controls provide security of access to funds without undue exposure to increased costs from the liquidation of assets or the aggressive bidding for deposits. The Group's liquidity controls ensure that, over the short term, the future profile of cash flows from maturing assets is adequately matched to the maturity of liabilities. Liquidity controls also provide for the maintenance of a stock of liquid and readily realisable assets and a diversified deposit base in terms of both maturities and range of depositors.

The management of liquidity and funding is primarily conducted in the Group's individual geographic entities within limits set and approved by the Board of Directors. The limits take account of the depth and liquidity of the market in which the entity operates. It is the Group's general policy that each geographic entity should be self-sufficient in relation to funding its own operations.

The Group's liquidity management policies include the following:-

- the monitoring of (i) future contractual cash flows against approved limits, and (ii) the level of liquid resources available in a stress event
- the monitoring of balance sheet liquidity ratios
- the monitoring of the sources of funding in order to ensure that funding is derived from a diversified range of sources
- the monitoring of depositor concentrations in order to avoid undue reliance on individual depositors
- the maintenance of a satisfactory level of term financing
- the maintenance of appropriate standby funding arrangements; and
- the maintenance of liquidity and funding contingency plans. These plans identify early indicators of stress conditions and prescribe the actions to be taken in the event of systemic or other crisis, while minimising adverse long term implications for the Group's business activities.

The Group has established limits which restrict the volume of liabilities maturing in the short term. An independent risk management function monitors the future cash flow maturity profile against approved limits on a daily basis. The cash flows are monitored against limits applying to both daily and cumulative cash flows occurring over a 30 day period. The liquidity limits ensure that the net cash outflows over a 30 day period do not exceed the eligible stock of available liquid resources. The cash flow analysis is also monitored on a weekly basis by the Assets and Liabilities Committee (ALCO).

Customer deposits form a significant part of the Group's funding. The Group places considerable importance on maintaining the stability of both its customer and interbank deposits. The stability of deposits depends on maintaining confidence in the Group's financial strength and financial transparency.

The maturity profile of assets and liabilities is set out in note 29. An analysis of debt investment securities by rating classification is set out in note 27(a).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

27. Risk management (continued)

d) Operational risk

Operational risk is the risk of unexpected losses resulting from inadequate or failed internal controls or procedures, systems failures, fraud, business interruption, compliance breaches, human error, management failure or inadequate staffing.

A framework and methodology has been developed to identify and control the various operational risks. While operational risk cannot be entirely eliminated, it is managed and mitigated by ensuring that the appropriate infrastructure, controls, systems, procedures, and trained and competent people are in place throughout the Group. A strong internal audit function makes regular, independent appraisals of the control environment in all identified risk areas. Adequately tested contingency arrangements are also in place to support operations in the event of a range of possible disaster scenarios.

e) Capital management

The Group's lead regulator, the Central Bank of Bahrain (CBB), sets and monitors capital requirements for the Group as a whole. The parent company and individual banking operations are directly supervised by their local regulators.

As referred to in more detail in note 34, the Group adopted the Basel 2 capital adequacy framework with effect from 1st January 2008.

In applying current capital requirements, the CBB requires the Group to maintain a prescribed minimum ratio of total regulatory capital to total risk-weighted assets. The CBB's minimum risk asset ratio is 12 per cent compared to a minimum ratio of 8 per cent prescribed by the Basel Committee on Banking Supervision. The Group calculates regulatory capital requirements for general market risk in its trading portfolios using a Value-at-Risk model and uses the CBB's prescribed risk weightings under the standardised approach to determine the risk-weighted amounts for credit risk and specific market risk. Operational risk is calculated in accordance with the standardised approach. The regulatory capital requirement is calculated by applying the CBB's prescribed range of beta coefficients, ranging from 12 to 18 per cent, to the average gross income for the preceding three financial years for each of eight predefined business lines.

The Group's regulatory capital is analysed into two tiers:-

- Tier 1 capital, comprising issued share capital, share premium, retained earnings and reserves, adjusted to exclude revaluation gains and losses arising on the remeasurement to fair value of derivative cash flow hedging transactions and unrealised gains on equity investment securities.
- Tier 2 capital, comprising qualifying subordinated term finance, collective impairment provisions and 45 per cent of unrealised gains arising on the remeasurement to fair value of equity investment securities.

The CBB applies various limits to elements of the capital base. The amount of innovative tier 1 securities cannot exceed 15 per cent of total tier 1 capital; qualifying tier 2 capital cannot exceed tier 1 capital; and qualifying subordinated term finance cannot exceed 50 per cent of tier 1 capital. There are also restrictions on the amount of collective impairment provisions that may be included as part of tier 2 capital. Collective impairment provisions cannot exceed 1.25 per cent of total risk-weighted assets.

The Group's risk exposures are categorised as either trading book or banking book, and risk-weighted assets are determined according to specified requirements that seek to reflect the varying levels of risk attached to assets and off-balance sheet exposures.

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

The Group complied with all externally imposed capital requirements throughout the years ended 31st December 2012 and 31st December 2011.

There have been no material changes in the Group's management of capital during the years ended 31st December 2012 and 31st December 2011.

The capital adequacy ratio calculation is set out in note 34.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

28. Geographical distribution of risk assets

	Placements, reverse repos & other liquid assets		Loans and advances	Credit- related contingent items	31.12.12	31.12.11
	US\$ millions	Securities US\$ millions			Total	Total
					US\$ millions	US\$ millions
GCC	1,404.9	1,481.8	6,588.2	3,850.5	13,325.4	12,867.4
Other Middle East & North Africa	-	4.4	28.6	21.4	54.4	120.4
Europe	3,544.1	1,179.0	330.9	292.0	5,346.0	5,114.6
North America	1,012.9	736.6	162.6	161.2	2,073.3	1,293.6
Asia	636.0	220.9	-	20.0	876.9	670.2
Latin America	-	37.9	-	-	37.9	22.7
	6,597.9	3,660.6	7,110.3	4,345.1	21,713.9	20,088.9

At 31st December 2012, risk exposures to customers and counterparties in the GCC represented 61.4 per cent (2011: 64.1 per cent) of total risk assets. The risk asset profile reflects the Group's strategic focus on wholesale banking activities in the GCC states.

Placements, reverse repos and other liquid assets exposure to Europe principally comprised exposure to financial institutions located in France, Germany, Holland, Switzerland and the United Kingdom.

An analysis of derivative and foreign exchange instruments is set out in note 31.

29. Maturities of assets and liabilities

The maturity profile of the carrying amount of assets and liabilities, based on the contractual maturity dates, was as follows:-

	Within 3 months	4 months to 1 year	Years 2 and 3	Years 4 and 5	Over 5 years and other	Total
	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions
At 31st December 2012						
Cash and other liquid assets	859.5	247.9	-	-	-	1,107.4
Securities purchased under agreements to resell	860.8	150.0	-	-	-	1,010.8
Placements	4,248.9	230.8	-	-	-	4,479.7
Trading securities	61.7	-	-	-	38.8	100.5
Investment securities	50.0	305.0	1,645.6	1,082.7	476.8	3,560.1
Loans and advances	1,644.2	1,414.8	1,460.6	1,106.2	1,484.5	7,110.3
Other assets	78.6	58.3	25.2	3.7	170.2	336.0
Total assets	7,803.7	2,406.8	3,131.4	2,192.6	2,170.3	17,704.8
Deposits	9,736.1	1,958.2	-	-	-	11,694.3
Securities sold under agreements to repurchase	382.4	215.3	-	-	-	597.7
Other liabilities	119.3	48.1	22.5	3.2	179.0	372.1
Term financing	-	100.0	1,661.2	1,149.3	-	2,910.5
Equity	-	-	-	-	2,130.2	2,130.2
Total liabilities & equity	10,237.8	2,321.6	1,683.7	1,152.5	2,309.2	17,704.8
At 31st December 2011						
Total assets	7,821.0	2,065.4	2,295.5	2,073.9	2,533.1	16,788.9
Total liabilities & equity	9,051.8	3,174.4	473.3	1,946.4	2,143.0	16,788.9

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

29. Maturities of assets and liabilities (continued)

The asset and liability maturities presented in the table above are based on contractual repayment arrangements and as such do not take account of the effective maturities of deposits as indicated by the Group's deposit retention records. Formal liquidity controls are nevertheless based on contractual asset and liability maturities.

The gross cash flows payable by the Group under financial liabilities, based on contractual maturity dates, was as follows:-

	Within 3 months	4 months to 1 year	Years 2 and 3	Years 4 and 5	Over 5 years
	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions
At 31st December 2012					
Deposits	9,748.8	1,975.9	-	-	-
Securities sold under agreements to repurchase	384.3	215.9	-	-	-
Term financing	4.9	153.3	1,753.6	1,180.2	-
Derivative financial instruments:					
- contractual amounts payable	76.5	110.5	233.7	117.7	47.8
- contractual amounts receivable	(41.8)	(95.2)	(175.0)	(102.8)	(39.5)
Total undiscounted financial liabilities	10,172.7	2,360.4	1,812.3	1,195.1	8.3
At 31st December 2011					
Deposits	8,684.7	1,411.5	-	-	-
Securities sold under agreements to repurchase	285.7	-	-	-	-
Term financing	8.0	1,794.6	530.1	1,986.5	-
Derivative financial instruments:					
- contractual amounts payable	46.5	73.6	170.0	115.0	49.6
- contractual amounts receivable	(40.3)	(59.3)	(140.1)	(97.5)	(46.4)
Total undiscounted financial liabilities	8,984.6	3,220.4	560.0	2,004.0	3.2

Information on the contractual terms for the drawdown of gross loan commitments is set out in note 32.

The figures in the table above do not agree directly to the carrying amounts in the consolidated statement of financial position as they incorporate all cash flows, on an undiscounted basis, related to both principal as well as those associated with future coupon and interest payments. Coupons and interest payments for periods for which the interest rate has not yet been determined have been calculated based on the relevant forward rates of interest prevailing at the balance sheet date.

A maturity analysis of derivative and foreign exchange instruments based on notional amounts is set out in note 31(c).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

30. Interest rate risk

The repricing profile of assets and liabilities categories were as follows:-

	Within 3 months US\$ millions	Months 4 to 6 US\$ millions	Months 7 to 12 US\$ millions	Over 1 year US\$ millions	Non-interest bearing items US\$ millions	Total US\$ millions
At 31st December 2012						
Cash and other liquid assets	909.5	197.9	-	-	-	1,107.4
Securities purchased under agreements to resell	860.8	150.0	-	-	-	1,010.8
Placements	4,478.9	0.8	-	-	-	4,479.7
Trading securities	61.7	-	-	-	38.8	100.5
Investment securities:-						
- Fixed rate	-	75.3	206.7	938.6	-	1,220.6
- Floating rate	1,634.8	422.2	-	-	(7.7)	2,049.3
- Equities	-	-	-	-	290.2	290.2
Loans and advances	4,868.6	1,978.2	106.7	345.8	(189.0)	7,110.3
Other assets	-	-	-	-	336.0	336.0
Total assets	12,814.3	2,824.4	313.4	1,284.4	468.3	17,704.8
Deposits	10,882.6	804.3	7.4	-	-	11,694.3
Securities sold under agreements to repurchase	382.4	215.3	-	-	-	597.7
Other liabilities	-	-	-	-	372.1	372.1
Term financing	2,046.3	864.2	-	-	-	2,910.5
Equity	-	-	-	-	2,130.2	2,130.2
Total liabilities & equity	13,311.3	1,883.8	7.4	-	2,502.3	17,704.8
Interest rate sensitivity gap	(497.0)	940.6	306.0	1,284.4	(2,034.0)	-
Cumulative interest rate sensitivity gap	(497.0)	443.6	749.6	2,034.0	-	-
At 31st December 2011						
Cumulative interest rate sensitivity gap	(1,176.3)	941.8	1,167.3	1,892.9	-	-

The repricing profile is based on the remaining period to the next interest repricing date. Derivative financial instruments that have been used for asset and liability management purposes to hedge exposure to interest rate risk are incorporated in the repricing profiles of the related hedged assets and liabilities. The non-specific investment security and loan provisions are classified in non-interest bearing items.

The substantial majority of assets and liabilities reprice within one year. Accordingly there is limited exposure to interest rate risk. The principal interest rate risk beyond one year as set out in the asset and liability repricing profile, represents the investment of the Group's net free capital in fixed rate government securities. At 31st December 2012 the modified duration of these fixed rate securities was 2.39. Modified duration represents the approximate percentage change in the portfolio value resulting from a 100 basis point change in yield. More precisely in dollar terms, the price value of a basis point of the fixed rate securities was US\$231,000.

Based on the repricing profile at 31st December 2012, and assuming that the financial assets and liabilities were to remain until maturity or settlement with no action taken by the Group to alter the interest rate risk exposure, an immediate and sustained one per cent increase in interest rates across all maturities would result in a reduction in net income before tax for the following year by approximately US\$1.0 million (2011: US\$11.3 million) and an increase in the Group's equity by US\$3.8 million (2011: reduction in the Group's equity of US\$30.4 million). The impact on the Group's equity represents the cumulative effect of the increase in interest rates over the entire duration of the mismatches in the repricing profile of the interest rate sensitive financial assets and liabilities.

The Value-at-Risk by risk class for the Group's trading positions is set out in note 27. The market risk relating to derivative and foreign exchange instruments classified as FVTPL is set out in note 31.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012****31. Derivative and foreign exchange instruments**

The Group utilises derivative and foreign exchange instruments to meet the needs of its customers, to generate trading revenues and as part of its asset and liability management (ALM) activity to hedge its own exposure to market risk. Derivative instruments are contracts whose value is derived from one or more financial instruments or indices. They include futures, forwards, swaps and options in the interest rate, foreign exchange, equity, credit and commodity markets. Derivatives and foreign exchange are subject to the same types of credit and market risk as other financial instruments. The Group has appropriate and comprehensive Board-approved policies and procedures for the control of exposure to both market and credit risk from its derivative and foreign exchange activities.

In the case of derivative transactions, the notional principal typically does not change hands. It is simply a quantity which is used to calculate payments. While notional principal is a volume measure used in the derivative and foreign exchange markets, it is neither a measure of market nor credit risk. The Group's measure of credit exposure is the cost of replacing contracts at current market rates should the counterparty default prior to the settlement date. Credit risk amounts represent the gross unrealised gains on non-margined transactions before taking account of any collateral held or any master netting agreements in place.

The Group participates in both exchange traded and over-the-counter (OTC) derivative markets. Exchange traded instruments are executed through a recognised exchange as standardised contracts and primarily comprise futures and options. OTC contracts are executed between two counterparties who negotiate specific agreement terms, including the underlying instrument, notional amount, maturity and, where appropriate, exercise price. In general, the terms and conditions of these transactions are tailored to the requirements of the Group's customers although conform to normal market practice. Industry standard documentation is used, most commonly in the form of a master agreement. The existence of a master netting agreement is intended to provide protection to the Group in the event of a counterparty default.

The Group's principal foreign exchange transactions are forward foreign exchange contracts, currency swaps and currency options. Forward foreign exchange contracts are agreements to buy or sell a specified quantity of foreign exchange on a specific future date at an agreed rate. A currency swap involves the exchange, or notional exchange, of equivalent amounts of two currencies and a commitment to exchange interest periodically until the principal amounts are re-exchanged on a specified future date. Currency options provide the buyer with the right, but not the obligation, either to purchase or sell a fixed amount of a currency at a specified exchange rate on or before a specified future date. As compensation for assuming the option risk, the option seller (or writer) receives a premium at the start of the option period.

The Group's principal interest rate-related derivative transactions are interest rate swaps, forward rate agreements, futures and options. An interest rate swap is an agreement between two parties to exchange fixed rate and floating rate interest by means of periodic payments based upon a notional principal amount and the interest rates defined in the contract. Certain agreements combine interest rate and foreign currency swap transactions, which may or may not include the exchange of principal amounts. In a forward rate agreement, two parties agree a future settlement of the difference between an agreed rate and a future interest rate, applied to a notional principal amount for an agreed period. The settlement, which generally occurs at the start of the contract period, is the discounted present value of the payment that would otherwise be made at the end of that period. An interest rate future is an exchange traded contract for the delivery of a standardised amount of a fixed income security or time deposit at a future specified date. Interest rate options, including caps, floors and collars, provide the buyer with the right, but not the obligation, either to purchase or sell an interest rate financial instrument at a specified price or rate on or before a specified future date.

The Group's principal equity-related derivative transactions are equity and stock index options. An equity option provides the buyer with the right, but not the obligation, either to purchase or sell a specified stock or index at a specified price or level on or before a specified future date.

The Group buys and sells credit protection through credit default swaps. Credit default swaps provide protection against the decline in value of a referenced asset as a result of credit events such as default or bankruptcy. It is similar in structure to an option whereby the purchaser pays a premium to the seller of the credit default swap in return for payment related to the deterioration in value of the referenced asset. Credit default swaps purchased and sold by the Group are classified as derivative financial instruments.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

31. Derivatives and foreign exchange instruments (continued)

a) Product analysis

The table below summarises the aggregate notional and credit risk amounts of foreign exchange, interest rate, credit and equity-related derivative contracts.

	Notional amounts			Credit risk amounts
	Trading US\$ millions	Hedging US\$ millions	Total US\$ millions	US\$ millions
At 31st December 2012				
Foreign exchange contracts:-				
Unmatured spot, forward and futures contracts	6,198.0	2,683.4	8,881.4	224.6
Options purchased	377.8	-	377.8	-
Options written	377.8	-	377.8	-
	6,953.6	2,683.4	9,637.0	224.6
Interest rate contracts:-				
Interest rate swaps	1,441.3	5,565.5	7,006.8	70.6
Cross currency swaps	-	533.3	533.3	-
Options, caps and floors purchased	24.3	-	24.3	-
Options, caps and floors written	24.3	-	24.3	-
	1,489.9	6,098.8	7,588.7	70.6
Credit contracts:-				
Protection sold	25.0	-	25.0	-
Total	8,468.5	8,782.2	17,250.7	295.2
At 31st December 2011				
Total	2,526.4	8,804.1	11,330.5	109.1

There is no credit risk in respect of options, caps and floors written, and protection sold on credit contracts as they represent obligations of the Group.

At 31st December 2012 the Value-at-Risk of the foreign exchange, interest rate and credit derivative trading contracts analysed in the table above, as calculated in accordance with the basis set out in note 34, was nil, nil and nil respectively (2011: US\$0.1 million, nil and nil). Value-at-Risk is a measure of market risk exposure and is accordingly separate and in addition to the credit risk exposure represented by the credit risk amounts in the table above.

b) Counterparty analysis

Credit risk amounts	Banks	Corporates	Governments	31.12.12 Total	31.12.11 Total
	US\$ millions	US\$ millions	US\$ millions	US\$ millions	US\$ millions
OECD countries	165.5	-	72.1	237.6	31.3
GCC countries	0.1	38.7	-	38.8	58.7
Other countries	1.3	17.5	-	18.8	19.1
	166.9	56.2	72.1	295.2	109.1

Credit risk is concentrated on major OECD-based banks and governments.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
for the year ended 31st December 2012

31. Derivatives and foreign exchange instruments (continued)

c) Maturity analysis

	Year 1 US\$ millions	Years 2 & 3 US\$ millions	Years 4 & 5 US\$ millions	Over 5 years US\$ millions	Total US\$ millions
At 31st December 2012					
Foreign exchange contracts	6,540.9	2,636.9	459.2	-	9,637.0
Interest rate contracts	3,088.8	1,830.8	2,285.1	384.0	7,588.7
Credit contracts	25.0	-	-	-	25.0
Total	9,654.7	4,467.7	2,744.3	384.0	17,250.7
At 31st December 2011					
Total	8,118.6	731.3	1,669.3	811.3	11,330.5

The Group's derivative and foreign exchange activities are predominantly short-term in nature. Transactions with maturities over one year principally represent either fully offset trading transactions or transactions that are designated, and qualify, as fair value and cash flow hedges.

d) Fair value analysis

	Positive fair value US\$ millions	31.12.12 Negative fair value US\$ millions	Positive fair value US\$ millions	31.12.11 Negative fair value US\$ millions
Derivatives classified as FVTPL:-				
Forward foreign exchange contracts	67.4	(75.7)	15.5	(2.1)
Interest rate swaps and swaptions	55.5	(53.6)	65.5	(63.1)
	122.9	(129.3)	81.0	(65.2)
Derivatives held as cash flow hedges:-				
Interest rate swaps	-	-	0.1	-
Derivatives held as fair value hedges:-				
Interest rate swaps	-	(52.1)	-	(47.3)
Amount included in other assets / (other liabilities)	122.9	(181.4)	81.1	(112.5)

e) Significant net open positions

There were no significant derivative trading or foreign currency net open positions at either 31st December 2012 or at 31st December 2011.

f) Hedge effectiveness

Gains and losses recognised in the consolidated statement of income relating to fair value hedging relationships were as follows:-

	2012 US\$ millions	2011 US\$ millions
Net losses on derivative fair value hedging instruments	2.1	32.7
Net gains on hedged items attributable to the hedged risk	2.1	32.7

There were no ineffective portions of derivative fair value or cash flow hedging transactions recognised in the consolidated statement of income in either the year ended 31st December 2012 or 31st December 2011.

Certain derivative cash flow hedging transactions were unwound during the year ended 31st December 2009. The resultant realised profits are being recognised in the consolidated statement of income over the respective tenors of the original transactions for periods to 2014.

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for the year ended 31st December 2012

32. Credit-related financial instruments

Credit-related financial instruments include commitments to extend credit, standby letters of credit and guarantees which are designed to meet the financing requirements of customers. The credit risk on these transactions is generally less than the contractual amount. The table below sets out the notional principal amounts of outstanding credit-related contingent items and the risk-weighted exposures calculated in accordance with the capital adequacy guidelines of the Basel Committee on Banking Supervision.

	<u>31.12.12</u>		<u>31.12.11</u>	
	<u>Notional principal amount</u>	<u>Risk- weighted exposure</u>	<u>Notional principal amount</u>	<u>Risk- weighted exposure</u>
	<u>US\$ millions</u>	<u>US\$ millions</u>	<u>US\$ millions</u>	<u>US\$ millions</u>
Direct credit substitutes	386.1	376.7	309.2	285.0
Transaction-related contingent items	2,559.8	935.5	2,618.9	907.2
Short-term self-liquidating trade-related contingent items	591.0	55.1	189.0	30.3
Commitments, including undrawn loan commitments and underwriting commitments under note issuance and revolving facilities	808.2	295.9	451.9	186.4
	<u>4,345.1</u>	<u>1,663.2</u>	<u>3,569.0</u>	<u>1,408.9</u>

Commitments may be drawdown on demand.

Direct credit substitutes at 31st December 2012 included financial guarantees amounting to US\$315.5 million (2011: US\$242.0 million). Financial guarantees may be called on demand.

The notional principal amounts reported above are stated gross before applying credit risk mitigants, such as cash collateral, guarantees and counter-indemnities. At 31st December 2012, the Group held cash collateral, guarantees, counter-indemnities or other high quality collateral in relation to credit-related contingent items amounting to US\$849.6 million (2011: US\$732.9 million).

33. Contingent liabilities

The Bank and its subsidiaries are engaged in litigation in various jurisdictions. The litigation involves claims by and against Group companies which have arisen in the ordinary course of business. The directors of the Bank, after reviewing the claims pending against Group companies and based on the advice of relevant professional legal advisors, are satisfied that the outcome of these claims will not have a material adverse effect on the financial position of the Group.

34. Capital adequacy

The CBB's Basel 2 guidelines became effective on 1st January 2008 as the common framework for the implementation of the Basel Committee on Banking Supervision's (Basel Committee) Basel 2 capital adequacy framework for banks incorporated in the Kingdom of Bahrain.

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34. **Capital adequacy** (continued)

The risk asset ratio calculated in accordance with the CBB's Basel 2 guidelines was as follows:-

	<u>31.12.12</u>		<u>31.12.11</u>
	US\$ millions		US\$ millions
Regulatory capital base			
Tier 1 capital:			
Total equity	2,130.2		1,962.8
Tier 1 adjustments	(75.4)		6.5
Tier 1 capital	<u>2,054.8</u>		<u>1,969.3</u>
Tier 2 capital:			
Subordinated term financing	221.1		316.7
Non-specific provisions subject to 1.25% risk weighted exposure limitation	147.3		128.4
Tier 2 adjustments	(51.9)		(25.1)
Tier 2 capital	<u>316.5</u>		<u>420.0</u>
Total regulatory capital base	<u>2,371.3</u>		<u>2,389.3</u>
Risk-weighted exposure			
	Notional principal amount	Risk-weighted exposure	Notional principal amount
	US\$ millions	US\$ millions	US\$ millions
<i>Credit risk</i>			
Balance sheet items:			
Cash and other liquid assets	1,107.4	206.2	858.7
Securities purchased under agreements to resell	1,010.8	7.8	280.0
Placements	4,479.7	1,018.9	5,394.0
Investment securities	3,560.1	1,319.0	3,151.7
Loans and advances	7,110.3	6,515.4	6,751.8
Other assets	336.0	193.9	269.0
		<u>9,261.2</u>	<u>8,207.4</u>
Off-balance sheet items:			
Credit-related contingent items	4,345.1	1,663.2	3,569.0
Foreign exchange-related items	9,637.0	61.6	4,356.6
Derivative-related items	7,613.7	14.1	6,973.9
Forward placements	68.3	13.7	39.5
Repo counterparty risk	-	21.7	-
		<u>1,774.3</u>	<u>1,466.7</u>
Credit risk-weighted exposure		<u>11,035.5</u>	<u>9,674.1</u>
<i>Market risk</i>			
General market risk		186.0	49.5
Specific market risk		87.1	65.9
Market risk-weighted exposure		<u>273.1</u>	<u>115.4</u>
<i>Operational risk</i>			
Operational risk-weighted exposure		<u>472.1</u>	<u>483.2</u>
Total risk-weighted exposure		<u>11,780.7</u>	<u>10,272.7</u>
Tier 1 risk asset ratio		<u>17.4%</u>	<u>19.2%</u>
Total risk asset ratio		<u>20.1%</u>	<u>23.3%</u>

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34. Capital adequacy (continued)

For regulatory Basel 2 purposes, the Group has initially adopted the standardised approach for credit risk. In time and subject to approval by the CBB, the Group plans to adopt the foundation internal ratings-based (FIRB) approach for credit risk as it is more closely aligned to the Group's internal risk and capital management methodologies. For market risk, the Group uses the internal models approach. GIB applies the standardised approach for determining the capital requirement for operational risk.

In accordance with the capital adequacy guidelines of the CBB, revaluation gains and losses arising on the remeasurement to fair value of derivative cash flow hedging transactions and unrealised gains on equity investment securities are excluded from tier 1 capital. In accordance with the CBB's guidelines, gains arising on the remeasurement to fair value of equity investment securities are included in tier 2 capital, although limited to 45 per cent of the unrealised revaluation gain.

The Group's subordinated term financing facilities have been approved for inclusion in tier 2 capital by the CBB. During the last five years before maturity, a cumulative amortisation (discount) factor of 20 per cent per year is to be applied to the facilities. As at 31st December 2012, the amortisation amount excluded from tier 2 capital amounted to US\$256.7 million (2011: US\$161.1 million).

The Group calculates the regulatory capital requirement for general market risk using a Value-at-Risk model. The use of the internal model approach for the calculation of the capital requirement for general market risk has been approved by the Bank's regulator, the CBB. The multiplication factor to be applied to the Value-at-Risk calculated by the internal model has been set at 3.0 (2011: 3.0) by the CBB, representing the regulatory minimum. During 2012, the CBB implemented revisions to the market risk framework, which have become known as Basel 2.5. Consequently, the inclusion of metrics such as a 'stressed VaR' measure has resulted in an increase in the regulatory capital requirement with respect to market risk.

Value-at-Risk is calculated based on a 99 per cent confidence level, a ten-day holding period and a twelve-month historical observation period of unweighted data from the DataMetrics regulatory data set. Correlations across broad risk categories are excluded. Prescribed additions in respect of specific risk are made to the general market risk. The resultant measure of market risk is multiplied by 12.5, the reciprocal of the 8 per cent international minimum capital ratio, to give market risk-weighted exposure on a basis consistent with credit risk-weighted exposure.

The regulatory capital requirement for operational risk is calculated by the Group in accordance with the standardised approach. The regulatory capital requirement is calculated based on a range of beta coefficients, ranging from 12 to 18 per cent, applied to the average gross income for the preceding three financial years for each of eight predefined business lines.

35. Fiduciary activities

The Group conducts investment management and other fiduciary activities on behalf of clients. Assets held in trust or in a fiduciary capacity are not assets of the Group and accordingly have not been included in the consolidated financial statements. The aggregate amount of the funds concerned at 31st December 2012 was US\$9,185.5 million (2011: US\$8,139.5 million).

36. Related party transactions

The Group is owned by the six Gulf Cooperative Council governments, with the Public Investment Fund holding a majority (97.2 per cent) controlling stake. The Public Investment Fund is an investment body of the Saudi Arabian Ministry of Finance. There were no individual or collectively significant transactions with the Public Investment Fund during the years ended 31st December 2012 or 31st December 2011, other than the senior term loan referred to in note 16.

The Group's related party transactions are limited to the compensation of its directors and executive officers.

The compensation of key management personnel was as follows:-

	2012	2011
	US\$ millions	US\$ millions
Short term employee benefits	7.8	6.8
Post-employment benefits	0.5	0.5
	8.3	7.3

Key management personnel comprise members of the Board of Directors, the Group Chief Executive Officer and the Managing Directors of the Group.

Post-employment benefits principally comprise compensation paid to personnel on retirement or resignation from the services of the Group.

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37. Fair value of financial instruments

The Group's financial instruments are accounted for under the historical cost method with the exception of trading securities, equity investment securities and derivative financial instruments. By contrast the fair value represents the amount at which an asset could be exchanged, or a liability settled, in a transaction between knowledgeable, willing parties in an arm's length transaction. Differences therefore can arise between book values under the historical cost method and fair value estimates. Underlying the definition of fair value is the presumption that the Group is a going concern without any intention or requirement to curtail materially the scale of its operation or to undertake a transaction on adverse terms. Generally accepted methods of determining fair value include reference to quoted prices or to the pricing prevailing for similar financial instruments and the use of estimation techniques such as discounted cash flow analysis.

The valuation methodologies applied are outlined below.

a) Trading securities

The fair values of trading securities are based on quoted prices or valuation techniques.

b) Investment securities

The fair values of equity investment securities are based on quoted prices or valuation techniques. The fair values of debt investment securities are based on market prices and approximate the carrying values.

c) Loans and advances

The fair values of loans held for trading are based on quoted market prices. The fair values of other loans on a floating interest rate basis are principally estimated at book value less provisions for impairment. The fair values of impaired loans are estimated at the recoverable amount, measured as the present value of expected future cash flows discounted based on the interest rate at the inception of the loan. The fair values of fixed rate loans are estimated on a discounted cash flow basis utilising discount rates equal to prevailing market rates of interest in the respective currencies for loans of similar residual maturity and credit quality.

d) Term financing

The fair value of term financing is based on observable market data, including quoted market prices for debt instruments issued by similarly rated financial institutions and with similar maturities, or estimated on a discounted cash flow basis utilising currently prevailing spreads for borrowings with similar maturities. The fair values of senior term financing and subordinated term financing at 31st December 2012 were US\$2,338.6 million and US\$453.6 million respectively (2011: US\$3,569.9 million and US\$437.4 million respectively).

e) Other on-balance sheet items

The fair values of foreign exchange and derivative financial instruments are based on market prices, discounted cash flow techniques or option pricing models as appropriate. The fair values of all other on-balance sheet financial assets and liabilities approximate their respective book values due to their short term nature.

f) Credit-related contingent items

There was no material fair value excess or shortfall in respect of credit-related off-balance sheet financial instruments, which include commitments to extend credit, standby letters of credit and guarantees, as the related future income streams reflected contractual fees and commissions actually charged at the balance sheet date for agreements of similar credit standing and maturity. Specific provisions made in respect of individual transactions where a potential for loss has been identified are included in provisions for the impairment of loans and advances.

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for the year ended 31st December 2012

37. Fair value of financial instruments (continued)

The valuation basis for financial assets and financial liabilities carried at fair value was as follows:-

	Quoted prices (level 1) <u>US\$ millions</u>	Valuation based on observable market data (level 2) <u>US\$ millions</u>	Other valuation techniques (level 3) <u>US\$ millions</u>
At 31st December 2012			
Financial assets:			
Trading securities	100.5	-	-
Investment securities - equities	160.9	-	129.3
Derivative financial instruments	-	122.9	-
Financial liabilities:			
Derivative financial instruments	-	181.4	-
At 31st December 2011			
Financial assets:			
Trading securities	83.7	-	-
Investment securities - debt and equities	3,016.5	-	107.0
Derivative financial instruments	-	81.1	-
Financial liabilities:			
Derivative financial instruments	-	112.5	-

Quoted prices include prices obtained from lead managers, brokers and dealers. Investment securities valued based on other valuation techniques comprise private equity investments that have been valued based on price / earnings ratios for similar entities, discounted cash flow techniques or other valuation methodologies.

During the year ended 31st December 2012, the value of investment securities whose measurement was determined by other valuation techniques (level 3 measurement) increased by US\$22.3 million (2011: US\$1.1 million). The increase comprised changes in assigned valuations as recognised in other comprehensive income. No transfers out of, or into, the level 3 measurement classification occurred during the year ended 31st December 2012 or 31st December 2011.

38. Earnings per share

Basic earnings per share is calculated by dividing the net income attributable to the shareholders by the weighted average number of shares in issue during the year.

	<u>2012</u>	<u>2011</u>
Net income after tax (US\$ millions)	117.9	104.5
Weighted average number of shares in issue (millions)	2,500	2,500
Basic earnings per share	<u>US\$0.05</u>	<u>US\$0.04</u>

The diluted earnings per share is equivalent to the basic earnings per share set out above.

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39. Principal subsidiaries

The principal subsidiary companies were as follows:-

	<u>Country of incorporation</u>	<u>Ownership interest</u>	
		<u>31.12.12</u>	<u>31.12.11</u>
Gulf International Bank (UK) Limited	United Kingdom	100%	100%
GIB Capital L.L.C.	Kingdom of Saudi Arabia	100%	100%

40. Average consolidated statement of financial position

The average consolidated statement of financial position was as follows:-

	<u>31.12.12</u>	<u>31.12.11</u>
	<u>US\$ millions</u>	<u>US\$ millions</u>
Assets		
Cash and other liquid assets	1,202.5	996.2
Securities purchased under agreements to resell	493.8	157.7
Placements	5,881.3	4,931.5
Trading securities	91.1	81.3
Investment securities	3,446.7	3,219.6
Loans and advances	6,536.8	7,131.7
Other assets	230.6	198.8
Total assets	17,882.8	16,716.8
Liabilities		
Deposits from banks	1,774.4	2,087.4
Deposits from customers	10,117.3	7,912.4
Securities sold under agreements to repurchase	349.5	450.8
Other liabilities	225.1	251.2
Senior term financing	2,894.6	3,552.3
Subordinated term financing	477.8	507.4
Total liabilities	15,838.7	14,761.5
Total equity	2,044.1	1,955.3
Total liabilities & equity	17,882.8	16,716.8