GULF INTERNATIONAL BANK

ANNUAL REPORT 2009

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Gulf International Bank

Gulf International Bank is a leading merchant bank in the Middle East with its principal focus on the Gulf Cooperation Council (GCC) states. GIB provides client-led, innovative financial products and services. Its client base includes major private-sector corporations, Gulf-based financial institutions, multinational companies active in the region and the governments of the GCC states.

GIB has gained an international reputation for project and trade finance and is a leading player in the regional syndicated loan market. Its other primary business areas include merchant banking services such as investment banking, capital markets and asset management.

The Bank was established in the Kingdom of Bahrain in 1975. It is owned by the six GCC governments, with the Public Investment Fund of Saudi Arabia holding a majority stake (97.2 per cent). GIB has branches in London, New York, Riyadh and Jeddah, and representative offices in Beirut and Abu Dhabi, in addition to its main subsidiary, Gulf International Bank (UK) Limited, and Riyadh-based GIB Financial Services.

THE GULF'S OWN MERCHANT BANK

Financial Highlights

	2009	2008	2007	2006	2005
EARNINGS (US$ millions)					
Net (Loss) / Income	**(152.6)**	(396.2)	(757.3)	255.5	203.0
Net Interest Income	**206.5**	288.3	305.6	257.7	209.0
Fee and Commission Income	**40.7**	73.3	88.1	65.8	46.2
Operating Expenses	**122.8**	142.9	141.2	144.0	138.7
FINANCIAL POSITION (US$ millions)					
Total Assets	**16,207.7**	25,033.5	29,954.0	24,787.2	22,856.6
Loans and Advances	**9,298.1**	12,972.1	12,601.8	8,145.0	6,273.7
Investment Securities	**2,018.1**	2,220.5	8,070.7	8,422.9	7,839.6
Senior Term Financing	**3,007.9**	2,431.5	2,657.8	1,867.1	1,944.5
Equity	**1,779.4**	1,925.5	2,215.3	1,856.6	1,718.3
RATIOS (Per cent)					
Profitability					
Return on Average Equity	**(8.2)**	(19.1)	(37.2)	14.3	12.3
Return on Average Assets	**(0.7)**	(1.4)	(2.8)	1.1	1.0
Capital					
Risk Asset Ratio [1]					
- Total	**22.3**	17.3	12.0	11.6	12.7
- Tier 1	**16.4**	12.5	9.5	8.7	9.2
Equity as % of Total Assets	**11.0**	7.7	7.4	7.5	7.5
Asset Quality					
Loans as % of Total Assets	**57.4**	51.8	42.1	32.9	27.4
Securities as % of Total Assets	**12.8**	9.7	31.4	42.8	43.1
Liquidity					
Liquid Assets Ratio	**41.2**	46.3	52.8	65.2	70.9
Deposits to Loans Cover (times) [2]	**1.4**	1.6	1.8	2.3	2.5

[1] From 2008, the risk asset ratio is calculated in accordance with CBB's Basel 2 guidelines. Comparative ratios are presented in accordance with the Basel 1 guidelines of the Basel Committee on Banking Supervision.

[2] Deposits include Senior Term Financing.

Credit Ratings

	Fitch	Moody's	Standard & Poor's	Capital Intelligence
Long-term	A	A3	BBB+	A+
Short-term	F-1	P-2	A-2	A1
Individual	C/D			
Financial Strength		D+		A-
Outlook	Stable	Stable	Stable	Stable

Board of Directors

H.E. Jammaz bin Abdullah Al-Suhaimi
Chairman
Kingdom of Saudi Arabia

Mr. Mansour bin Saleh Al Maiman
Vice Chairman
Deputy Minister of Finance
Secretary General of the Public Investment Fund
Kingdom of Saudi Arabia

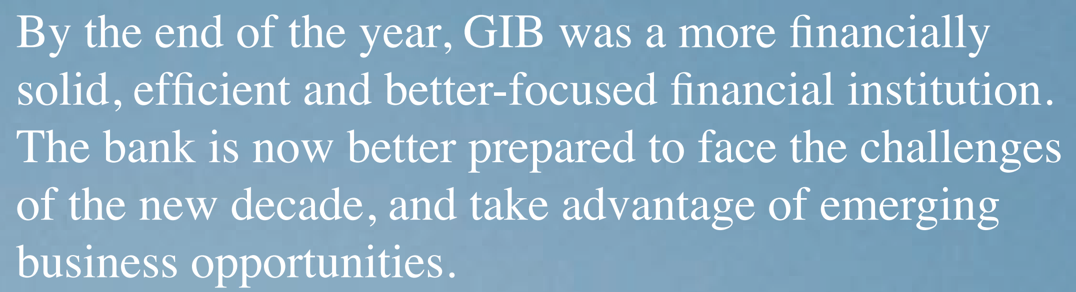
H.E. Dr. Hamad bin Sulaiman Al-Bazai
Vice Minister of Finance
Ministry of Finance
Kingdom of Saudi Arabia

Dr. Abdullah bin Hassan Al-Abdul-Gader
Professor
King Fahd University of Petroleum & Minerals
Kingdom of Saudi Arabia

Mr. Sulaiman bin Abdullah Al-Hamdan
Chief Executive Officer
National Air Services
Kingdom of Saudi Arabia

Mr. Abdulla bin Mohammed Al Zamil
Chief Executive Officer
Zamil Industrial Investment Company
Kingdom of Saudi Arabia

Mr. Khaled bin Saleh Al-Mudaifer
Vice President
Business Development
Saudi Arabian Mining Company
Kingdom of Saudi Arabia



By the end of the year, GIB was a more financially solid, efficient and better-focused financial institution. The bank is now better prepared to face the challenges of the new decade, and take advantage of emerging business opportunities.

Chairman's Statement

Jammaz bin Abdullah Al-Suhaimi
Chairman

ON BEHALF OF THE BOARD OF DIRECTORS, it is my pleasure to present the Annual Report for Gulf International Bank (GIB) for the year ended 31st December 2009. In what proved to be yet another challenging year, I am happy to report that the successful stabilisation and derisking of the Bank placed GIB in a much stronger financial position at the end of 2009.

The year started with the world still reeling from the aftershocks of the worst global financial crisis since the 1930s. The crisis, with its resulting adverse effect on the GCC, which started in September 2008, carried through into 2009. Toward the end of the second quarter of the year, however, due to the countercyclical fiscal measures introduced by governments and central banks across the world, there was a mild revival in the worldwide macroeconomic environment and an improvement in global business sentiment and investor confidence. With most major economies beginning to register modest growth, oil prices recovered, more than doubling from their lows of US$33 per barrel at the end of 2008.

While the increase in the price of oil helped to alleviate concerns across the GCC about the lack of liquidity, the credit squeeze, and market volatility, the region still faces a number of economic and banking challenges. Corporate default rates and the overleveraging challenges faced by a number of financial institutions across the GCC have focused attention on the need for stronger regulatory control, corporate governance and risk management.

The outlook for the region remains positive especially in the medium and long term. The GCC states have built up very substantial reserves following their six-year growth on the back of rising oil prices. Their underlying macroeconomic fundamentals remain sound, and the IMF is forecasting GDP growth of over 4 per cent in 2010. Following their recovery, oil prices stabilised during 2009. They are expected to remain stable for the foreseeable future, with the International Energy Agency predicting global oil demand to rise by around 2 per cent in 2010. The GCC states had set prudent fiscal budgets for 2009, based on prevailing low oil prices at the end of 2008, but are now predicting budget surpluses for the year on the back of higher than expected oil revenues.

Against this background, GIB entered the year facing a challenge to the future growth of the Bank as one of the region's leading regional financial institutions. Accordingly, the Board and management identified and addressed a number of key issues, namely: deleveraging and derisking the balance sheet through a managed reduction in the loan portfolio; an

associated restructuring of the portfolio to reduce undue concentrations; the elimination of lower rated exposures; the termination of all proprietary trading activities; the strengthening of the funding position of the Bank through the further diversification of funding sources and a reduction in the asset and liability maturity mismatch; and the alignment of the Bank's organisation and infrastructure, and associated costs, in order to maintain its historic efficient cost-to-income ratio. At the same time, it was important to achieve these objectives in the minimum amount of time while avoiding disruption to the Bank's ongoing business activities and potential operational risks.

I am pleased to report that these key objectives were all successfully achieved. By the end of the year, the gross loan portfolio had been reduced by US$3.3 billion or 25 per cent to US$9.9 billion; the funding base had been significantly strengthened, with placements and cash and other liquid assets totalling US$4.6 billion and representing a very high 28 per cent of total assets. The cost realignment programme that was completed by the end of the year has resulted in a 20 per cent reduction in the underlying cost base of the Bank.

The managed reduction in the loan portfolio has resulted in a decrease in the loan to equity ratio from 6.7 at the beginning of the year to 5.2 at the end of 2009. The loan portfolio is now planned to be maintained at this more comfortable multiple of equity in the current environment. Importantly, the reduction in the loan volume was achieved while maintaining revenue levels from the strategically important GCC lending activity. As a result of enhancements to loan margins to reflect the new market dynamics, margin income derived from the GCC lending portfolio in 2009 was only slightly lower than in the prior year.

The Bank's funding profile was significantly strengthened by a groundbreaking Saudi Riyal 2 billion 3-year bond issue; the establishment of a US$4 billion EMTN programme; and the extension of deposit tenors. Currently, more than one quarter of the Bank's deposits mature beyond three months, in addition to term finance facilities totalling US$3.5 billion.

In November, GIB successfully closed a 2 billion (US$533 million) Saudi Riyal-denominated 3-year bond issue that was oversubscribed more than three times. This transaction was the first bond to be issued by a financial institution in the Kingdom of Saudi Arabia in 2009. The demand from a diverse group of highly respected institutional investors reflected not only the market's strong confidence in GIB, but also manifests the dynamism of Saudi Arabia's economy and its growing capital markets.

GIB also signed a US$4 billion Euro Medium Term Note (EMTN) programme in November. This programme provides the Bank with a platform to diversify its investor base and gives it the flexibility to further improve the maturity profile of its liabilities. Under this programme, GIB will be able to issue bonds in a variety of currencies and maturities. The Bank will continue to monitor markets in the future to access new funding opportunities and utilise the programme in due course.

The cost realignment measures implemented during the year have resulted in a significant 20 per cent reduction in the Bank's underlying cost base. The full extent of the cost reductions will only be evident in 2010 as the initiatives were implemented in stages during 2009. The cost realignment programme caused personnel redundancies in Bahrain and overseas locations. The Group's total headcount was reduced by 124 or 22 per cent during the year. All redundant staff were provided with fair compensation packages. The cost realignment measures also included actions taken to achieve greater operational efficiencies, including a restructuring of the Group's London-based subsidiary, GIBUK Limited, in order to derive further efficiencies from the relocation of back office support functions to Head Office and the migration to Head Office IT systems.

GIB posted an encouraging financial performance for 2009. Total income of US$286.0 million was 11 per cent

lower than the previous year, while operating income was US$163.2 million compared to US$179.8 million in 2008. Within operating income, there was a significant year-on-year improvement in trading income, resulting from the elimination of trading losses incurred in the prior year following the termination of proprietary trading activities. Total expenses decreased by 14 per cent to US$122.8 million, reflecting the previously mentioned effective measures to align the cost base with the Bank's current operating model, and further improvements in operational efficiencies. In line with the Bank's traditional conservative approach to provisioning, the net provision charge for both loans and securities in 2009 was US$291.2 million. In view of the ongoing challenging environment, the Bank continued to make significant additions to its non-specific provisions in 2009, increasing the non-specific loan provision by US$60.0 million to US$240.0 million. This represented 2.6 times the carrying amount of unsecured past due loans, thereby providing a highly conservative buffer in the current uncertain environment and minimising future provisioning requirements. The net provision charge principally related to exceptional events for which the potential losses were fully provisioned. Excluding the provisions relating to these events, the provisioning requirements in 2009 were limited reflecting the quality of the Bank's loan portfolio. After taking account of the exceptional provision charge, the Bank recorded a net loss of US$152.6 million for the year. This was a significant improvement over the net loss of US$396.2 million recorded in the previous year.

During the year, there was a change in GIB's shareholding structure, with the Public Investment Fund of Saudi Arabia's ownership interest increasing to 97.2 per cent. This resulted in the election of a new Board of Directors, comprising Mr. Mansour Al Maiman as Vice Chairman, Dr. Hamad Al-Bazai, Dr. Abdulla Al-Abdul-Gader, Mr. Sulaiman Al-Hamdan, Mr. Abdulla Al-Zamil, and Mr. Khaled Al-Mudaifer, in addition to myself as Chairman. I would like to welcome our new Directors, who collectively have extensive experience in both the public and private sectors, and thank the outgoing Directors for their valuable contributions. I am committed to working with my fellow Directors to strengthen the Bank's franchise and ensure its continued success during these challenging times for international financial institutions.

The achievements and developments in 2009 put GIB in a considerably stronger, leaner, and more efficient and focused position to begin looking forward, and determine the Bank's future in the light of changing economic, financial and market dynamics. To this end, GIB has appointed consultants and retained advisors to assist the Board and management in developing a new and dynamic business model as well as a strategy to achieve it. I am confident that the Bank will be well placed to take advantage of new business opportunities, continue its key role in Saudi Arabia and the region as a leading financial institution, and ensure prosperity for all its stakeholders.

On behalf of the Board of Directors, I would like to express my sincere thanks for the financial support and guidance of our shareholders; the trust and loyalty of our clients; the positive collaboration of our business partners; and the constructive cooperation of the regulatory and supervisory authorities in the jurisdictions where GIB operates. Finally, I would like to pay tribute to the professionalism, dedication, understanding and patience of the Bank's management and staff during this most difficult period in the long history of GIB. The Board is highly appreciative of their excellent efforts.

Jammaz bin Abdullah Al-Suhaimi
Chairman

Investment banking activities included the successful conclusion of the Saudi Steel Pipe Co. transaction - the first premium IPO in Saudi Arabia since the start of the international financial crisis.

Yahya A. Alyahya
Chief Executive Officer

At the beginning of 2009, GIB faced a number of challenges affecting the future viability of the Bank. Through the concerted and proactive efforts of the shareholders, directors, management and staff, these challenges were successfully addressed and conclusively overcome. As a result, by the end of the year, GIB was a more financially solid, efficient and better-focused financial institution. The Bank is now better prepared to face the challenges of the new decade, and take advantage of emerging business opportunities associated with the expected global and regional economic and market recovery during 2010.

As part of GIB's strategic initiative to delever and derisk its balance sheet and to focus on its core GCC business franchise, the Bank's non-core investment securities were sold to the Public Investment Fund (PIF) of Saudi Arabia and the Saudi Arabian Monetary Agency (SAMA). The sold securities included GIB's entire exposure to collateralised debt obligations, asset backed securities, and subordinated international bank debt. The securities were sold at their amortised cost less specific provisions for impairment at the effective date of sale. Accordingly, no profit or loss was recorded on the sale.

In order to compensate the PIF and SAMA for the difference between the total consideration paid for the securities and the fair value of the securities as at an agreed date, GIB's shareholders re-allocated the ownership of GIB's issued share capital between themselves in accordance with a pre-determined formula. In late 2009, SAMA transferred all of its shares in GIB to the PIF. Following this transfer, the PIF owns 97.2 per cent of the Bank.

ECONOMIC AND MARKET BACKGROUND

The global economy at the start of 2009 was in recession. For most of the year, widespread systemic risks eroded confidence, while overall economic prospects appeared difficult and uncertain. Key global factors witnessed during the year included a lack of liquidity, continued market volatility, and constrained access to sources of capital. Regionally, the financial crisis flowed through to the real GCC economy. This was illustrated by the problems faced by some investment banks; defaults by certain companies; and the Dubai World standstill announcement. A number of regional corporate defaults also highlighted the particular need for stronger corporate governance and risk management practices within the corporate sector.

Unprecedented policy actions and fiscal measures eventually induced a mild revival in the global macroeconomic environment by the third quarter. There are nascent signs that the economies around the world are now in the midst of a recovery. However, risks of a relapse are ever-present as the flow of credit remains strained and the deleveraging of the global financial sector continues.

Economic conditions across the GCC region have also stabilised, largely buoyed by a recovery in oil prices. After falling from US$147 to US$33 in the second half of 2008, oil prices recovered by 78 per cent during the course of 2009; the largest year-on-year increase in a decade. Despite the recent problems faced by GCC economies, it is important to note the achievements in the region during the growth period between 2002 and 2007. These include increasing GDP growth levels supported by oil revenues, enabling the accumulation

of healthy reserves and liquidity, and the expansion of investments in oil, gas, and petrochemical projects, as well as non-oil sectors.

From an economic perspective, the future outlook looks positive, and is underlined by two key factors. Firstly, in the short-to-medium term, the liquidity that was accumulated during the growth years of high oil prices will allow governments to continue funding infrastructure projects, and will provide fiscal breathing space to support the ongoing recovery and eventual expansion. Secondly, in the longer term, as global growth picks up, there will be greater demand for oil and gas, and by-products such as petrochemicals, which will help accelerate and sustain economic growth.

MEETING CHALLENGES

At the start of 2009, the Board of Directors and management identified the key issues that needed to be addressed on an urgent basis. First and foremost, it was essential to secure the support of the Bank's shareholders in stabilising the balance sheet and preserving capital. This was achieved through the sale of the Bank's non-core investment securities. This action protected the Bank from any future losses from these securities, materially delevered and derisked the balance sheet, reduced risk-weighted assets resulting in a significant enhancement of the Bank's regulatory capital adequacy ratios, and significantly reduced the Bank's funding requirements.

Secondly, the Bank took actions to delever and derisk the loan portfolio. At the end of the year, the loan portfolio had reduced to US$9.9 billion from more than US$13 billion a year earlier. This represented a more comfortable multiple of equity in the prevailing economic environment. At the same time, actions were taken to reduce undue concentrations in the loan portfolio, and to eliminate lower-related and higher risk exposures. The decision was also taken to exit from certain businesses, including the termination of all proprietary trading activities, as part of the derisking initiatives.

The third issue was the need to align costs with revenues. Cost efficiencies implemented by management during the year included rationalising the number of staff, moving certain processes and operations from the Bank's London-based subsidiary, GIBUK, to Head Office in Bahrain, and making more efficient use of the Bank's IT infrastructure.

Fourth was a major review of the Bank's credit risk policies, including a re-evaluation of the Bank's risk appetite and related limit structures. In addition, training courses were conducted to improve awareness and skills in early problem recognition and remedial management.

Finally, there was a need to raise longer term funding in order to diversify the Bank's funding base and further improve the maturity profile of its liabilities, thereby more closely aligning the maturity profile of assets and liabilities.

By the end of 2009, all these challenges and issues had been successfully addressed and the Bank is now well positioned to embark upon a path of measured and focused growth.

BUSINESS DEVELOPMENTS

The most notable business achievement during the year was the Bank's success in raising long-term liabilities. This included a groundbreaking SAR 2 billion (US$533 million) 3 year bond issue – the first to be issued by a financial institution in the Kingdom of Saudi Arabia in 2009, and the largest ever book size for a fixed income Saudi Riyal private placement by a financial institution in the Kingdom. The issue was oversubscribed by more than three times. In addition, GIB signed a US$4 billion Euro Medium Term Note (EMTN) programme under which the Bank will be able to issue bonds in a variety of currencies and maturities.

Overall, 2009 proved to be a challenging business environment, affected by a lack of liquidity and an associated credit squeeze, and reduced corporate and investor confidence. While continuing to respond to the needs of its existing clients, GIB adopted a cautious approach to new lending, syndication activities and project financing during the year, although was nevertheless successful in further developing its investment banking franchise through a number of important advisory mandates. Investment banking activities included the successful conclusion of the Saudi Steel Pipe Co. transaction - the first premium IPO in Saudi Arabia since the start of the international financial crisis. GIB was also appointed by First Energy Bank as exclusive financial advisor for debt and equity funding for the Saudi Polysilicon project, the first plant of its kind in the region. On the commercial banking side, GIB refinanced facilities for a number of existing clients. This cautious approach to new business and the scheduled repayment of facilities contributed to a reduction in the loan portfolio to US$9.9 billion at the 2009 year end, representing a prudent multiple of equity. The Bank's asset management business in London adopted a new strategy with a greater focus on emerging markets. At the end of the year, total assets under management stood at US$16.6 billion.

Another important development in 2009 was the re-affirmation of GIB's long-term issuer ratings by the major international rating agencies. The re-affirmation of GIB's ratings constituted a positive independent endorsement of the proactive and conclusive actions taken by the Bank and its shareholders to address the challenges created by the global credit crisis. It also reflected GIB's ability to withstand the unprecedented pressures caused by the international financial crisis, and its commitment to continue its leading role in the financial community in the region.

HUMAN RESOURCES DEVELOPMENT

As we develop the new strategy for the Bank in 2010 and beyond, we will be adopting new processes and tools to help build the capability and capacity to change and achieve greater effectiveness. We will be introducing a change management strategy that will enhance our organizational culture. We will also explore issues relating to our performance management philosophy to ensure that our staff are suitably motivated and enthused to work at GIB.

Throughout 2009, GIB continued to invest in the training and development of its people. At a strategic level, GIB has in place a comprehension succession and development planning process. The Bank has also developed a pool of young talented individuals who are being groomed for more challenging roles in the future. This is supported by the GIB graduate development and the Internship programmes. The Bank also encourages its staff to achieve appropriate professional qualifications, such as the Chartered Financial Analyst, Association of Chartered Certified Accountants, and Chartered Institute of Personnel and Development. During the year, specialised training courses were conducted to address regulatory and topical issues such as compliance, anti-money laundering, risk management awareness, problem recognition and remedial management, and information security awareness. In addition, special simulation workshops were carried out in areas such as treasury operations and sales. As we strive towards becoming the "Employer of Choice" we will continue to attract, develop and retain the best talent in the industry.

OPERATIONS AND INFORMATION TECHNOLOGY

A number of initiatives to consolidate operations and support functions were implemented during the year, aiming to support GIB's objectives of cost alignment and improving productivity and efficiency. The entire processing and control procedures for business delivery were reviewed and updated to reflect current best industry practices.

The consolidation of the Bank's operations in Bahrain included a wide range of treasury and banking business activities, for which associated operational and control functions and tasks were evaluated to enhance the efficiency of business delivery.

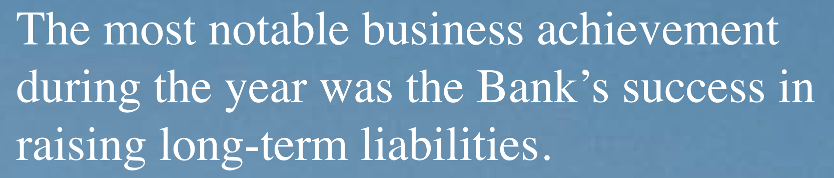
LOOKING AHEAD

In late 2009, GIB appointed an international consulting group to assist the Board and management in developing a new strategy and appropriate business model to ensure the ongoing growth of the Bank. The strategy review is expected to be concluded during the first half of 2010 and will include initiatives to create a more stable funding base and to reduce the vulnerability of the wholesale banking model to external shocks. The Bank is also looking to expand its footprint, both regionally and globally. Of key importance is the need to diversify at all levels – funding, products and clients – and to develop and improve the culture of relationship management and cross selling in order to maximise business opportunities, enhance revenue generation, and thereby boost profitability. In addition, a new branch in Al-Khobar, KSA, will be opened in 2010. This significant initiative will allow the Bank to expand its operations in the Kingdom, build stronger relationships with customers and achieve greater market penetration in the region's largest economy.

In addition, GIB is planning to build on a number of key inherent strengths and unique competitive advantages. These include the Bank's excellent regional relationships, franchise and footprint, as well as its global outreach and relationships with international institutions. In addition, GIB has a strong demonstrated leadership position in certain niche areas, such as project finance, syndications, and equity capital markets. Finally, GIB has a large pool of experienced and dedicated human capital committed to driving its future business endeavours.

The positive and constructive manner in which GIB has responded to various challenges during 2009 has positioned the Bank to take advantage of emerging business opportunities as market conditions start to recover. GIB is confident of its ability to maintain its market leadership and important role it plays in the economic development of the region.

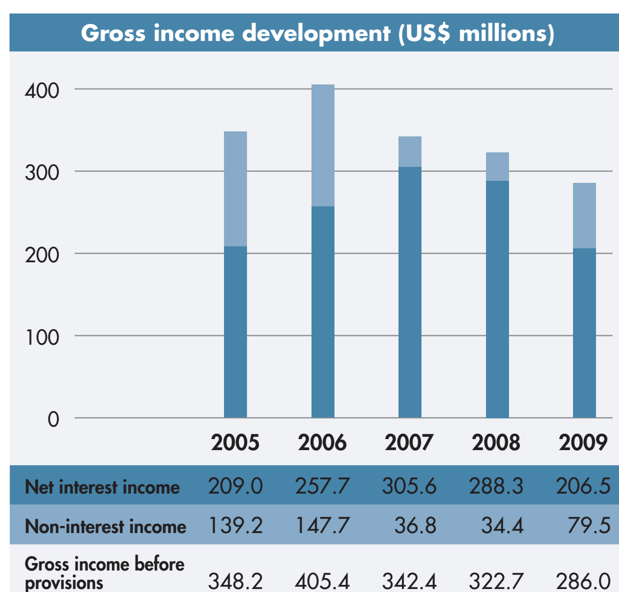
Yahya A. Alyahya
Chief Executive Officer



The most notable business achievement during the year was the Bank's success in raising long-term liabilities.

OPERATING INCOME WAS US$163.2 MILLION for the year. This was only 9 per cent lower than the prior year operating income of US$179.8 million, despite the ongoing market volatility and the challenging economic environment prevailing during the year. Total income of US$286.0 million was 11 per cent lower than in 2008 while total expenses at US$122.8 million were 14 per cent down on the prior year. Within operating income, there was a significant year-on-year improvement in trading income resulting from the elimination of trading losses incurred in the prior year following the termination of all proprietary trading activities as part of the Bank's derisking initiatives. A year-on-year decrease in net interest income was attributable to the deleveraging of the balance sheet in the current challenging environment and the negative impact on interest earnings of the historically low interest rate environment. Market conditions also contributed to lower fee-related income. A US$20.1 million or 14 per cent year-on-year decrease in total expenses reflected the implementation of effective measures to align the cost base with the Bank's current operating model, and further improvements in operational efficiencies.

In keeping with GIB's traditional conservative approach to provisioning, the Bank made significant additions to both specific and non-specific loan provisions in 2009. In view of the prevailing economic conditions, the Bank increased its non-specific loan provision so as to maintain provisions at a level consistent with the historical highest ever corporate default rates. As a result, the non-specific loan provision was increased by US$60.0 million to US$240.0 million at the end of 2009. This represented 2.6 times the carrying amount of unsecured past due loans, thereby providing a highly conservative buffer in the current uncertain environment and minimising future provisioning requirements. The net loan and investment securities provision charge for the year amounted to US$313.7 million. The loan provision charge principally related to exceptional events for which the potential losses were fully provisioned. Excluding the provisions relating to these exceptional events, the provisioning requirements in 2009 were limited reflecting the quality of the Bank's loan portfolio.



	2005	2006	2007	2008	2009
Net interest income	209.0	257.7	305.6	288.3	206.5
Non-interest income	139.2	147.7	36.8	34.4	79.5
Gross income before provisions	348.2	405.4	342.4	322.7	286.0

After taking account of the exceptional provision charge, the Bank recorded a net loss of US$152.6 million for the year. This was a significant improvement over the net loss of US$396.2 million recorded in the previous year.

NET INTEREST INCOME

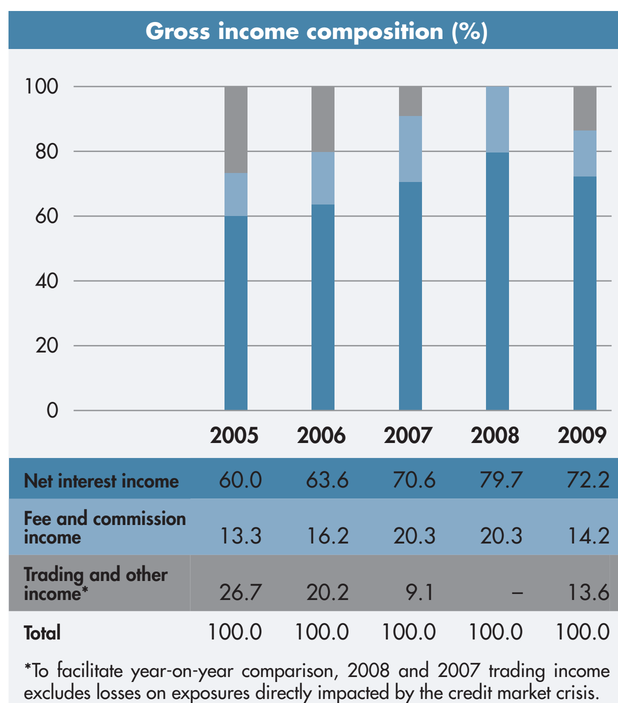
Net interest income at US$206.5 million was US$81.8 million or 28 per cent lower than in the prior year. Net interest income is principally derived from the following sources:-

- margin income on the commercial lending portfolio,
- margin income on the investment securities portfolio,
- money book activities, and
- earnings on the investment of the Group's net free capital.

The year-on-year decrease in net interest income was largely attributable to lower interest earnings derived from the investment securities portfolio as a result of the sale of US$4.8 billion of non-core securities in the first quarter of the year, and also to lower interest earnings on the investment of the net free capital attributable to the reduction in US interest rates to historically low levels.

Despite a US$3.3 billion or 25 per cent managed reduction in the gross loan volume during the year, interest earnings derived from the strategically important GCC commercial lending portfolio were only 4 per cent lower than in the prior year. This was achieved through the restructuring of the loan portfolio and the enhancement of lending margins on both renewed and new credit facilities. A significant increase in loan margins largely offset the impact of the decrease in loan volumes.

Margin income on the investment securities portfolio accounted for 7 per cent of net interest income in 2009. The



	2005	2006	2007	2008	2009
Net interest income	60.0	63.6	70.6	79.7	72.2
Fee and commission income	13.3	16.2	20.3	20.3	14.2
Trading and other income*	26.7	20.2	9.1	–	13.6
Total	100.0	100.0	100.0	100.0	100.0

*To facilitate year-on-year comparison, 2008 and 2007 trading income excludes losses on exposures directly impacted by the credit market crisis.

sale of non-core securities in the first quarter of the year resulted in a significant decrease in interest earnings derived from the investment securities portfolio. As commented on in more detail in the investment securities section of the Financial Review, the investment securities portfolio now represents a liquidity reserve, with a focus on high quality and liquid securities.

Money book earnings represent the differential between the funding cost of interest-bearing assets based on internal transfer pricing methodologies and the actual funding cost incurred by the Bank. This includes benefits derived from the mismatch of the repricing profile of the Group's interest-bearing assets and liabilities. Money book earnings in 2009 were 37 per cent higher than in the prior year reflecting a lower cost of funds compared to 2008. Due to a focus on deposits from counterparties in the GCC and wider Middle East, the increase in costs in the international interbank market associated with the credit market crisis and related liquidity crunch had a relatively limited impact on the Bank's interest earnings in 2009.

Earnings on the investment of the Group's net free capital were 46 per cent lower than in the prior year although nevertheless accounted for almost one fifth of net interest income. The net free capital was largely uninvested during the year with the uninvested funds placed on a short term basis in the money market. This strategy was adopted to protect the Bank from any unanticipated increase in bond yields as a result of expectations of a higher interest rate environment. Earnings on the net free capital were negatively impacted by the significant reduction in short term US interest rates during the early part of the year to historically low levels.

NON-INTEREST INCOME

Non-interest income comprises fee and commission income, trading income, realised profits on investment securities, and other income.

Fee and commission income at US$40.7 million was US$32.6 million or 44 per cent lower than in the prior year. Fee and commission income was nevertheless almost double the level when the GCC-focused merchant banking strategy was adopted in 2002. An analysis of fee and commission income with prior year comparatives is set out in note 22 to the consolidated financial statements. Investment banking and management fees were US$24.6 million for the year, thereby representing 60 per cent of fee and commission income. This income category comprises fees generated by the Group's asset management, fund management, corporate advisory and underwriting activities. A year-on-year decrease reflected the generally lower level of investment banking activity in the prevailing stressed market environment. As referred to in note 34 to the consolidated financial statements, assets held in a fiduciary capacity amounted to US$16.6 billion at 31st December 2009 being 16 per cent up on the 2008 year end level. GIB therefore continues to be the largest Arab-owned commercial asset manager. Commissions on letters of credit and guarantee at US$14.7 million were the second largest source of fee-based income and continued to make an important contribution to fee and commission income. A 36 per cent year-on-year decrease in commissions on letters of credit and guarantee was largely attributable to a decrease in guarantee commissions on GCC-related business activities following a record level of income in 2008.

The Group's various trading activities recorded a US$28.2 million profit compared to an US$86.7 million loss in the previous year. Trading income is reported inclusive of all related income, including interest income, gains and losses arising on the purchase and sale, and from changes in the

fair value of trading securities, dividend income, and interest expense, including all related funding costs. An analysis of trading income is set out in note 23 to the consolidated financial statements. The trading profit in 2009 principally comprised a US$13.0 million profit arising on externally managed funds, primarily investments in alternative investment (hedge) funds, and foreign exchange profits of US$11.2 million. The foreign exchange profits were entirely customer-related. All other trading activities, which were also customer-related, recorded a US$4.0 million profit for the year. All proprietary trading activities were terminated in early 2009 as part of the Bank's derisking initiatives. During the year, the Bank actively reduced its exposure to hedge funds. The Group's hedge funds classified as held-for-trading were reduced from US$152.8 million at the end of 2008 to only US$50.2 million at 31st December 2009. The Bank is continuing to exit its remaining investments in hedge funds at the earliest possible opportunity.

Profits on investment securities amounted to US$1.2 million for the year. The profits principally comprised excess distributions received from private equity fund investments. Prior year profits were exceptional in nature and principally arose on the sale of a strategic private equity investment and on the early redemption of securities in the floating rate debt securities portfolio.

Other income of US$9.4 million principally comprised profits of US$8.3 million arising on the repurchase of the Group's own subordinated debt. The Group repurchased US$39.0 million of a subordinated floating rate note maturing in 2015. The subordinated debt was repurchased at a discount, thereby generating a profit of US$8.3 million. Other income also included profits realised on the sale of premises and equipment, loan recoveries, and dividends received from equity investments.

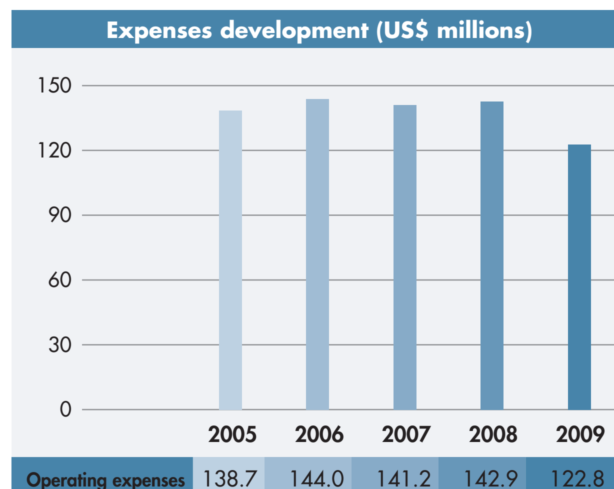
OPERATING EXPENSES

Operating expenses at US$122.8 million were US$20.1 million or 14 per cent down on the prior year. The year-on-year decrease reflected the benefits derived from a cost realignment programme implemented over the course of the year. The programme included a reduction in staffing levels in line with the Bank's current operating model, a migration to uniform IT platforms, and associated operational efficiencies. These initiatives have resulted in total annual cost savings of around US$30 million or 20 per cent. The full extent of the cost savings will be evident in 2010 as the cost realignment programme was implemented in stages during 2009.

Operating expenses in 2009 included exceptional restructuring-related costs of US$7.2 million. Excluding these exceptional restructuring costs, operating expenses were US$27.3 million or 19 per cent down on the prior year.

Staff expenses, which accounted for almost two thirds of total operating expenses, were US$17.8 million or 19 per cent down on the prior year. Staff expenses in 2009 included a one-off, exceptional expense of US$3.7 million relating to the restructuring of the Group's London-based subsidiary, GIBUK. Excluding this exceptional expense, staff expenses were 23 per cent lower than in the prior year. The significant year-on-year decrease was attributable to a reduction in headcount during the year. The Group's total headcount at 31st December 2009 of 437 staff was 124 lower than at the end of 2008. The headcount reduction took place at both Head Office in Bahrain and in GIBUK. The reduced staffing levels were based on a detailed evaluation of resourcing requirements, undertaken in conjunction with external specialist consultants, in the context of the new level of business activities following the deleveraging and derisking initiatives implemented during the year, in addition to the transfer of GIBUK's operational support functions to Head Office in Bahrain, and the migration of GIBUK IT systems to Head Office's core banking system.

Premises expenses were US$1.9 million up on the prior year. The year-on-year increase was attributable to increased



	2005	2006	2007	2008	2009
Operating expenses	138.7	144.0	141.2	142.9	122.8

rent expenses in the Group's overseas offices and one-off refurbishment expenses in its Saudi Arabia offices.

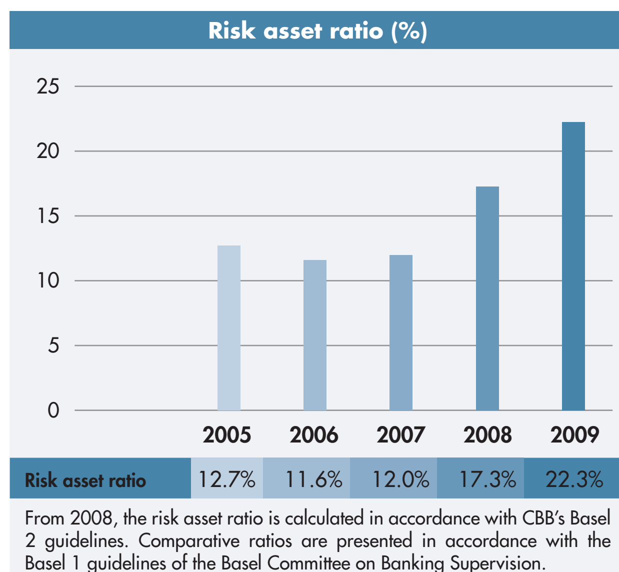
Other operating expenses were US$4.2 million down on the prior year despite the inclusion of US$3.5 million of exceptional restructuring expenses. Reductions were recorded in most expense categories as a result of ongoing cost saving initiatives, although most notably in IT-related expenses as a result of the migration of GIBUK to the Head Office core banking system.

PROVISIONS

In accordance with its traditional conservative policy, the Bank took prudent provisioning actions in relation to exposures that were adversely impacted by the credit market crisis and also in anticipation of the higher level of corporate defaults that are expected in the current challenging economic environment.

In 2009, there was a US$48.0 million release of investment security provisions and a US$361.7 million provision charge for loans and advances.

The investment security provision release principally arose on the release of portfolio-related provisions that were no longer required following the sale of the non-core investment securities in the first quarter of the year. As explained in note 7 to the consolidated financial statements, the securities were sold at amortised cost less specific provisions for impairment. The remaining unrequired non-specific portfolio-related provisions were accordingly released to income.



Risk asset ratio	12.7%	11.6%	12.0%	17.3%	22.3%

From 2008, the risk asset ratio is calculated in accordance with CBB's Basel 2 guidelines. Comparative ratios are presented in accordance with the Basel 1 guidelines of the Basel Committee on Banking Supervision.

The US$361.7 million loan provision charge comprised specific provisions of US$301.7 million and an increase in the non-specific loan provision of US$60.0 million. The specific provision charge largely related to a small number of regional exposures that were impacted by unexpected exceptional circumstances. The potential losses were fully provisioned in 2009. Excluding the specific provisions relating to these exceptional circumstances, the specific provisioning requirements in 2009 were limited.

A further significant addition was made to the non-specific loan provision in line with the Bank's traditionally conservative provisioning policy. As commented on in more detail in the loans and advances section of the Financial Review, the non-specific loan provision is based on historical highest probabilities of default. Higher levels of default are anticipated to result from the impact of the global recession on the regional economic environment. While the Bank's lending activities are primarily focused on providing financing to key infrastructure projects, shareholder-related entities and top tier corporates, it was nevertheless considered prudent to enhance provisions in order to provide a conservative buffer in the current uncertain operating environment.

CAPITAL STRENGTH

Total equity amounted to US$1,779.4 million at 31st December 2009. At the 2009 year end, the ratio of equity and Tier 1 capital to total assets were 11.0 per cent and 11.3 per cent respectively, ratios that are high by international comparison.

A US$146.1 million decrease in total equity during 2009 comprised the net of the US$152.6 million loss for the year, and a US$6.5 million net increase in the fair value of available-for-sale securities and derivative cash flow hedges. In accordance with IAS 39, changes in the fair values of securities classified as available-for-sale, and derivative cash flow hedges are accounted for in equity through the comprehensive statement of income. The net increase in the fair value of available-for-sale securities reflected an improvement in the market environment and a contraction in credit spreads resulting in an improvement in the fair value of the investment securities portfolio. The unrealised revaluation loss on investment securities at the 2009 year end was US$64.5 million, representing only 3 per cent of the total value of the securities portfolio. The relatively small

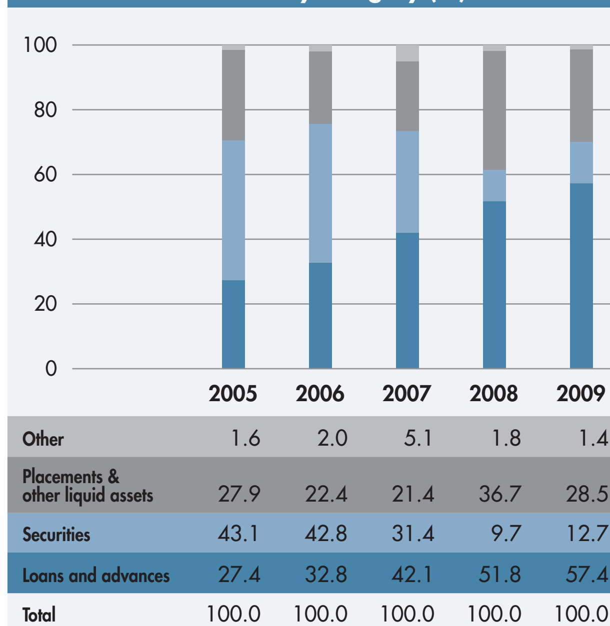
unrealised revaluation loss reflected the high quality of the remaining securities portfolio following the sale of the non-core securities in the first quarter of the year. The remaining investment securities principally comprise investment grade-rated debt securities issued by major international financial institutions and government-related entities.

With a total regulatory capital base of US$2,488.9 million and total risk-weighted exposure of US$11,149.4 million, the risk asset ratio calculated in accordance with the Central Bank of Bahrain's Basel 2 guidelines was 22.3 per cent while the Tier 1 ratio was a particularly strong 16.4 per cent. In accordance with international regulatory guidelines, the fair value adjustments to equity arising under IAS 39 in relation to available-for-sale securities and derivative cash flow hedges are excluded from the regulatory capital base, with the exception of unrealised gains and losses on equity investments. As a result, at the 2009 year end net fair value losses of US$53.4 million were added back to equity to derive the regulatory capital base for capital adequacy purposes. The Bank's regulatory capital base is enhanced by subordinated term financing facilities amounting in total to US$511.0 million. The subordinated term financing facilities are approved for inclusion in Tier 2 capital for capital adequacy purposes by the Bank's regulator, the Central Bank of Bahrain (CBB).

The risk asset ratio incorporates both market and operational risk-weighted exposures. The Basel 2 Pillar 3 report set out in a later section of the Annual Report provides further details on capital adequacy and the Bank's capital management framework. The Group's policies in relation to capital management are set out in note 26 to the consolidated financial statements. As described in more detail in the note, the Group's policy is to maintain a strong capital base so as to maintain investor, counterparty and market confidence and to sustain the future development of the Group's business.

ASSET QUALITY

The geographical distribution of risk assets is set out in note 27 to the consolidated financial statements. The credit risk profile of financial assets, based on internal credit ratings, is set out in note 26(a) to the consolidated financial statements. This note demonstrates that 78 per cent of all financial assets, comprising placements, securities and loans, were rated 4- or above, i.e. the equivalent of investment grade-rated.



	2005	2006	2007	2008	2009
Other	1.6	2.0	5.1	1.8	1.4
Placements & other liquid assets	27.9	22.4	21.4	36.7	28.5
Securities	43.1	42.8	31.4	9.7	12.7
Loans and advances	27.4	32.8	42.1	51.8	57.4
Total	100.0	100.0	100.0	100.0	100.0

Further assessment of asset quality can be facilitated by reference to note 36 to the consolidated financial statements on the fair value of financial instruments. Based on the valuation methodologies set out in that note, the net fair values of all on- and off-balance sheet financial instruments at 31st December 2009 were not significantly different to their carrying amounts. All non-trading securities are classified as available-for-sale and measured at fair value. Investment securities are accordingly stated at fair value in the consolidated balance sheet.

At the 2009 year end, placements and investment securities accounted for 28 per cent and 12 per cent of total assets respectively while loans and advances represented 57 per cent.

Investment Securities

Investment securities totalled US$2,018.1 million at 31st December 2009. The investment securities portfolio, which is entirely classified as available-for-sale, principally comprised investment grade-rated debt securities issued by major international financial institutions and government-related entities.

An analysis of the basis used for determining the fair values of investment securities is set out in note 36 to the consolidated financial statements. At 31st December 2009,

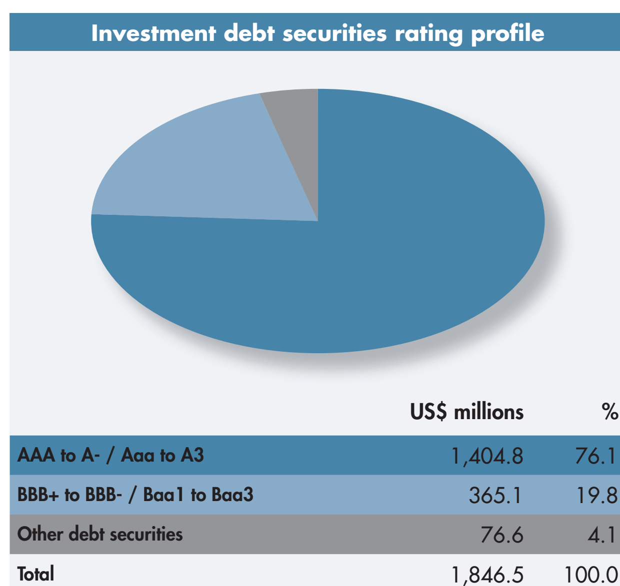
US$1,868.0 million or 99 per cent of investment securities that were valued at fair value, were valued based on quoted prices while US$125.2 million was valued based on cost less provisions for impairment. Only US$24.9 million was based on other valuation techniques. This represented private equity fund investments for which the fair values were based on the net asset values of the funds. No fair values of available-for-sale securities were derived from modelled-based valuation methodologies.

Investment securities comprise two types of debt security portfolios and a limited investment in equities and equity funds. The larger debt security portfolio comprises floating rate securities or fixed rate securities that have been swapped to yield constant spreads over LIBOR. These accounted for 84 per cent of the total investment securities portfolio at the 2009 year end. The smaller debt security portfolio comprises fixed income securities. This portfolio amounted to US$151.5 million at the end of 2009. This largely comprised GCC government-related bonds.

Equity investments at the end of 2009 amounted to US$171.6 million and largely comprised private equity-related investments.

An analysis of the investment securities portfolio by rating category is set out in note 9(a) to the consolidated financial statements. US$1,404.8 million or 76 per cent of the debt securities at the 2009 year end were rated A- or above. Based on the rating of the issuer, a further US$365.1 million or 20 per cent of the debt securities represented other investment grade-rated securities. Thus 96 per cent of the total debt securities comprised investment grade-rated securities.

Investment debt securities rating profile



	US$ millions	%
AAA to A- / Aaa to A3	1,404.8	76.1
BBB+ to BBB- / Baa1 to Baa3	365.1	19.8
Other debt securities	76.6	4.1
Total	1,846.5	100.0

Other debt securities, the issuers of which are rated below BBB- / Baa3 or are unrated, amounted to US$76.6 million at the end of 2009, thus comprising only 4 per cent of the total investment debt securities portfolio. These largely comprised securities issued by unrated GCC entities.

There were no past due securities at 31st December 2009. During the year, the Group's investments in structured investment vehicles (SIVs) were written off against the related specific provisions. The SIVs were fully provisioned and accordingly no incremental losses arose as a result of the write offs.

Impaired investment securities, representing securities against which a specific provision is maintained, amounted to only US$84.1 million at 31st December 2009. They principally comprised investments in managed funds that are closed to redemption for the foreseeable future, and private equity investments. The total specific provisions for impairment at 31st December 2009, amounting to US$67.2 million, represented 80 per cent of the gross impaired investment securities. The Group also held non-specific portfolio provisions of US$30.3 million at the 2009 year end.

Loans and Advances

Loans and advances amounted to US$9,298.1million at the 2009 year end. This represented a US$3,674.0 million or 28 per cent decrease compared to the 2008 year end. 95 per cent of the loan portfolio at the 2009 year end represented lending within GIB's core market in the GCC states.

Based on contractual maturities at the balance sheet date, 39 per cent of the loan portfolio was due to mature within one year while 64 per cent was due to mature within three years. Only 24 per cent of loans were due to mature beyond five years. Details of the classification of loans and advances by industry are set out in note 10(a) to the consolidated financial statements while the geographical distribution of loans and advances is contained in note 27. At 31st December 2009, 32 per cent of the loan portfolio comprised exposure to the energy, oil and petrochemical sector. This reflects the Group's strategic focus on project finance and syndicated lending in the GCC states.

The credit risk profile of loans and advances, based

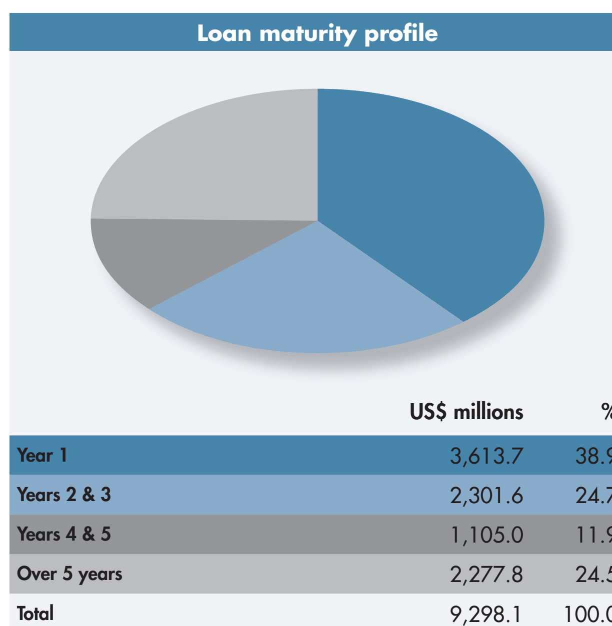
on internal credit ratings, is set out in note 26(a) to the consolidated financial statements. US$6,132.8 million or 66 per cent of total loans were rated 4- or above, i.e. the equivalent of investment grade-rated. Only US$410.0 million or 4 per cent of loans and advances were classified as individually impaired. Individually impaired loans represent loans for which there is objective evidence that the Group will not collect all amounts due in accordance with the contractual terms of the obligation. Therefore, 96 per cent of loans and advances were not individually impaired.

Total loan loss provisions at 31st December 2009 amounted to US$634.1 million. Counterparty specific provisions amounted to US$394.1 million while non-specific provisions were US$240.0 million. Total specific provisions of US$394.1 million exceeded the gross book value of unsecured past due loans by US$29.9 million. Specific provisions were therefore maintained against loans that were not past due in respect of either principal or interest. In addition, total provisions of US$634.1 million significantly exceeded the gross book value of unsecured past due loans by US$269.9 million, thereby providing a substantial buffer to accommodate any additional past due loans that may arise.

Specific provisions are determined based on the recoverable amount of the loan. The recoverable amount is measured as the present value of the expected future cash flows discounted based on the interest rate at the inception of the facility. Non-specific provisions are determined on a portfolio basis utilising an incurred loss model. The incurred loss model estimates the probable losses inherent within the portfolio at the balance sheet date but that have not been specifically identified. The model is based on applicable credit ratings and associated historical default probabilities, loss severity and rating migrations, and reflects the current macroeconomic, political and business environment and other pertinent indicators.

There was a US$60.0 million increase in non-specific loan provisions during 2009 to US$240.0 million at the 2009 year end. The increase in the non-specific provision was based on the expected probabilities of default used in the calculation of provisions for impairment measured on a collective basis. Higher levels 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 non-specific provisions at 31st December 2009 equated to a speculative-grade default rate of 13.9 per cent, exceeding the previous highest corporate default rates witnessed in July 1991. The default rates applied in the calculation of the non-specific loan provision and the resultant provisioning levels for senior, unsecured exposure by internal rating category were as follows:-

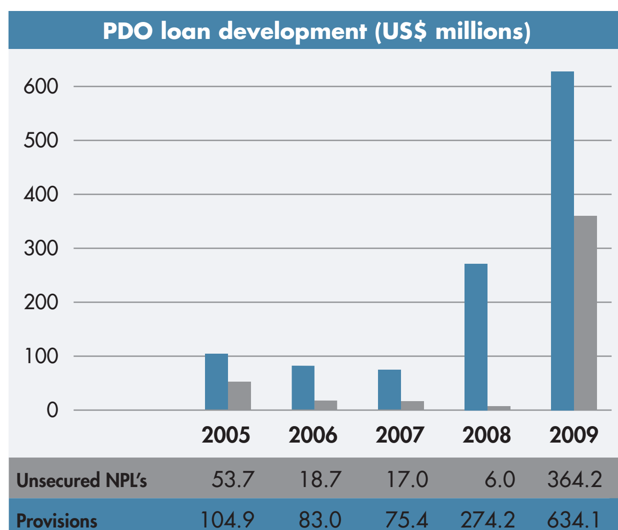
Loan maturity profile



	US$ millions	%
Year 1	3,613.7	38.9
Years 2 & 3	2,301.6	24.7
Years 4 & 5	1,105.0	11.9
Over 5 years	2,277.8	24.5
Total	9,298.1	100.0

Internal rating grade	Probability of default (PDs)	Senior, unsecured provisioning level
1	0.03%	-
2+	0.03%	-
2	0.03%	-
2-	0.06%	-
3+	0.18%	0.1%
3	0.34%	0.2%
3-	0.36%	0.2%
4+	1.02%	0.7%
4	1.05%	0.7%
4-	1.29%	0.8%
5+	2.25%	1.5%
5	3.48%	2.3%
5-	6.21%	4.0%
6+	9.87%	6.4%
6	27.93%	18.2%
6-	39.45%	25.6%
7	83.61%	54.3%

The provisioning level is based on a Loss Given Default (LGD) of 65 per cent for senior, unsecured exposure.



	2005	2006	2007	2008	2009
Unsecured NPL's	53.7	18.7	17.0	6.0	364.2
Provisions	104.9	83.0	75.4	274.2	634.1

For the purpose of the calculation of the non-specific provision, the Bank only takes account of collateral held in the form of cash. While collateral in the form of securities, listed equities and physical assets is used for risk mitigation and protection purposes, it is not taken into account in the calculation of the non-specific provision.

The gross and net book values of unsecured past due loans amounted to US$364.2 million and US$91.2 million respectively. The provisioning coverage for unsecured past due loans was therefore 75 per cent. Past due loans are defined as those loans for which either principal or interest is over 90 days past due. Under IAS 39, interest on impaired loans should be recognised in income based on the net book value of the loan and the interest rate that was used to discount the future cash flows for the purpose of measuring the recoverable amount. However, in accordance with guidelines issued by the Bank's regulator, the CBB, interest on past due loans is only to be recognised in income on a cash basis. In view of the Group's high provisioning coverage for impaired loans, the difference between the two bases of accounting is not material. The gross volume of past due loans also continued to be substantially less than total provisions. Total provisions for loan losses exceeded the gross volume of past due loans by US$269.9 million. This means that rather than earnings being impaired by the funding cost of the net book value of past due loans, there is an earnings enhancement.

Other Asset Categories

Cash and other liquid assets, which amounted to US$508.2 million at the 2009 year end, are analysed in note 5 to the consolidated financial statements. They principally comprised cash and balances with banks, and certificates of deposits held for liquidity management purposes.

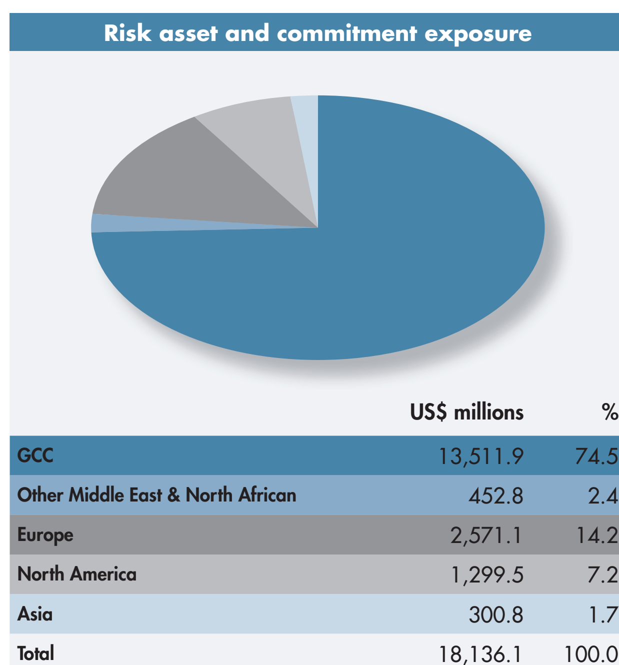
Placements with banks totalled US$4,101.1 million at the 2009 year end and were well diversified by geography as illustrated in note 27 to the consolidated financial statements. Interbank placements were largely with GCC and European bank counterparties, representing the Group's two principal operating locations. Placements with banks represented 25 per cent of total assets at the 2009 year end. A high level of placements is being maintained in the current uncertain and volatile market environment.

Trading securities at US$50.2 million comprised investments in hedge funds. During 2009, the Bank's investments in hedge funds were reduced from US$207 million at the end of 2008 to US$50 million at the 2009 year end. The Bank is continuing to reduce its investments in hedge funds with the intention of fully exiting the investments at the earliest possible opportunity.

Risk Asset and Commitment Exposure

Risk asset and commitment exposure at 31st December 2009 amounted to US$18,136.1 million. Risk assets and commitments comprise all assets included in the balance sheet (with the exception of other assets) and credit-related contingent items. As referred to earlier, an analysis of risk asset and commitment exposure by category and geography is contained in note 27 to the consolidated financial statements. As is evident from this note, US$13,511.9 million or 75 per cent of total risk assets and commitments represented exposure to counterparties and entities located in the GCC states. The remaining risk asset exposure largely represented short term interbank placements with major European banks. An analysis of derivative and foreign exchange products is set out in note 30 while a further analysis of credit-related contingent items together with their risk-weighted equivalents is contained in note 31.

Risk asset and commitment exposure



	US$ millions	%
GCC	13,511.9	74.5
Other Middle East & North African	452.8	2.4
Europe	2,571.1	14.2
North America	1,299.5	7.2
Asia	300.8	1.7
Total	18,136.1	100.0

FUNDING

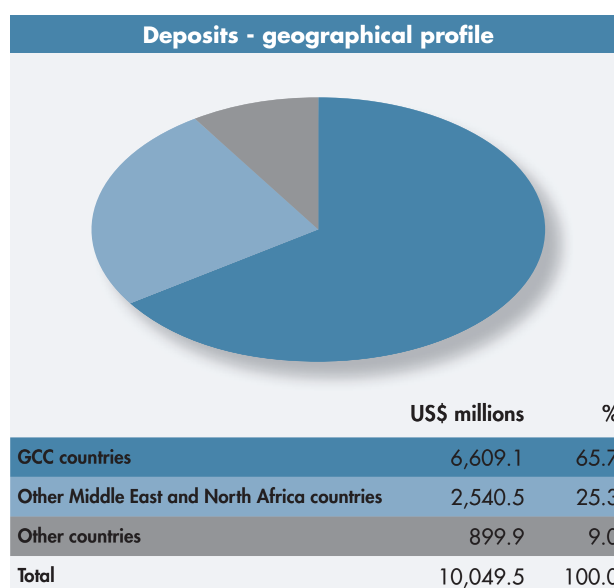
Bank and customer deposits at 31st December 2009 totalled US$10,049.5 million. Customer deposits amounted to US$7,495.3 million at the 2009 year end, representing 75 per cent of total deposits. A lower funding requirement resulting from the deleveraging initiatives implemented during 2009, including the sale of the non-core investment securities and the reduction in the loan portfolio, contributed to a significant reduction in the Bank's funding requirements and a resultant decrease in both customer and bank deposits. Bank deposits at 31st December 2009 amounted to US$2,554.2 million, representing only 25 per cent of total deposits.

Total deposits are analysed by geography in note 13 to the consolidated financial statements. US$6,609.1 million or 66 per cent of total deposits were derived from counterparties in GCC countries while a further US$2,540.5 million or 25 per cent were derived from the wider Middle East and North Africa. Deposits derived from other countries, principally Europe, amounted to US$899.9 million or only 9 per cent of total deposits. This compares to placements with non-GCC counterparties of US$2,856.6 million. The Group is therefore a net placer of funds in the international interbank market, and accordingly has no net reliance on the international interbank market. This helped to protect the Bank during the unprecedented liquidity squeeze and associated drying up of liquidity in the interbank market witnessed in the latter part of 2008 and early part of 2009.

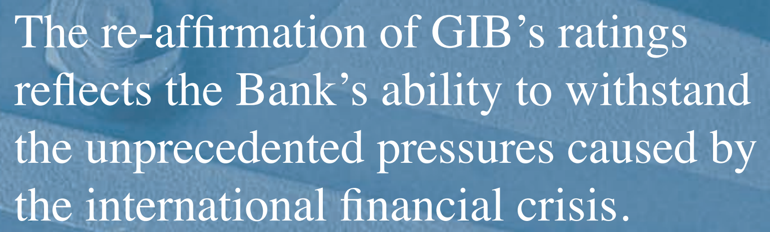
Securities sold under agreements to repurchase (repos) were US$565.0 million at 31st December 2009. A significant decrease in repos during 2009 was attributable to the sale of the non-core investment securities. The Bank continues to utilise its remaining high quality and highly rated investment securities to raise funding on a collateralised basis which were effective from a cost and tenor perspective.

Senior term financing at 31st December 2009 totalled US$3,007.9 million. New senior term finance of US$883.3 million was raised in the second half of 2009, including a groundbreaking SAR 2 billion 3 year bond issue. The new term finance was raised in 2009 in advance of maturities in 2010, amounting in total to US$864.6 million. US$1,783.3 million, or well over half, of the Group's senior term financing is not due to mature until 2012. Further commentary on liquidity and funding is provided in the Basel 2 Pillar 3 report.

Deposits - geographical profile



	US$ millions	%
GCC countries	6,609.1	65.7
Other Middle East and North Africa countries	2,540.5	25.3
Other countries	899.9	9.0
Total	10,049.5	100.0



The re-affirmation of GIB's ratings reflects the Bank's ability to withstand the unprecedented pressures caused by the international financial crisis.

Corporate Governance

SOUND GOVERNANCE

Headquartered in the Kingdom of Bahrain, and registered as a conventional wholesale bank by the Central Bank of Bahrain (CBB), GIB has long recognised the importance of sound corporate governance as a critical factor in attaining fairness for all stakeholders, and achieving organisational integrity and efficiency.

Since 2003, GIB has progressively adopted and implemented standards of corporate governance relevant to publicly-traded financial institutions, and has published a statement on corporate governance in its Annual Report. The Board of Directors and Management of GIB are fully committed to complying with established corporate governance best practices.

GIB has in place the necessary infrastructure and controls to comply with the requirements of the rules and regulations of the CBB. In addition, as an international financial institution, the Bank has implemented the additional practices required to comply with the requirements of the regulatory and supervisory authorities in the various jurisdictions where it operates.

During 2009, GIB continued to strengthen its corporate governance framework and introduced new initiatives aimed at promoting enhanced corporate governance practices, with particular emphasis on increasing the awareness and understanding of Directors, management and staff on this important topic.

In addition, a number of steps were taken to further strengthen GIB's corporate governance framework, ranging from self-assessments to ensure compliance with the requirements of the CBB on corporate governance, to specific milestones such as the implementation of GIB's Disclosure Policy in accordance with Basel 2 Pillar 3 requirements. This reflects the Bank's commitment to enhancing transparency, and fairness in the disclosure of financial information, for the benefit of all users of that information, including regulators, customers, counterparties, rating agencies and other stakeholders.

KEY DEVELOPMENTS IN 2009

- Change in shareholding structure
- New Chief Executive Officer appointed
- Newly constituted Board of Directors
- New Board Executive Committee established
- Letters of Appointment & Guidelines issued to new Directors and new CEO
- Updated Corporate Policy Manual approved by the Board
- Annual 'Compliance Message' to all staff issued by the CEO
- All departments of the Bank now produce a quarterly self-assessment report on Compliance with CBB rules
- Adoption of new automated Institutional Information System
- New Compliance Manager & MLRO appointed for Saudi Arabia
- Compliance awareness programmes for staff conducted throughout the GCC
- 105 staff attended AML/CFT training courses, and 63 additional staff completed online AML/CFT training
- Senior management attended special AML/CFT awareness workshop
- Sponsored 2009 GCC Regulators Summit in Dubai

ORGANISATION

The Bank has a corporate governance structure in place that segregates functions and responsibilities, reflecting the necessary division of roles and responsibilities between the Board of Directors and management:

- There is an effective and appropriately constituted Board of Directors responsible for the stewardship of the Bank and the supervision of the Bank's business, which receives from management the information required to properly fulfill its duties and the duties of the Committees that assist it, and which delegates to management the authority and responsibility for managing the day-to-day business of the Bank.

- There is an effective and appropriately organised management structure responsible for the day-to-day management of the Bank and the implementation of Board-approved strategy, policies and internal controls.
- There is a clear division of roles and responsibilities between the Board of Directors and management, and between the Chairman and the Chief Executive Officer.
- There are defined and documented mandates and responsibilities (as well as delegated authorities, where applicable) for:
    - The Board of Directors
    - The Chairman of the Board
    - The Board Committees
    - The Management
    - The Chief Executive Officer
    - The Management Committees

The Bank's corporate governance structure and organisation chart is set out on page 121 of this Annual Report.

SHAREHOLDERS

In 2009, changes took place in the shareholding of GIB both in terms of actual shareholders and in shareholding percentages.

The current shareholding structure is as follows (as of January 2010):

Public Investment Fund, Saudi Arabia	97.226%
Kuwait Investment Authority, Kuwait	0.730%
Qatar Holding Company, Qatar	0.730%
Bahrain Mumtalakat Holding Company, Bahrain	0.438%
Ministry of Finance, Oman	0.438%
Ministry of Finance, United Arab Emirates	0.438%

BOARD OF DIRECTORS

In accordance with the Bank's Articles of Association, Directors are appointed by the Bank's shareholders.

The Board comprises seven non-executive directors, including the Chairman and Vice-Chairman, who together bring a wide range of skills and experience to the Board. Their biographies are set out on page 122 of this Annual Report.

Independence of Directors

In December 2009, the Board of Directors of the Bank approved a detailed criteria to determine whether a director should be classified as independent or non-independent; such criteria sets out a number of factors which would prevent a director from being classified as independent; directors prevented from being classified as independent by the criteria are automatically classified as being non-independent, and all other directors are automatically classified as being independent. The Central Bank of Bahrain has established rules relating to when directors of entities such as the Bank can be classified as independent and the criteria approved by the Board of Directors is consistent with such rules or is more restrictive. The approved criteria includes a materiality threshold relative to payments to a director and various related parties that would preclude such directors from being classified as being independent. As at 31st December 2009, only two directors of the Bank are classified as non-independent in accordance with the approved criteria, and all the other directors of the Bank are classified as independent (*see chart on page 27*).

Board Responsibilities

The Board is responsible for the strategic direction of the Bank; maintaining an appropriate organisation structure; approving major policies; monitoring business performance, operations and the integrity of internal controls; nurturing proper and ethical behaviour; providing appropriate oversight; and conducting corporate governance in a transparent manner.

The Board performs its responsibilities as a supervisory board while delegating to the Bank's management the responsibility for the management of the Bank within policies, guidelines and parameters set by the Board.

In fulfilment of the requirements of the corporate governance rules of the CBB, Letters of Appointment were issued in 2009 by the Chairman to the newly-appointed directors:

- First, reminding them that directors are responsible for contributing to the oversight of the Bank's affairs with professionalism and integrity, with the aim of achieving the strategic and financial objectives adopted by the Board;

- Second, pointing out that a key responsibility of the Board is to fill the gap between stakeholders (shareholders, creditors, employees, depositors, investment account holders, etc.) to whom the Board owes a duty of care, and executive management, by monitoring management closely on behalf of stakeholders; and
- Third, drawing attention to the fact that a detailed description of directors' responsibilities is outlined in the Mandate of the Board and in the Mandate of Directors, as adopted by the Board; and that these responsibilities are to be carried out in line with the standards of the Code of Conduct adopted by the Board.

In preparation for Board and Committee meetings, the directors receive in a timely manner regular reports and all other information required for such meetings, supplemented by any additional information specifically requested by the directors from time to time. The directors also receive monthly financial reports and other regular management reports that enable them to evaluate the Bank's and management's performance against agreed objectives. As prescribed in the Bank's Articles of Association, the Board plans at least four meetings per year, with further meetings to occur at the discretion of the Board.

The details of committee membership and directors' attendance in 2009 are set out in the following two tables (*Table 1 covers the period January to August 2009 for the then-existing Board, and Table 2 covers the period August to December 2009 for the newly constituted Board*).

TABLE 1 - DIRECTORS' ATTENDANCE JANUARY TO AUGUST 2009

Board Members	Board Meetings	Audit Committee Meetings	HR & Compensation Committee Meetings	Risk Policy Committee Meetings
H.E. Mr. Jammaz Abdulla Al-Suhaimi – Chairman *(Saudi Arabian Monetary Agency)*	**6 (6)**			
Mr. Abdul Aziz M. Al-Abdulkader – Vice Chairman *(Saudi Arabian Monetary Agency)*	**6 (6)**			
H.E. Dr. Hamad Sulaiman Al-Bazai *(Public Investment Fund, KSA)*	**6 (6)**	**5 (5) ***		
Mr. Saud Nassir Al-Shukaily *(Ministry of Finance, Oman)*	**5 (6)**	**3 (5)**		**3 (3)**
Mr. Khalid Abdulla Al-Sowaidi *(Qatar Investment Authority)*	**6 (6)**			**3 (3)**
Mr. Nasser Khamis Al-Suwaidi *(Ministry of Finance, United Arab Emirates)*	**6 (6)**	**5 (5)**		
Dr. Khalid Abdulla Al-Sweilem *(Saudi Arabian Monetary Agency)*	**6 (6)**	**5 (5)**		**3 (3) ***
H.E. Dr. Abdul Rahman Ahmed Al-Jafary *(Saudi Arabian Monetary Agency)*	**5 (6)**			
Mr. Ahmed Tahous Al-Rashed Al-Tahous *(Kuwait Investment Authority)*	**5 (6)**	**4 (5)**		**2 (3)**
Mr. Khalil Ebrahim Nooruddin *(Bahrain Mumtalakat Holding Co., Bahrain)*	**6 (6)**			**3 (3)**

TABLE 2 - DIRECTORS' ATTENDANCE SEPTEMBER TO DECEMBER 2009

Board Members	Board Meetings	Audit Committee Meetings	HR & Compensation Committee Meetings	Risk Policy Committee Meetings	Executive Committee Meetings	Executive/ Non-Executive	Independent/ Non-Independent
H.E. Mr. Jammaz Abdulla Al-Suhaimi Chairman	**1 (3)**					**Non-Executive**	**Independent**
Mr. Mansour Saleh Al-Maiman Vice Chairman	**3 (3)**					**Non-Executive**	**Non-Independent**
H.E. Dr. Hamad Sulaiman Al-Bazai	**3 (3)**			**1 (1) ***		**Non-Executive**	**Non-Independent**
Dr. Abdullah Hassan Al-Abdul-Gader	**3 (3)**	**2 (2) ***				**Non-Executive**	**Independent**
Mr. Sulaiman Abdullah Al-Hamdan	**3 (3)**			**1 (1)**		**Non-Executive**	**Independent**
Mr. Abdulla Mohammed Al Zamil	**3 (3)**	**2 (2)**		**1 (1)**		**Non-Executive**	**Independent**
Mr. Khaled Saleh Al-Mudaifer	**3 (3)**	**2 (2)**				**Non-Executive**	**Independent**

** Committee Chairman*

Figures in brackets indicate maximum number of meetings during the period of membership

BOARD COMMITTEES

The Committees of the Board of Directors derive their authorities and powers from the Board. Details of Board Committee membership and attendance are listed on pages 26 and 27 of this Annual Report.

Board Committees	Member Name	Member Position
Executive Committee	Mr. Jammaz Al-Suhaimi	Chairman
	Mr. Mansour Al Maiman	Member
	Dr. Hamad Al-Bazai	Member
	Mr. Sulaiman Al-Hamdan	Member
Audit Committee	Dr. Abdullah Al-Abdul-Gader	Chairman
	Mr. Abdulla Al Zamil	Member
	Mr. Khaled Al-Mudaifer	Member
HR & Compensation Committee	Mr. Mansour Al Maiman	Chairman
	Dr. Abdullah Al-Abdul-Gader	Member
	Mr. Khaled Al-Mudaifer	Member
Risk Policy Committee	Dr. Hamad Al-Bazai	Chairman
	Mr. Abdulla Al Zamil	Member
	Mr. Sulaiman Al-Hamdan	Member

Executive Committee

In September 2009, the newly-constituted Board of Directors decided to establish a new Executive Committee. Details of the mandate of this committee are pending final review and approval by the Board.

Audit Committee

The mandate of the Audit Committee requires it to:

- Assist the Board in fulfilling its statutory and fiduciary responsibilities with respect to internal controls, accounting policies, auditing and financial reporting practices.
- Assist the Board in its oversight of (i) the integrity and reporting of the Bank's quarterly and annual financial statements, (ii) compliance with legal and regulatory requirements; and (iii) the independence and performance of the Bank's internal and external auditors.
- Review the activities and performance of the internal audit function.

The mandate of the Audit Committee provides further particulars on financial reporting processes, process improvements, as well as additional ethical and legal compliance overview responsibilities.

The Group Chief Auditor reports functionally to the Audit Committee, and administratively to the Chief Executive Officer.

Human Resources and Compensation Committee

The mandate of the Human Resources and Compensation Committee requires it to:

- Assist the Board in fulfilling its responsibilities for the Bank's human resources and remuneration policies.
- Review the Bank's human resources and compensation policy proposals, and make the necessary recommendations in that regard for approval by the Board.
- Ensure that the Bank's remuneration levels remain competitive for the Bank to continue to attract, retain and motivate competent staff to achieve the strategy and objectives of the Bank.
- Monitor the overall cost of remuneration structures of the Bank.
- Ensure that effective management systems are in place to monitor and evaluate the performance of staff.
- Review the Bank's succession plan report for submission to the regulators.

Risk Policy Committee

The mandate of the Risk Policy Committee requires it to:

- Assist the Board in fulfilling its oversight responsibilities with respect to setting the Bank's overall risk appetite, parameters and limits within which it conducts its activities.
- Ensure that the Bank has an effective risk management framework in place and that all risk controls operating throughout the Bank are in accordance with regulatory requirements and best practice standards for management of risks in banks.
- Ensure that realistic policies with respect to management of all significant risks are drafted and approved appropriately.
- Review the Bank's risk profile and significant risk positions.
- Approve with management the overall credit risk policy limits.
- Receive, review, challenge and recommend for approval, by the full Board, any proposed amendments to the overall risk appetite for the Bank.
- Ensure that roles and responsibilities for risk management are clearly defined, and that they remain independent of business development.
- Ensure that, on a timely basis, management informs the Committee of all significant risks arising and that it is comfortable with management's responses and actions taken to address such findings.
- Ensure that management reports significant excesses and exceptions, as and when they arise, to the Committee for information and review.
- Monitor whether management maintains a culture that rewards the recognition, communication and management of risks.

MANAGEMENT

The Senior Management team, which is responsible for the day-to-day management of the Bank entrusted to it by the Board, is headed by the Chief Executive Officer, who is assisted by the Chief Financial Officer, the Chief Investment & Treasury Officer, the Head of Risk Management, the Managing Director Merchant Banking, and the Managing Director Operations & Administration. Their biographies are set out on page 123 of this Annual Report.

Dr. Yahya A. Alyahya officially assumed his duties as Chief Executive Officer on 1st January 2009.

Six committees assist the Chief Executive Officer in the management of the Bank:

- Management Committee
- Group Risk Committee
- Assets and Liabilities Committee (ALCO)
- Information Technology Steering Committee
- Information Security Management Committee
- Operational Risk Committee

These committees derive their authorities from the Chief Executive Officer, based on the authorities and limits delegated by the Board of Directors.

In fulfilling its principal responsibility for the day-to-day management of the Bank, the Senior Management team is required to implement Board-approved policies and effective controls, within the strategy and objectives set by the Board.

Letters of Appointment are issued by the Chairman to members of the Senior Management team setting out their specific responsibilities and accountabilities that include assisting with and contributing to the following:

- Formulation of the Bank's strategic objectives and direction.
- Formulation of the Bank's annual budget and business plan.
- Ensuring that high-level policies are in place for all areas and that such policies are fully applied.
- Setting and managing of risk/return targets in line with the Bank's overall risk appetite.
- Determining the Bank's overall risk-based performance measurement standards.
- Reviewing business units' performance and initiating appropriate action.
- Ensuring that the Bank operates to the highest ethical standards, and complies with both the letter and spirit of the law, applicable regulations and codes of conduct.
- Ensuring that the Bank is an exemplar of good business practice and customer service.

Their attention is also drawn to the fact that these obligations are in addition to their specific functional responsibilities and objectives, and those set out in the Bank's Corporate Policy Manual.

STAFF COMPENSATION

In line with industry best practice, and in consultation with external independent remuneration consultants, GIB has established a comprehensive staff compensation policy based on total compensation.

The scheme consists of the following for all staff except the CEO:

- A fixed component representing basic pay, allowances and benefits, which are reviewed and compared annually with market levels, based on an independent market survey and adjusted as appropriate.
- A variable component representing a performance-related award linked to the performance of the Bank, the contribution of the relevant unit and the individual's personal performance. The scheme is based on defined quantitative as well as qualitative measures.
- Based on established criteria, the performance bonus of the Managing Directors is recommended by the CEO for review and endorsement by the Board's Human Resources and Compensation Committee, subject to Board approval.
- Annually, the Human Resources and Compensation Committee reviews management proposals with regard to long term retention incentives, and makes necessary recommendations for Board approval.

CEO COMPENSATION

- The CEO is appointed by the Board of Directors for a term of three years. Renewal is considered prior to the expiration of each term.
- The fixed compensation components are negotiated and determined at time of renewal, with the assistance and input from independent external compensation evaluation experts.
- The performance bonus of the CEO is recommended by the Board's Human Resources and Compensation Committee, and approved by the Board based on the established scheme mechanism approved by the Board.

BOARD OF DIRECTORS COMPENSATION

To assist with establishing the appropriate structure and level of compensation, independent external consultants are involved to advise on market practice and provide suggestions. Generally, the compensation is linked to actual attendance of meetings.

The structure and level of compensation for members of the Board of Directors are approved by the AGM and consist of the following:

- Attendance fees payable to members attending different Board and related Committees' meetings.
- Allowance to cover travelling, accommodation and subsistence, while attending Board and related Committees' meetings.
- A pre-defined fixed amount representing an annual remuneration fee.

STRATEGY & OBJECTIVES

After having conducted a thorough analysis of its operations in the context of the regional and global industry in 2002, the Bank implemented improvements to its governance structure, organisational structure, business model and performance framework, and started to put into effect its new objective, best summarised as follows: *To become the GCC merchant bank of choice, with market leadership in a diversified portfolio of activities*.

Within that objective, every year the Board of Directors reassesses and approves a detailed strategic plan that covers the planned activities of the Bank for the next three years, in light of changing global and regional market conditions.

Given the impact of the global financial crisis and economic downturn during 2009, the Board has appointed the Boston Consulting Group to assist the Board and management in developing a new appropriate business model and a strategy to achieve it. This is expected to be approved and announced during the first half of 2010.

COMPLIANCE

The Board has adopted a Compliance framework that reflects the principles for promoting sound compliance practices at GIB, which demonstrates the Bank's adherence to applicable legal and regulatory requirements and to high professional standards. The role of the Compliance function is to assist senior management to ensure that the activities of GIB and its staff are conducted in conformity with applicable laws and regulations, and generally with sound practices pertinent to those activities. The Head of Compliance (Bahrain), who reports directly to the Chief Executive Officer, also has access to the Board of Directors through the Audit Committee if required.

In ensuring that the tone emanates from the top, the Chief Executive Officer issues a yearly message to all of GIB reminding everyone of the importance of complying with all laws and regulations applicable to GIB's operations, and good compliance behaviour is rewarded by making it a mandatory measurement item in staff evaluations.

ANTI-MONEY LAUNDERING

The Bank's current anti-money laundering and combating the financing of terrorism (AML/CFT) procedures and guidelines conform to the legal and regulatory requirements of the Kingdom of Bahrain. These legal and regulatory requirements reflect the FATF recommendations on Money Laundering and special recommendations on Terrorist Financing.

The GIB AML/CFT procedures and guidelines apply to all of the Bank's offices, branches and subsidiaries (collectively "GIB entities"), wherever located. In addition, the GIB entities located outside Bahrain are subject to the laws and requirements of the jurisdictions where they operate, and if local standards differ, the higher standards apply.

Systems are in place to ensure that business relationships are commenced with clients whose identity and activities can reasonably be established to be legitimate, to collect and record all relevant client information, to monitor and report suspicious transactions, to provide periodic AML/CFT training to employees, and to review with external auditors the effectiveness of the AML/CFT procedures and controls.

A proactive structure of officers is in place to ensure group-wide compliance with AML/CFT procedures, and the timely update of the same to reflect the changes in regulatory requirements. This structure consists of the Head of Compliance (Bahrain) and Group Money Laundering Reporting Officer, Compliance Officers, MLROs, and Deputy MLROs.

CORPORATE COMMUNICATIONS

The Bank has in place a Corporate Communications policy in line with the requirements of the Central Bank of Bahrain, to ensure that the disclosures made by the Bank are fair, transparent, comprehensive and timely, and reflect the character of the Bank and the nature, complexity and risks inherent in its business activities. Main communications channels include an Annual Report, corporate brochure, newsletter, and announcements in the appropriate media.

This transparency is also reflected in the Bank's website (www.gibonline.com) that provides substantial information on the Bank, including its profile and milestones; its vision, mission, strategy and objectives; its Code of Conduct; its financial statements; and its press releases.

DISCLOSURES

The Bank's website also provides access to GIB's Annual Reports, and all the information contained in these reports is therefore accessible globally. That information includes management discussion on the business activities of the Bank, as well as discussion and analysis of the financial statements and risk management. The financial information reflects the latest international accounting standards requirements, including the increased level of disclosure resulting from the adoption of IFRS 7 – Financial Instruments Disclosures, such as the disclosures on related party transactions in note 35 to the consolidated financial statements.

The Board-approved Disclosure Policy reflects the requirements of Basel 2 Pillar 3, in compliance with CBB rules. The objective of this policy is to ensure transparency in the disclosure of the financial and risk profiles of the Bank to all interested parties.

CODE OF CONDUCT

The Bank's website also contains the Board-approved Code of Conduct that contains rules on conduct, ethics and on avoiding conflicts of interest, applicable to all the employees and directors of the Bank.

The Code of Conduct is designed to guide all employees and directors through best practices to fulfill their responsibilities and obligations towards the Bank's stakeholders (shareholders, clients, staff, regulators, suppliers, the public, the host countries in which the Bank conducts business, etc.), in compliance with all applicable laws and regulations.

The Code addresses such issues as upholding the law and following best practices; acting responsibly, honestly, fairly and ethically; avoiding conflicts of interest; protecting Bank property and data; protecting client confidential information and safeguarding the information of others; complying with inside information rules and with the prohibition on insider trading; preventing money laundering and terrorism financing; rejecting bribery and corruption; avoiding compromising gifts; as well as speaking up and 'whistle-blowing'.

Members of staff can also access the Code of Conduct on the GIB intranet, where it is available both in English and Arabic.

POLICY ON CONNECTED COUNTERPARTIES

In December 2009, the Board approved a Policy on Connected Counterparties that governs GIB's dealings with such parties. The Policy defines which parties are considered to be connected to GIB within the criteria set by the CBB, and imposes not only the limitations placed by the CBB but also additional criteria imposed by GIB. The Policy sets out the internal responsibilities for reporting GIB's connected counterparties exposures to the CBB, and the disclosures to be made in GIB's financial statements and Annual Reports, in line with applicable disclosure requirements.

As we strive towards becoming the "Employer of Choice" we will continue to attract, develop and retain the best talent in the industry.

Financial Statements

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Independent Auditor's Report to the Shareholders

Report to 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 31st December 2009, and the consolidated statements of income, comprehensive income, cash flows and the changes in equity for the year ended, and a summary of significant accounting policies and other explanatory notes.

Responsibility of the directors for the consolidated financial statements

The directors of the Bank are responsible for the preparation and fair presentation of these consolidated financial statements in accordance with the International Financial Reporting Standards. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and fair presentation of the consolidated financial statements that are free from material misstatements, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are responsible in the circumstances.

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 relevant ethical requirements and plan and perform the audit to obtain reasonable assurance 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 principles 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 financial position of the Group as at 31st December 2009, and of its financial performance and its cash flows for the year then ended in accordance with the International Financial Standards.

Report on other legal and regulatory requirements

In addition, in our opinion, the Bank has maintained proper accounting records and the consolidated financial statements are in agreement therewith. We have viewed the accompanying Chairman's Statement and confirm that the information contained therein is consistent with the consolidated financial statement. We are not aware of any violation of the Bahrain Commercial Law 2006, terms of the Bank's license or it's memorandum and articles of association having occurred during the year ended 31st December 2009 that might have had a material effect on the business of the Bank or on its financial position. Satisfactory explanations and information have been provided to us by the management in response to all our requests.

KPMG
Public Accountants
Manama, Kingdom of Bahrain
27th February 2010

Consolidated Statement of Financial Position

	Note	**31.12.09 US$ millions**	31.12.08 US$ millions
ASSETS			
Cash and other liquid assets	5	**508.2**	303.0
Placements	6	**4,101.1**	4,037.4
Due from shareholders	7	**–**	4,832.0
Trading securities	8	**50.2**	207.1
Investment securities	9	**2,018.1**	2,220.5
Loans and advances	10	**9,298.1**	12,972.1
Other assets	11	**232.0**	461.4
Total assets		**16,207.7**	25,033.5
LIABILITIES			
Deposits from banks	13	**2,554.2**	3,385.9
Deposits from customers	13	**7,495.3**	15,009.1
Securities sold under agreements to repurchase	14	**565.0**	1,244.8
Other liabilities	15	**294.9**	486.7
Senior term financing	16	**3,007.9**	2,431.5
Subordinated term financing	17	**511.0**	550.0
Total liabilities		**14,428.3**	23,108.0
EQUITY			
Share capital	18	**2,500.0**	2,500.0
Share premium		**7.6**	7.6
Reserves	19	**222.5**	216.0
Retained earnings		**(950.7)**	(798.1)
Total equity		**1,779.4**	1,925.5
Total liabilities & equity		**16,207.7**	25,033.5

The consolidated financial statements were approved by the Board of Directors on 27th February 2010 and signed on its behalf by:-

Mansour bin Saleh Al Maiman Vice Chairman	Abdullah bin Hassan Al-Abdul-Gader Chairman of Board Audit Committee	Yahya bin Abdullah Alyahya Chief Executive Officer

The notes on pages 40 to 85 form an integral part of these consolidated financial statements.

Consolidated Statement of Income

	Note	**Year ended 31.12.09 US$ millions**	Year ended 31.12.08 US$ millions
Interest income	21	**462.8**	1,222.0
Interest expense	21	**256.3**	933.7
Net interest income		**206.5**	288.3
Fee and commission income	22	**40.7**	73.3
Net trading income / (loss)	23	**28.2**	(86.7)
Realised profits on investment securities		**1.2**	39.4
Other income	24	**9.4**	8.4
Total income		**286.0**	322.7
Staff expenses		**77.2**	95.0
Premises expenses		**12.3**	10.4
Other operating expenses		**33.3**	37.5
Total operating expenses		**122.8**	142.9
Net income before provisions and tax		**163.2**	179.8
Provisions for investment securities	9	**48.0**	(365.1)
Provisions for loans and advances	10	**(361.7)**	(201.7)
Net loss before tax		**(150.5)**	(387.0)
Taxation charge on overseas activities		**(2.1)**	(9.2)
Net loss		**(152.6)**	(396.2)
Earnings per share	37	***(US$0.06)***	*(US$0.16)*

Mansour bin Saleh Al Maiman
Vice Chairman

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

Yahya bin Abdullah Alyahya
Chief Executive Officer

The notes on pages 40 to 85 form an integral part of these consolidated financial statements.

Consolidated Statement of Comprehensive Income

	Year ended 31.12.09 US$ millions	Year ended 31.12.08 US$ millions
Net loss	**(152.6)**	(396.2)
Other comprehensive income		
Cash flow hedges:-		
- net fair value gains	**9.9**	10.5
- transfers to consolidated statement of income	**(6.0)**	(4.4)
Available-for-sale securities:-		
- net fair value gains	**2.6**	8.2
- transfers to consolidated statement of income	**–**	92.1
Total other comprehensive income	**6.5**	106.4
Total comprehensive income	**(146.1)**	(289.8)

The notes on pages 40 to 85 form an integral part of these consolidated financial statements.

Consolidated Statement of Changes in Equity

	Share capital US$ millions	Proposed increase in share capital US$ millions	Share premium US$ millions	Reserves US$ millions	Retained earnings US$ millions	Total US$ millions
At 1st January 2008	**1,500.0**	**1,000.0**	**7.6**	**109.6**	**(401.9)**	**2,215.3**
Transfer to share capital	1,000.0	(1,000.0)	–	–	–	–
Total comprehensive income for the year	–	–	–	106.4	(396.2)	(289.8)
At 31st December 2008	**2,500.0**	–	**7.6**	**216.0**	**(798.1)**	**1,925.5**
Total comprehensive income for the year	–	–	–	**6.5**	**(152.6)**	**(146.1)**
At 31st December 2009	**2,500.0**	–	**7.6**	**222.5**	**(950.7)**	**1,779.4**

The notes on pages 40 to 85 form an integral part of these consolidated financial statements.

Consolidated Statement of Cash Flows

	Year ended 31.12.09 US$ millions	Year ended 31.12.08 US$ millions
OPERATING ACTIVITIES		
Net loss after tax	**(152.6)**	(396.2)
Adjustments to reconcile net loss to net cash inflow from operating activities:		
Provisions for investment securities	**(48.0)**	365.1
Provisions for loans and advances	**361.7**	201.7
Profits on investment securities	**(1.2)**	(39.4)
Amortisation of investment securities	**0.3**	0.7
Decrease in accrued interest receivable	**177.6**	109.7
Decrease in accrued interest payable	**(143.5)**	(77.2)
Net (increase) / decrease in other net assets	**(40.3)**	36.7
Net decrease in trading securities	**156.9**	1,135.5
Net cash inflow from operating activities	**310.9**	1,336.6
INVESTING ACTIVITIES		
Net decrease in due from brokers	**–**	243.3
Net (increase) / decrease in placements	**(63.7)**	1,591.6
Decrease / (increase) in due from shareholders	**4,832.0**	(4,832.0)
Net decrease / (increase) in loans and advances	**3,312.4**	(572.0)
Purchase of investment securities	**(47.7)**	(462.4)
Sale and maturity of investment securities	**349.2**	6,071.3
Net cash inflow from investing activities	**8,382.2**	2,039.8
FINANCING ACTIVITIES		
Net decrease in deposits from banks	**(831.7)**	(2,584.9)
Net (decrease) / increase in deposits from customers	**(7,513.8)**	1,335.0
Net decrease in securities sold under agreements to repurchase	**(679.8)**	(2,896.7)
Net decrease in securities sold but not yet purchased	**–**	(233.2)
Net increase / (decrease) in senior term financing	**576.4**	(226.3)
Decrease in subordinated term financing	**(39.0)**	–
Increase in share capital	**–**	1,000.0
Net cash outflow from financing activities	**(8,487.9)**	(3,606.1)
Increase / (decrease) in cash and cash equivalents	**205.2**	(229.7)
Cash and cash equivalents at 1st January	**303.0**	532.7
Cash and cash equivalents at 31st December	**508.2**	303.0

The notes on pages 40 to 85 form an integral part of these consolidated financial statements.

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 437.

2. 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 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, available-for-sale 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 as noted below.

The amendment to International Accounting Standard (IAS) 1 - Presentation of Financial Statements became effective as of 1st January 2009. As a result, the Group has amended the presentation of the consolidated financial statements, most notably the inclusion of the consolidated statement of comprehensive income. As a result, all owner-related changes in equity are presented in the consolidated statement of changes in equity, whereas all non-owner related changes in equity are presented in the consolidated statement of comprehensive income. The amendment to IAS 1 only impacts presentation, and as such, there is no impact on the financial position of the Group. Comparative information has been re-presented in conformity with the amended standard.

The Group has applied the amendments to International Financial Reporting Standard (IFRS) 7 - Financial Instruments: Disclosures that require enhanced disclosure about fair value measurements and liquidity risk in respect of financial instruments. The amendments require disclosure of information relating to fair value measurement that was previously voluntarily disclosed by the Group, and hence has limited impact on the consolidated financial statements. The disclosures in respect of the fair values of financial instruments are set out in note 36. The disclosures in respect of liquidity risk are set out in notes 26(c), 28 and 31.

The Group has adopted the new IFRS 8 - Operating Segments which became effective as of 1st January 2009. The standard replaces IAS 14 - Segment Reporting. In accordance with the new standard, operating segments are determined and presented based on the information that is internally provided to the Board of Directors, and the Group Management Committee which is the Group's chief operating decision maker. The new standard requires the presentation of operating segments on the same basis as were previously disclosed by the Group, and hence has no impact on the consolidated financial statements. The disclosures in respect of operating segments are set out in note 25.

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. ACCOUNTING POLICIES (continued)

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 Bank'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 on 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

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

- held-for-trading
- loans and receivables
- available-for-sale financial assets

Financial assets, other than those held-for-trading, 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 held-for-trading 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.

b) Subsequent measurement

Subsequent to initial measurement, financial assets and liabilities are measured at either fair value or amortised cost, depending on their classification:-

Held-for-trading

Held-for-trading financial assets and liabilities are assets or liabilities acquired or incurred for the purpose of generating a profit from short-term fluctuations in price or are included in a portfolio in which a pattern of short-term profit taking exists.

Held-for-trading financial assets and liabilities are measured at fair value. The fair value for financial assets and liabilities traded in active markets is based on quoted prices, including quotations obtained from lead managers, brokers and dealers. The bid price is used to measure financial assets and the offer price is used to measure financial liabilities. Mid-market prices are used to measure fair value only to the extent that the Group has financial assets and liabilities with offsetting risk positions.

Realised and unrealised gains and losses, interest earned or incurred, and dividends received on held-for-trading financial assets and liabilities are included in trading income.

2. ACCOUNTING POLICIES (continued)

2.4 Financial assets and liabilities (continued)

b) Subsequent measurement (continued)

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than those classified as held-for-trading. The majority of the Group's loans and receivables are included in the loans and advances category.

Financial assets classified as loans and receivables are stated at amortised cost using the effective interest rate method as described in note 2.7(a), less provision for impairment, with interest revenue recognised in the consolidated statement of income.

Available-for-sale financial assets

Available-for-sale financial assets are assets which are intended to be held for an indefinite period of time and may be sold in response to needs for liquidity, changes in interest rates, or concerns with respect to credit deterioration. Available-for-sale financial assets are measured at fair value. The fair value for available-for-sale financial assets in active markets is based on quoted prices, including quotations obtained from lead managers, brokers and dealers. The fair value for available-for-sale financial assets in inactive markets is determined using appropriate valuation techniques. Valuation techniques include comparison to similar instruments for which there are observable prices, and discounted cash flow techniques. Unquoted and illiquid equity investments for which fair values cannot be reliably measured are stated at cost less provision for impairment.

Unrealised gains and losses arising from changes in the fair values of available-for-sale financial assets are recognised in other comprehensive income. The cumulative fair value adjustments on available-for-sale financial assets which are sold or otherwise disposed or become impaired, and which had previously been recognised in other comprehensive income are transferred to the consolidated statement of income.

Non-trading financial liabilities

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

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

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, that 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. For equity securities classified as available-for-sale, a significant or prolonged decline in fair value below cost is considered in determining whether a security is impaired. Where such evidence exists, the cumulative net loss that has been previously recognised in other comprehensive income is transferred to the consolidated statement of income. The amount of the cumulative loss that is removed from other comprehensive income and recognised in the consolidated statement of income is the difference between the acquisition cost and current fair value, less any impairment loss on that security previously recognised in the consolidated statement of income.

2. ACCOUNTING POLICIES (continued)

2.5 Impairment of financial assets (continued)

With the exception of provisions for the impairment of available-for-sale financial assets, 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 remeasured to fair value, at the current market rate of interest for a similar financial asset. Provisions for the impairment of available-for-sale financial assets are determined based on the difference between the acquisition cost, net of principal repayments and amortisation adjustments, and the fair value of the financial asset, less any impairment loss previously recognised in the consolidated statement of income. Cumulative losses previously recognised in other comprehensive income, are reclassified from the available-for-sale securities revaluation reserve in equity to the consolidated statement of income.

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.

With the exception of provisions for the impairment of available-for-sale equity investments, 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. Impairment provisions for available-for-sale equity investments are only released and transferred to the consolidated statement of income on the redemption or sale of the investment.

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 held-for-trading 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

2. ACCOUNTING POLICIES (continued)

2.7 Revenue recognition (continued)

a) Interest income and interest expense (continued)

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.

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) Net 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 net trading instruments are included in net 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 held-for-trading are recognised when the right to receive the dividend is established and are included in net trading income.
- dividends from equity instruments classified as available-for-sale are recognised when the right to receive the dividend is established and are included in other income.
- dividends from structured finance investments are recognised when received and are included in interest income.
- in the separate financial statements of the Bank, dividends from subsidiaries are recognised when received.

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. Securities purchased under agreements to resell are included in cash and other liquid assets.

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 programmes beyond their original specifications and lives is recognised as a capital improvement and capitalised as part of the original cost of the software.

2. ACCOUNTING POLICIES (continued)

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.

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 net 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 net 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 net 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.

2. ACCOUNTING POLICIES (continued)

2.11 Derivative financial instruments and hedge accounting (continued)

Some hybrid instruments contain both a derivative and non-derivative component. In such cases, the derivative is categorised as an embedded derivative. If 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 held-for-trading and measured at fair value. Changes in fair value are included in net trading income.

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, and 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, and (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. ACCOUNTING POLICIES (continued)

2.15 Cash and cash equivalents

In the consolidated statement of cash flows, cash and cash equivalents comprise cash and other liquid assets.

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.

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 2009. The relevant new standards, amendments to standards, and interpretations, are as follows:-

- IAS 39 - Financial Instruments: Recognition and Measurement - Eligible Hedged Items. The amendment to IAS 39 becomes effective, with retrospective application, for financial years beginning on or after 1st January 2010. The amendment to IAS 39 clarifies the application of existing principles that determine whether specific risks or portions of cash flows are eligible for designation in a hedging relationship. The adoption of this amendment is not expected to have any material impact on the consolidated financial statements.
- IFRS 9 - Financial Instruments. The new standard is effective for financial years beginning on or after 1st January 2013. The standard amends the measurement categories currently defined under IAS 39, specifically, held-to-maturity, loans and receivables and available-for-sale categories are eliminated. The standard also amends the accounting for embedded derivatives. The Group is currently evaluating the potential affect of this standard which is expected to require certain valuation and associated presentational changes.

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.

Equity securities classified as available-for-sale are considered to be impaired when there has been a significant or prolonged decline in fair value below cost. The determination of significant or prolonged requires judgement. In making the judgement, a number of factors are taken into account including the normal volatility in valuation, evidence of a deterioration in the financial condition of the investee, industry and sector performance, and operational and financing cash flows.

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.

4. CLASSIFICATION OF ASSETS & LIABILITIES

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

	Held to maturity US$ millions	Loans and receivables US$ millions	Held-for-trading US$ millions	Available-for-sale US$ millions	Financial liabilities at amortised cost US$ millions	Non-financial assets & liabilities US$ millions	Total US$ millions
At 31st December 2009							
Cash and other liquid assets	**277.6**	**230.6**	**–**	**–**	**–**	**–**	**508.2**
Placements	**4,101.1**	**–**	**–**	**–**	**–**	**–**	**4,101.1**
Trading securities	**–**	**–**	**50.2**	**–**	**–**	**–**	**50.2**
Investment securities	**–**	**–**	**–**	**2,018.1**	**–**	**–**	**2,018.1**
Loans and advances	**–**	**9,298.1**	**–**	**–**	**–**	**–**	**9,298.1**
Other assets	**–**	**104.9**	**60.5**	**–**	**–**	**66.6**	**232.0**
Total assets	**4,378.7**	**9,633.6**	**110.7**	**2,018.1**	–	**66.6**	**16,207.7**
Deposits from banks	**–**	**–**	**–**	**–**	**2,554.2**	**–**	**2,554.2**
Deposits from customers	**–**	**–**	**–**	**–**	**7,495.3**	**–**	**7,495.3**
Securities sold under agreements to repurchase		**–**	**–**	**–**	**565.0**	**–**	**565.0**
Other liabilities	**–**	**–**	**137.5**	**–**	**–**	**157.4**	**294.9**
Senior term financing	**–**	**–**	**–**	**–**	**3,007.9**	**–**	**3,007.9**
Subordinated term financing	**–**	**–**	**–**	**–**	**511.0**	**–**	**511.0**
Equity	**–**	**–**	**–**	**–**	**–**	**1,779.4**	**1,779.4**
Total liabilities & equity	**–**	–	**137.5**	–	**14,133.4**	**1,936.8**	**16,207.7**
At 31st December 2008							
Cash and other liquid assets	1.0	302.0	–	–	–	–	303.0
Placements	4,037.4	–	–	–	–	–	4,037.4
Due from shareholders	–	4,832.0	–	–	–	–	4,832.0
Trading securities	–	–	207.1	–	–	–	207.1
Investment securities	–	–	–	2,220.5	–	–	2,220.5
Loans and advances	–	12,972.1	–	–	–	–	12,972.1
Other assets	–	300.5	116.7	–	–	44.2	461.4
Total assets	4,038.4	18,406.6	323.8	2,220.5	–	44.2	25,033.5
Deposits from banks	–	–	–	–	3,385.9	–	3,385.9
Deposits from customers	–	–	–	–	15,009.1	–	15,009.1
Securities sold under agreements to repurchase		–	–	–	1,244.8	–	1,244.8
Other liabilities	–	–	158.9	–	–	327.8	486.7
Senior term financing	–	–	–	–	2,431.5	–	2,431.5
Subordinated term financing	–	–	–	–	550.0	–	550.0
Equity	–	–	–	–	–	1,925.5	1,925.5
Total liabilities & equity	–	–	158.9	–	22,621.3	2,253.3	25,033.5

The held-for-trading category includes the fair values of derivatives designated as fair value and cash flow hedges.

The Group did not have any financial assets or financial liabilities classified as fair value through the statement of income, other than those classified as held-for-trading, at either 31st December 2009 or 31st December 2008.

5. CASH AND OTHER LIQUID ASSETS

	31.12.09 US$ millions	31.12.08 US$ millions
Cash and balances with banks	**230.6**	302.0
Certificates of deposit	**251.0**	1.0
Government bills	**26.6**	–
	508.2	303.0

6. PLACEMENTS

Placements at 31st December 2009 included placements with central banks amounting to US$1,251.2 million (2008: US$44.0 million). The placements with central banks represented the placement of surplus liquid funds.

7. DUE FROM SHAREHOLDERS

Based on the Asset Sale and Purchase Deed effective 31st December 2008, and the associated Share Re-allocation Deed, the Group sold, without recourse, a significant portion of its investment securities portfolio to shareholders of the Bank. The securities were sold at their amortised cost less specific provisions for impairment as at the effective date of the sale. Accordingly, no profit or loss was recorded on the transaction.

The total amortised cost less specific provisions for impairment of the sold securities at the effective date of sale on 31st December 2008, based on rates of exchange prevailing on that date, was US$4,832.0 million. This was net of specific provisions for impairment of US$544.7 million. As reported in note 9(b), the specific provisions relating to the sold securities were written off. The settlement date for the sale of the securities was 27th March 2009. The receivable due from the shareholders in respect of the sale of the securities based on rates of exchange prevailing at 31st December 2008 is separately disclosed in the consolidated statement of financial position.

The securities sold to the shareholders comprised the Bank's entire exposure to collateralised debt obligations and other asset backed securities other than those sold or maturing prior to the settlement date of the transaction, investments in non-GCC financial institution subordinated debt, and impaired financial institution senior debt. Following the sale, the Group had no exposure, net of specific provisions, to collateralised debt obligations or other asset backed securities.

This transaction protected the Group from any future losses from these securities, materially derisked and delevered the balance sheet, reduced risk-weighted assets thereby increasing the regulatory capital adequacy ratio, and eliminated the funding risks of the assets.

8. TRADING SECURITIES

	31.12.09 US$ millions	31.12.08 US$ millions
Managed funds	**50.2**	207.0
Equities	**–**	0.1
	50.2	207.1

Managed funds represent funds placed for investment with external specialist managers. At 31st December 2009, the funds had been redeemed and were in the process of liquidation.

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:-

	31.12.09		31.12.08	
	US$ millions	**%**	US$ millions	%
AAA to A- / Aaa to A3	**1,404.8**	**76.1**	1,690.4	84.1
BBB+ to BBB- / Baa1 to Baa3	**365.1**	**19.8**	256.4	12.7
Other debt securities	**76.6**	**4.1**	64.4	3.2
Total debt securities	**1,846.5**	**100.0**	2,011.2	100.0
Equity investments	**171.6**		209.3	
	2,018.1		2,220.5	

Investment securities at 31st December 2009 principally comprised investment-grade rated debt securities issued by major international financial institutions and government-related entities.

At 31st December 2009, 76.1 per cent of debt securities were rated A- / A3 or above (2008: 84.1 per cent).

At 1st October 2008, and in accordance with the amendments to IAS 39 - Financial Instruments: Recognition and Measurement, a number of externally managed funds that were no longer held for the purpose of sale in the short term were reclassified from held-for-trading to available-for-sale. Due to the adverse impact of the credit crisis, which was considered to meet the IAS 39 amendment definition of a rare event, the managed funds are closed to redemptions for the foreseeable future. The funds were reclassified at their net asset values on the date of transfer on 1st October 2008. The movements in the carrying amount of the reclassified funds were as follows:-

	Carrying amount US$ millions
At 1st October 2008	**60.8**
Provisions for impairment	**(37.7)**
Net movement in fair value	**4.2**
At 31st December 2008	**27.3**
Redemptions and maturities	**(8.2)**
Net movement in fair value	**(0.1)**
At 31st December 2009	**19.0**

During 2008, subsequent to the date of transfer, no amounts were recognised in income other than provisions for impairment. During 2009, realised gains of US$0.5 million were recognised as realised profits on investment securities in the consolidated statement of income. These profits would have been recognised as trading income had the assets not been reclassified.

9. INVESTMENT SECURITIES (continued)

b) Provisions for impairment

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

	2009 US$ millions	2008 US$ millions
At 1st January	**776.5**	985.0
Exchange rate movements	**(0.8)**	–
Amounts utilised	**(630.2)**	(573.6)
(Release) / charge for the year	**(48.0)**	365.1
At 31st December	**97.5**	776.5

Amounts utilised during the years ended 31st December 2009 and 31st December 2008 represented provisions utilised on the sale or write off of the related securities. The amounts utilised during the year ended 31st December 2009 principally comprised US$563.5 million on the write off of the Group's investments in structured investment vehicles (SIVs), and write offs of US$49.5 million on the settlement of credit default swaps. The write offs on the SIVs and credit default swaps were fully covered by specific provisions for impairment. No incremental losses arose as a result of the write offs.

c) 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.

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

	31.12.09			31.12.08		
	Gross US$ millions	**Impairment provisions US$ millions**	**Carrying amount US$ millions**	Gross US$ millions	Impairment provisions US$ millions	Carrying amount US$ millions
Equity investments	**84.1**	**67.2**	**16.9**	95.8	68.5	27.3
Structured investment vehicles (SIVs)	**–**	**–**	**–**	564.5	564.5	–
Residential mortgage-backed CDOs	**–**	**–**	**–**	9.5	9.5	–
	84.1	**67.2**	**16.9**	669.8	642.5	27.3
Non-specific / portfolio provisions		**30.3**			134.0	
Total provisions for impairment		**97.5**			776.5	

Total specific provisions for impairment at 31st December 2009 represented 79.9 per cent of gross impaired investment securities (2008: 95.9 per cent).

As referred to in note 9(b), the investments in structured investment vehicles (SIVs) at 31st December 2008 were written off against the related specific impairment provisions during 2009. No gain or loss arose as a result of the write offs.

The impaired investment securities in the table above include past due debt securities as set out in note 9(d) below.

9. INVESTMENT SECURITIES (continued)

d) Past due debt securities

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

	31.12.09		31.12.08	
	Gross US$ millions	**Carrying amount US$ millions**	Gross US$ millions	Carrying amount US$ millions
Residential mortgage-backed CDOs	**–**	**–**	9.5	–

At 31st December 2009 uncollected interest-in-suspense on past due debt securities amounted to nil (2008: US$0.6 million).

e) Unquoted equity investments

Investment securities at 31st December 2009 included US$125.2 million (2008: US$130.8 million) of unquoted equity investments for which fair values cannot be reliably measured. These investments are stated at cost less provision for impairment. They principally represent private equity investments and investments in managed entities, the underlying investments of which are primarily of either a corporate debt or private equity nature, managed by external specialist managers and international investment banks. There are no active markets or other appropriate methods from which to derive reliable fair values for these investments. The Group intends to exit these investments principally by means of IPOs or private placements.

10. LOANS AND ADVANCES

	31.12.09 US$ millions	31.12.08 US$ millions
Gross loans and advances	**9,932.2**	13,246.3
Provisions for impairment	**(634.1)**	(274.2)
Net loans and advances	**9,298.1**	12,972.1

10. LOANS AND ADVANCES (continued)

a) Industrial classification

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

	31.12.09 US$ millions	31.12.08 US$ millions
Energy, oil and petrochemical	**3,135.5**	3,352.2
Financial	**1,598.3**	2,260.7
Trading and services	**1,371.7**	2,231.6
Transportation	**827.8**	936.0
Real estate	**768.0**	845.1
Manufacturing	**691.9**	1,154.4
Construction	**641.0**	1,093.9
Communication	**446.4**	616.8
Government	**320.1**	450.8
Other	**131.5**	304.8
	9,932.2	13,246.3
Provisions for impairment	**(634.1)**	(274.2)
	9,298.1	12,972.1

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.

b) Provisions for impairment

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

	2009			2008		
	Specific US$ millions	**Non-Specific US$ millions**	**Total US$ millions**	Specific US$ millions	Non-Specific US$ millions	Total US$ millions
At 1st January	**94.2**	**180.0**	**274.2**	10.4	65.0	75.4
Amounts utilised	**(1.8)**	**–**	**(1.8)**	(2.9)	–	(2.9)
Charge for the year	**301.7**	**60.0**	**361.7**	86.7	115.0	201.7
At 31st December	**394.1**	**240.0**	**634.1**	94.2	180.0	274.2

Total provisions at 31st December 2009 exceeded the gross book value of unsecured past due loans by US$269.9 million (2008: US$268.2 million).

The increase in non-specific loan provisions during the year ended 31st December 2008 reflected increases in the expected probabilities of default used in the calculation of provisions for impairment measured on a collective basis. Higher 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 at 31st December 2009 and 31st December 2008 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.

Amounts utilised during the years ended 31st December 2009 and 31st December 2008 represented provisions utilised on the settlement of the related loans.

10. LOANS AND ADVANCES (continued)

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:-

	31.12.09				31.12.08			
	Secured		**Unsecured**		Secured		Unsecured	
	Gross US$ millions	**Carrying amount US$ millions**	**Gross US$ millions**	**Carrying amount US$ millions**	Gross US$ millions	Carrying amount US$ millions	Gross US$ millions	Carrying amount US$ millions
Corporates	**198.1**	**198.1**	**238.3**	**73.2**	–	–	4.0	–
Financial Institutions	**–**	**–**	**125.9**	**18.0**	–	–	2.0	1.0
	198.1	**198.1**	**364.2**	**91.2**	–	–	6.0	1.0

Corporates include loans extended for investment purposes.

The secured past due loan facilities were fully secured by shares listed on recognised stock exchanges. At 31st December 2009, the market value of the collateral represented 134 per cent of the total principal amount of the secured past due loan facilities.

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

	31.12.09 US$ millions	31.12.08 US$ millions
Less than 1 year	**557.4**	–
2 to 5 years	**4.9**	6.0
	562.3	6.0

At 31st December 2009 uncollected interest-in-suspense on past due loans amounted to US$25.4 million (2008: US$0.4 million).

d) Renegotiated loans

There were no renegotiated loans during either the year ended 31st December 2009 or 31st December 2008. Renegotiated loans are loans that have been restructured due to a deterioration in the borrower's financial position and where the Group has made concessions that it would not have otherwise considered.

e) Collateral

The Group did not take possession of any collateral as a result of a loan default during either the year ended 31st December 2009 or 31st December 2008.

11. OTHER ASSETS

	31.12.09 US$ millions	31.12.08 US$ millions
Derivative financial instruments	**60.6**	113.5
Accrued interest, fees and commissions	**57.8**	235.4
Premises and equipment	**40.4**	44.2
Prepaid pension cost	**17.6**	16.2
Prepayments	**10.0**	8.7
Deferred items	**4.0**	6.2
Other, including accounts receivable	**41.6**	37.2
	232.0	461.4

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 30(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 2009 amounted to US$5.3 million (2008: US$6.3 million).

The Bank's principal subsidiary, Gulf International Bank (UK) Limited (GIBUK), maintains a defined benefit pension plan for a large 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 2008.

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

	31.12.09 US$ millions	31.12.08 US$ millions
Fair value of plan assets	**144.8**	117.5
Present value of fund obligations	**149.8**	101.5
Plan (deficit) / surplus	**(5.0)**	16.0
Unrecognised actuarial loss	**22.6**	0.2
Net asset in the consolidated statement of financial position	**17.6**	16.2

12. POST RETIREMENT BENEFITS (continued)

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

	2009 US$ millions	2008 US$ millions
At 1st January	**117.5**	169.9
Expected return on plan assets	**7.1**	10.9
Contributions paid by the Group	**1.5**	2.9
Benefits paid by the plan	**(3.1)**	(2.7)
Actuarial gains / (losses)	**7.0**	(19.3)
Exchange rate movements	**14.8**	(44.2)
At 31st December	**144.8**	117.5

The plan assets at 31st December 2009 comprise equity and debt securities in the ratio of 30 per cent and 70 per cent respectively (2008: 23 per cent and 77 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 2009 were US$7.1 million and US$10.5 million respectively (2008: US$10.9 million and US$(8.8) 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:-

	2009 US$ millions	2008 US$ millions
At 1st January	**101.5**	162.5
Current service cost	**1.1**	2.2
Interest cost	**7.7**	9.4
Actuarial losses / (gains)	**27.3**	(31.7)
Benefits paid by the plan	**(3.1)**	(2.7)
Exchange rate movements	**15.3**	(38.2)
At 31st December	**149.8**	101.5

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

	2009 US$ millions	2008 US$ millions
At 1st January	**16.2**	14.6
Net expense included in staff expenses	**(0.5)**	(0.9)
Contributions paid by the Group	**1.5**	2.9
Exchange rate movements	**0.4**	(0.4)
At 31st December	**17.6**	16.2

The Group paid US$1.5 million in contributions to the plan during 2009 and expects to pay US$0.8 million during 2010.

12. POST RETIREMENT BENEFITS (continued)

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

	2009 US$ millions	2008 US$ millions
Current service cost	**1.1**	2.2
Interest cost	**7.7**	9.4
Expected return on plan assets	**(7.1)**	(10.9)
Amortisation of actuarial loss	**–**	0.1
(Gains) / losses on curtailments and settlements	**(1.2)**	0.1
Net expense included in staff expenses	**0.5**	0.9

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

	2009	2008
Discount rate	**5.7%**	6.4%
Expected return on plan assets - equities	**7.3%**	8.0%
Expected return on plan assets - bonds	**5.1%**	5.8%
Future salary increases	**4.8%**	4.2%
Future increases to pensions in payment	**3.4%**	3.0%

g) Historical information

	2009 US$ millions	2008 US$ millions	2007 US$ millions	2006 US$ millions	2005 US$ millions
Fair value of plan assets	**144.8**	117.5	169.9	132.5	105.9
Present value of fund obligations	**149.8**	101.5	162.5	161.7	138.1
Plan (deficit) / surplus	**(5.0)**	16.0	7.4	(29.2)	(32.2)
Experience gains on plan assets	**10.0**	3.2	4.2	3.5	10.4
Experience (losses) / gains on plan liabilities	**(2.6)**	(14.6)	(1.2)	0.3	5.0

13. DEPOSITS

Deposits from customers include deposits from central banks.

The geographical composition of total deposits was as follows:-

	31.12.09 US$ millions	31.12.08 US$ millions
GCC countries	**6,609.1**	12,223.4
Other Middle East and North Africa countries	**2,540.5**	4,213.9
Other countries	**899.9**	1,957.7
	10,049.5	18,395.0

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

GCC deposits at 31st December 2009 represented 65.8 per cent (2008: 66.4 per cent) of total deposits.

13. DEPOSITS (continued)

The significant decrease in deposits during the year ended 31st December 2009 reflected the Group's reduced funding requirement resulting from the derisking and deleveraging of the balance sheet, and in particular the sale of non-core investment securities to shareholders, as referred to in note 7, and a managed reduction in the loan portfolio to a lower level in the prevailing credit environment.

Total deposits at 31st December 2009 included Islamic-related transactions amounting to US$1,459.2 million (2008: US$1,086.0 million). Islamic-related transactions comprised murabaha contracts.

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 2009, the fair value of investment securities that had been pledged as collateral under repurchase agreements was US$858.2 million (2008: US$1,687.0 million). The collateralised borrowing transactions are conducted under standardised terms that are usual and customary for such transactions.

At 31st December 2008, the fair value of investment securities that had been pledged as collateral under the term repo facility referred to in note 16 was US$106.1 million. This was in addition to the investment securities pledged as collateral under repurchase agreements referred to above. The term repo facility matured and was fully repaid in 2009.

15. OTHER LIABILITIES

	31.12.09 US$ millions	31.12.08 US$ millions
Derivative financial instruments	**137.5**	158.9
Deferred items	**53.2**	75.4
Accrued interest	**39.6**	183.1
Other, including accounts payable and accrued expenses	**64.6**	69.3
	294.9	486.7

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 30(d).

16. SENIOR TERM FINANCING

	Maturity	**31.12.09 US$ millions**	31.12.08 US$ millions
Floating rate loan	2010	**850.0**	850.0
Islamic murabaha term facility	2010	**14.6**	14.6
Floating rate loans	2011	**360.0**	60.0
Floating rate loans	2012	**1,733.3**	1,200.0
Islamic murabaha term facility	2012	**50.0**	–
Floating rate repo	2009	**–**	100.0
Floating rate loans	2009	**–**	177.9
Islamic murabaha term facilities	2009	**–**	29.0
		3,007.9	2,431.5

17. SUBORDINATED TERM FINANCING

	Maturity	**31.12.09 US$ millions**	31.12.08 US$ millions
Floating rate note	2015	**361.0**	400.0
Floating rate loans	2016	**150.0**	150.0
		511.0	550.0

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.

During the year ended 31st December 2009, the Group repurchased US$39.0 milion of the subordinated floating rate note maturing in 2015. The subordinated notes were repurchased at a discount. The profit realised on the repurchase of the subordinated notes was recognised in other income in the consolidated statement of income.

18. SHARE CAPITAL

The authorised share capital at 31st December 2009 comprised 3.0 billion shares of US$1 each (2008: 3.0 billion shares of US$1 each). The issued share capital at 31st December 2009 comprised 2.5 billion shares of US$1 each (2008: 2.5 billion shares of US$1 each). All issued shares are fully paid.

19. RESERVES

	Compulsory reserve US$ millions	**Voluntary reserve US$ millions**	**Cash flow hedge reserve US$ millions**	**Available-for-sale securities revaluation reserve US$ millions**	**Total US$ millions**
At 1st January 2008	169.2	106.7	1.1	(167.4)	109.6
Arising in the year:-					
- Available-for-sale securities:					
net fair value gains	–	–	–	8.2	8.2
- Cash flow hedges:					
net fair value gains	–	–	10.5	–	10.5
Transfers in the year:-					
- Transfers to consolidated statement of income	–	–	(4.4)	92.1	87.7
Net gains	–	–	6.1	100.3	106.4
At 31st December 2008	169.2	106.7	7.2	(67.1)	216.0
Arising in the year:-					
- Available-for-sale securities:					
net fair value gains	–	–	–	2.6	2.6
- Cash flow hedges:					
net fair value gains	–	–	9.9	–	9.9
Transfers in the year:-					
- Transfers to consolidated statement of income	–	–	(6.0)	–	(6.0)
Net gains	–	–	3.9	2.6	6.5
At 31st December 2009	**169.2**	**106.7**	**11.1**	**(64.5)**	**222.5**

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. No transfers were made to the compulsory or voluntary reserve for either the year ended 31st December 2009 or 31st December 2008.

20. DIVIDENDS

No dividend is proposed in respect of the financial year ended 31st December 2009.

21. NET INTEREST INCOME

	2009 US$ millions	2008 US$ millions
Interest income		
Placements and other liquid assets	**56.5**	221.2
Due from brokers	**–**	0.8
Investment securities	**77.1**	370.4
Loans and advances	**329.2**	629.6
Total interest income	**462.8**	1,222.0
Interest expense		
Deposits from banks and customers	**193.4**	662.6
Securities sold under agreements to repurchase	**24.0**	152.1
Term financing	**38.9**	119.0
Total interest expense	**256.3**	933.7
Net interest income	**206.5**	288.3

Interest income on investment securities includes dividends received from structured finance investments.

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 2009 amounted to US$1.3 million (2008: US$1.1 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 2009 or 31st December 2008.

22. FEE AND COMMISSION INCOME

	2009 US$ millions	2008 US$ millions
Fee and commission income		
Investment banking and management fees	**24.6**	48.1
Commissions on letters of credit and guarantee	**14.7**	22.8
Loan commitment fees	**1.5**	3.2
Other fee and commission income	**1.6**	1.4
Total fee and commission income	**42.4**	75.5
Fee and commission expense	**(1.7)**	(2.2)
Net fee and commission income	**40.7**	73.3

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 2009 included fee income relating to the Group's fiduciary activities amounting to US$17.7 million (2008: US$29.5 million).

Fee and commission expense principally comprises security custody fees.

23. NET TRADING INCOME / (LOSS)

	2009 **US$ millions**	2008 US$ millions
Managed funds	**13.0**	(65.8)
Foreign exchange	**11.2**	16.1
Debt securities	**2.7**	(30.5)
Interest rate derivatives	**1.3**	3.3
Loans held for trading	**–**	0.2
Equity securities	**–**	(10.0)
	28.2	(86.7)

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.

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

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

Equity securities includes equities, equity convertibles, and contracts for differences.

The loss on debt securities for the year ended 31st December 2008 included a loss of US$28.4 million arising on the liquidation of the Group's asset backed security proprietary trading portfolio. The portfolio was entirely liquidated during the year ended 31st December 2008.

An analysis of the basis used for determining the fair values of held-for-trading financial assets and liabilities is set out in note 36.

24. OTHER INCOME

Other income principally comprised profits of US$8.3 million arising on the repurchase of subordinated debt as referred to in note 17. Other income also includes profits realised on the sale of premises and equipment, dividends on available-for-sale equity investments, and loan recoveries.

25. 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:-

- Merchant 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 activities and the management of the Group's balance sheet, including funding.

25. SEGMENTAL INFORMATION (continued)

a) Business Segments (continued)

- Financial Markets: the provision of asset and fund management services, and proprietary trading activities.
- 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. 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.

The business segment analysis is as follows:-

	Merchant Banking US$ millions	Treasury US$ millions	Financial Markets US$ millions	Corporate and support units US$ millions	Total US$ millions
2009					
Net interest income	**145.5**	**26.9**	**–**	**34.1**	**206.5**
Total income	**170.4**	**51.4**	**21.8**	**42.4**	**286.0**
Segment result	**(209.4)**	**27.9**	**9.8**	**21.2**	**(150.5)**
Taxation charge on overseas activities					**(2.1)**
Net loss after tax					**(152.6)**
Segment assets	**9,731.6**	**6,392.1**	**6.5**	**77.5**	**16,207.7**
Segment liabilities	**–**	**11,353.2**	**14.4**	**3,060.7**	**14,428.3**
Total equity					**1,779.4**
Total liabilities and equity					**16,207.7**
2008					
Net interest income	155.3	38.2	(0.4)	95.2	288.3
Total income	202.4	(7.9)	(2.2)	130.4	322.7
Segment result	(33.6)	(364.4)	(27.7)	38.7	(387.0)
Taxation charge on overseas activities					(9.2)
Net loss after tax					(396.2)
Segment assets	13,519.8	11,382.6	50.7	80.4	25,033.5
Segment liabilities	–	20,597.4	27.5	2,483.1	23,108.0
Total equity					1,925.5
Total liabilities and equity					25,033.5

25. SEGMENTAL INFORMATION (continued)

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:-

	2009		2008	
	Total income US$ millions	**Total assets US$ millions**	Total income US$ millions	Total assets US$ millions
Bahrain	**195.9**	**10,932.4**	241.4	18,947.6
Saudi Arabia	**42.6**	**3,013.9**	49.4	2,450.1
Other countries	**47.5**	**2,261.4**	31.9	3,635.8
	286.0	**16,207.7**	322.7	25,033.5

The geographical analysis of deposits and risk assets are set out in notes 13 and 27 respectively.

26. 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 Managing Director - Risk Management 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.

26. RISK MANAGEMENT (continued)

a) Credit risk (continued)

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.

Maximum exposure to credit risk

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

	31.12.09 **US$ millions**	31.12.08 US$ millions
Balance sheet items:		
Cash and other liquid assets	**508.2**	303.0
Placements with banks	**4,101.1**	4,037.4
Due from shareholders	**–**	4,832.0
Trading securities	**50.2**	207.1
Investment securities	**2,018.1**	2,220.5
Loans and advances	**9,298.1**	12,972.1
Other assets, excluding derivative-related items	**57.8**	235.4
Total on-balance sheet credit exposure	**16,033.5**	24,807.5
Off-balance sheet items:		
Credit-related contingent items	**2,160.4**	3,637.5
Foreign exchange-related items	**9.5**	76.0
Derivative-related items	**69.0**	123.3
Total off-balance sheet credit exposure	**2,238.9**	3,836.8
Total gross credit exposure	**18,272.4**	28,644.3

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 set out on the following page.

26. RISK MANAGEMENT (continued)

a) Credit risk (continued)

Internal rating grade	Internal classification	Historical default rate range	External Rating Fitch and Standard & Poor's	Moody's
		%		
Investment grade				
Rating grade 1	Standard	0.00 – 0.00	AAA	Aaa
Rating grade 2	Standard	0.00 – 0.04	AA	Aa
Rating grade 3	Standard	0.06 – 0.09	A	A
Rating grade 4	Standard	0.15 – 0.34	BBB	Baa
Sub-investment grade				
Rating grade 5	Standard	0.57 – 1.38	BB	Ba
Rating grade 6	Standard	2.56 – 8.84	B	B
Rating grade 7	Standard	25.67	CCC	Caa
Classified				
Rating grade 8	Substandard	25.67	CC	Ca
Rating grade 9	Doubtful	25.67	C	C
Rating grade 10	Loss	–	D	–

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 28 years from 1981 to 2008 for senior unsecured obligations. The default rates represent the averages over the 28 year period and therefore reflect the full range of economic conditions over that period.

26. RISK MANAGEMENT (continued)

a) Credit risk (continued)

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

	31.12.09			31.12.08		
	Placements & other liquid assets US$ millions	**Securities US$ millions**	**Loans and advances US$ millions**	Placements, due from shareholders & other liquid assets US$ millions	Securities US$ millions	Loans and advances US$ millions
Neither past due nor impaired						
Rating grades 1 to 4-	**4,573.3**	**1,769.9**	**6,132.8**	9,172.4	1,946.8	9,378.3
Rating grades 5+ to 5-	**36.0**	**29.5**	**1,858.6**	–	29.5	3,124.6
Rating grades 6+ to 6-	**–**	**30.2**	**570.1**	–	15.0	354.8
Rating grade 7	**–**	**16.9**	**128.5**	–	19.9	6.7
Equity investments	**–**	**204.9**	**–**	–	389.1	–
Carrying amount	**4,609.3**	**2,051.4**	**8,690.0**	9,172.4	2,400.3	12,864.4
Past due but not impaired						
Rating grades 1 to 7	**–**	**–**	**26.7**	–	–	–
Rating grade 8	**–**	**–**	**171.4**	–	–	–
Carrying amount	**–**	**–**	**198.1**	–	–	–
Past due and individually impaired						
Rating grade 8	**–**	**–**	**9.3**	–	–	–
Rating grade 9	**–**	**–**	**81.9**	–	–	1.0
Carrying amount	**–**	**–**	**91.2**	–	–	1.0
Individually impaired but not past due						
Rating grades 1 to 7	**–**	**–**	**257.2**	–	–	–
Rating grade 8	**–**	**–**	**36.3**	–	–	26.2
Rating grade 9	**–**	**–**	**25.3**	–	–	80.5
Equity investments	**–**	**16.9**	**–**	–	27.3	–
Carrying amount	**–**	**16.9**	**318.8**	–	27.3	106.7
Total	**4,609.3**	**2,068.3**	**9,298.1**	9,172.4	2,427.6	12,972.1

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

Provisions for impairment	**–**	**(97.5)**	**(634.1)**	–	(776.5)	(274.2)

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.

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 2009 or 31st December 2008.

26. RISK MANAGEMENT (continued)

a) Credit risk (continued)

An analysis of the credit risk in respect of foreign exchange and derivative financial instruments is set out in note 30 while the notional and risk-weighted exposures for off-balance sheet credit-related financial instruments are set out in note 31.

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. The geographical distribution of risk assets is set out in note 27. An analysis of the credit risk in respect of foreign exchange and derivative financial instruments is set out in note 30.

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 30.

26. RISK MANAGEMENT (continued)

b) Market risk (continued)

The VaR by risk class for the Group's trading positions, as calculated in accordance with the basis set out in note 33, was as follows:-

	2009				2008			
	31.12.09 US$ millions	**Average US$ millions**	**High US$ millions**	**Low US$ millions**	31.12.08 US$ millions	Average US$ millions	High US$ millions	Low US$ millions
Interest rate risk	**0.1**	**0.4**	**1.4**	**0.1**	1.4	1.6	2.6	1.1
Foreign exchange risk	**–**	**0.1**	**0.2**	**–**	–	0.2	0.9	–
Equity risk	**0.6**	**2.3**	**4.0**	**0.6**	3.8	5.8	7.6	3.8
Total diversified risk	**0.6**	**2.5**	**4.9**	**0.6**	4.6	7.1	9.7	4.6

- **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 29. The Group is exposed to the impact of changes in credit spreads on the fair value of available-for-sale debt securities. Movements in the fair value of available-for-sale securities are accounted for in equity. Credit spread risk is managed within VaR limits and through the use of models to evaluate the sensitivity of changes in equity to movements in credit spreads. Based on the available-for-sale debt securities held at 31st December 2009, a 1 b.p. increase in credit spreads would result in a US$0.5 million decrease in fair value (2008: US$0.6 million). The Group does not maintain material non-trading equity or 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 30(e).

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:-

Activity	**Risk**	**Risk Mitigant**
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

26. RISK MANAGEMENT (continued)

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 assets available in the event of 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; 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 14 day period. 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 28. An analysis of debt investment securities by rating classification is set out in note 26 (a).

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.

26. RISK MANAGEMENT (continued)

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 33, 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 by applying the CBB's prescribed alpha co-efficient to the Group's average gross income for the preceding three financial years.

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 available-for-sale securities and derivative cash flow hedging transactions with the exception of unrealised losses arising on the remeasurement to fair value of equity securities classified as available-for-sale 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 securities classified as available-for-sale 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, the issue of new shares, subordinated term finance and innovative tier 1 capital securities.

The Group and its individually regulated operations complied with all externally imposed capital requirements throughout the years ended 31st December 2009 and 31st December 2008.

There have been no material changes in the Group's management of capital during the years ended 31st December 2009 and 31st December 2008.

The capital adequacy ratio calculation is set out in note 33.

27. GEOGRAPHICAL DISTRIBUTION OF RISK ASSETS

	31.12.09					31.12.08
	Placements & other liquid assets US$ millions	Securities US$ millions	Loans and advances US$ millions	Credit-related contingent items US$ millions	Total US$ millions	Total US$ millions
GCC	**1,752.7**	**1,338.7**	**8,810.9**	**1,609.6**	**13,511.9**	22,272.7
Other Middle East & North Africa	**54.0**	**42.9**	**233.6**	**122.3**	**452.8**	543.9
Europe	**2,027.5**	**63.0**	**238.9**	**241.7**	**2,571.1**	4,040.0
North America	**530.0**	**582.5**	**0.2**	**186.8**	**1,299.5**	1,090.6
Asia	**245.1**	**41.2**	**14.5**	**–**	**300.8**	262.4
	4,609.3	**2,068.3**	**9,298.1**	**2,160.4**	**18,136.1**	28,209.6

At 31st December 2009, risk exposures to customers and counterparties in the GCC represented 74.5 per cent (2008: 79.0 per cent) of total risk assets. The risk asset profile reflects the Group's strategic focus on merchant banking activities in the GCC states.

An analysis of derivative and foreign exchange instruments is set out in note 30.

28. 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 US$ millions	4 months to 1 year US$ millions	Years 2 and 3 US$ millions	Years 4 and 5 US$ millions	5 years and other US$ millions	Total US$ millions
At 31st December 2009						
Cash and other liquid assets	**507.2**	**1.0**	**–**	**–**	**–**	**508.2**
Placements	**4,101.1**	**–**	**–**	**–**	**–**	**4,101.1**
Trading securities	**50.2**	**–**	**–**	**–**	**–**	**50.2**
Investment securities	**165.3**	**218.0**	**724.5**	**288.1**	**622.2**	**2,018.1**
Loans and advances	**2,031.5**	**1,582.2**	**2,301.6**	**1,105.0**	**2,277.8**	**9,298.1**
Other assets	**156.8**	**23.6**	**5.6**	**3.1**	**42.9**	**232.0**
Total assets	**7,012.1**	**1,824.8**	**3,031.7**	**1,396.2**	**2,942.9**	**16,207.7**
Deposits	**8,824.8**	**1,216.3**	**8.4**	**–**	**–**	**10,049.5**
Securities sold under agreements to repurchase	**565.0**	**–**	**–**	**–**	**–**	**565.0**
Other liabilities	**174.6**	**59.4**	**32.5**	**9.5**	**18.9**	**294.9**
Term financing	**–**	**864.6**	**2,143.3**	**–**	**511.0**	**3,518.9**
Equity	**–**	**–**	**–**	**–**	**1,779.4**	**1,779.4**
Total liabilities & equity	**9,564.4**	**2,140.3**	**2,184.2**	**9.5**	**2,309.3**	**16,207.7**
At 31st December 2008						
Total assets	13,085.2	3,037.2	3,566.7	1,916.4	3,428.0	25,033.5
Total liabilities & equity	18,253.1	2,026.1	988.8	1,255.4	2,510.1	25,033.5

28. 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 US$ millions	4 months to 1 year US$ millions	Years 2 and 3 US$ millions	Years 4 and 5 US$ millions	Over 5 years US$ millions
At 31st December 2009					
Deposits	**8,854.1**	**1,236.2**	**9.2**	**–**	**–**
Securities sold under agreements to repurchase	**573.5**	**–**	**–**	**–**	**–**
Term financing	**21.6**	**886.3**	**2,256.0**	**55.0**	**544.7**
Derivative financial instruments:					
- contractual amounts payable	**66.1**	**88.4**	**189.5**	**145.6**	**210.4**
- contractual amounts receivable	**(10.5)**	**(57.6)**	**(167.9)**	**(146.8)**	**(212.8)**
Total undiscounted financial liabilities	**9,504.8**	**2,153.3**	**2,286.8**	**53.8**	**542.3**
At 31st December 2008					
Deposits	17,050.3	1,502.5	16.3	4.8	–
Securities sold under agreements to repurchase	1,044.1	225.3	–	–	–
Term financing	59.2	310.2	1,020.7	1,273.1	596.3
Derivative financial instruments:					
- contractual amounts payable	116.0	183.3	293.2	163.7	214.3
- contractual amounts receivable	(52.0)	(137.7)	(228.4)	(149.4)	(193.0)
Total undiscounted financial liabilities	18,217.6	2,083.6	1,101.8	1,292.2	617.6

Information on the contractual terms for the drawdown of gross loan commitments is set out in note 31.

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 30(c).

29. 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 2009						
Cash and other liquid assets	480.6	27.6	–	–	–	508.2
Placements	4,101.1	–	–	–	–	4,101.1
Trading securities	–	–	–	–	50.2	50.2
Investment securities:-						
- Fixed rate	–	–	–	151.5	–	151.5
- Floating rate	1,672.7	52.6	–	–	(30.3)	1,695.0
- Equities & equity funds	–	–	–	–	171.6	171.6
Loans and advances	7,755.9	1,706.6	60.4	15.2	(240.0)	9,298.1
Other assets	–	–	–	–	232.0	232.0
Total assets	14,010.3	1,786.8	60.4	166.7	183.5	16,207.7
Deposits	8,822.7	663.6	559.2	4.0	–	10,049.5
Securities sold under agreements to repurchase	565.0	–	–	–	–	565.0
Other liabilities	–	–	–	–	294.9	294.9
Term financing	2,208.9	1,260.0	50.0	–	–	3,518.9
Equity	–	–	–	–	1,779.4	1,779.4
Total liabilities & equity	11,596.6	1,923.6	609.2	4.0	2,074.3	16,207.7
Interest rate sensitivity gap	2,413.7	(136.8)	(548.8)	162.7	(1,890.8)	–
Cumulative interest rate sensitivity gap	2,413.7	2,276.9	1,728.1	1,890.8	–	–
At 31st December 2008						
Cumulative interest rate sensitivity gap	(69.3)	1,376.7	1,381.6	1,848.4	–	–

The repricing profile is based on the remaining period to the next interest repricing date. The repricing profile of placements incorporates the effect of interest rate swaps used to lock-in a return on the Group's net free capital funds. 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 loan provision is deducted from non-interest bearing assets.

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 2009 the modified duration of these fixed rate securities was 3.55. 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$54,000.

29. INTEREST RATE RISK (continued)

Based on the repricing profile at 31st December 2009, 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 and in the Group's equity by approximately US$5.6 million and US$10.9 million respectively (2008: US$7.0 million and US$22.1 million respectively). 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 26. The market risk relating to foreign exchange and derivative trading instruments is set out in note 30.

30. 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,

30. DERIVATIVE AND FOREIGN EXCHANGE INSTRUMENTS (continued)

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.

The Group also transacts in other derivative products including total return swaps used to hedge trading transactions.

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
	Trading US$ millions	Hedging US$ millions	Total US$ millions	amounts US$ millions
At 31st December 2009				
Foreign exchange contracts:-				
Unmatured spot, forward and futures contracts	**419.5**	**2,890.9**	**3,310.4**	**9.5**
Interest rate contracts:-				
Interest rate swaps and swaptions	**2,505.1**	**1,131.5**	**3,636.6**	**67.8**
Financial futures	**–**	**181.6**	**181.6**	**1.0**
Options, caps and floors purchased	**24.3**	**–**	**24.3**	**0.2**
Options, caps and floors written	**24.3**	**–**	**24.3**	**–**
	2,553.7	**1,313.1**	**3,866.8**	**69.0**
Credit contracts:-				
Protection sold	**39.0**	**–**	**39.0**	**–**
Total	**3,012.2**	**4,204.0**	**7,216.2**	**78.5**
At 31st December 2008				
Total	4,087.2	5,623.6	9,710.8	199.3

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 2009 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 33, was nil, US$0.1 million and nil respectively (2008: US$0.2 million, US$0.2 million and US$1.1 million). 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.

30. DERIVATIVE AND FOREIGN EXCHANGE INSTRUMENTS (continued)

b) Counterparty analysis

	31.12.09			31.12.08
	Banks US$ millions	**Corporates US$ millions**	**Total US$ millions**	Total US$ millions
Credit risk amounts				
OECD countries	**18.9**	**–**	**18.9**	100.1
GCC countries	**2.4**	**47.2**	**49.6**	98.8
Other countries	**–**	**10.0**	**10.0**	0.4
	21.3	**57.2**	**78.5**	199.3

Credit risk is concentrated on major OECD-based banks and GCC-related customers.

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 2009					
Foreign exchange contracts	**3,310.4**	**–**	**–**	**–**	**3,310.4**
Interest rate contracts	**824.6**	**1,414.1**	**343.1**	**1,285.0**	**3,866.8**
Credit contracts	**–**	**10.0**	**25.0**	**4.0**	**39.0**
Total	**4,135.0**	**1,424.1**	**368.1**	**1,289.0**	**7,216.2**
At 31st December 2008					
Total	6,393.2	1,088.5	971.7	1,257.4	9,710.8

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

	31.12.09		31.12.08	
	Positive fair value US$ millions	**Negative fair value US$ millions**	Positive fair value US$ millions	Negative fair value US$ millions
Derivatives held for trading:-				
Forward foreign exchange contracts	**2.2**	**(44.7)**	7.0	(7.0)
Foreign exchange options	**–**	**–**	0.3	(0.3)
Interest rate swaps and swaptions	**58.3**	**(53.7)**	92.0	(86.6)
Total return swaps	**–**	**–**	–	(0.3)
	60.5	**(98.4)**	99.3	(94.2)
Derivatives held as cash flow hedges:-				
Interest rate swaps	**–**	**–**	14.2	–
Forward foreign exchange contracts	**0.1**	**–**	–	(7.0)
	0.1	**–**	14.2	(7.0)
Derivatives held as fair value hedges:-				
Interest rate swaps	**–**	**(39.1)**	–	(57.7)
Amount included in other assets / (other liabilities)	**60.6**	**(137.5)**	113.5	(158.9)

30. DERIVATIVE AND FOREIGN EXCHANGE INSTRUMENTS (continued)

e) Significant net open positions

There were no significant derivative trading or foreign currency net open positions at either 31st December 2009 or at 31st December 2008.

f) Hedge effectiveness

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

	2009 **US$ millions**	2008 US$ millions
Net gains / (losses) on derivative fair value hedging instruments	**27.4**	(19.6)
Net (losses) / gains on hedged items attributable to the hedged risk	**(27.4)**	19.6

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 2009 or 31st December 2008.

The periods over which the Group was hedging its exposure to the variability in future cash flows for forecasted transactions were as follows:-

	31.12.09 **US$ millions**	31.12.08 US$ millions
Year 1	**–**	75.0
Years 2 & 3	**–**	200.0
Years 4 & 5	**–**	100.0

The derivative cash flow hedging transactions at 31st December 2008 were unwound during the year ended 31st December 2009 in anticipation of a rise in interest rates. 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.

31. 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.

	31.12.09		31.12.08	
	Notional principal amount US$ millions	**Risk-weighted exposure US$ millions**	Notional principal amount US$ millions	Risk-weighted exposure US$ millions
Direct credit substitutes	**171.6**	**161.4**	334.6	283.6
Transaction-related contingent items	**808.7**	**322.4**	1,147.2	440.0
Short-term self-liquidating trade-related contingent items	**234.3**	**48.3**	546.4	89.9
Commitments, including undrawn loan commitments and underwriting commitments under note issuance and revolving facilities	**945.8**	**450.2**	1,609.3	782.8
	2,160.4	**982.3**	3,637.5	1,596.3

Commitments may be drawndown on demand.

Direct credit substitutes at 31st December 2009 included financial guarantees amounting to US$138.5 million (2008: US$156.5 million). Financial guarantees may be called on demand.

Credit-related financial instruments are reported gross before applying credit risk mitigants, such as cash collateral, guarantees and counter-indemnities. At 31st December 2009 the Group held cash collateral, guarantees, counter-indemnities or other high quality collateral in relation to credit-related financial instruments amounting to US$115.1 million (2008: US$433.8 million).

32. CONTINGENT LIABILITIES

Litigation

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.

33. 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.

33. CAPITAL ADEQUACY (continued)

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

		31.12.09 US$ millions	31.12.08 US$ millions
Regulatory capital base			
Tier 1 capital:			
Total equity		**1,779.4**	1,925.5
Adjustment to exclude net fair value losses		**53.4**	59.9
Tier 1 capital		**1,832.8**	1,985.4
Tier 2 capital:			
Subordinated term financing		**511.0**	550.0
Non-specific provisions subject to 1.25% risk weighted exposure limitation		**139.4**	198.7
Unrealised gains on fair value of equity investments		**5.7**	13.8
Tier 2 capital		**656.1**	762.5
Total regulatory capital base	(a)	**2,488.9**	2,747.9

Risk-weighted exposure

		31.12.09		31.12.08	
		Notional principal amount US$ millions	**Risk-weighted exposure US$ millions**	Notional principal amount US$ millions	Risk-weighted exposure US$ millions
Credit risk					
Balance sheet items:					
Cash and other liquid assets		**508.2**	**73.8**	303.0	50.5
Placements		**4,101.1**	**593.5**	4,037.4	798.7
Due from shareholders		**–**	**–**	4,832.0	–
Investment securities		**2,018.1**	**1,067.9**	2,220.5	1,167.1
Loans and advances		**9,298.1**	**7,557.1**	12,972.1	10,637.7
Other assets		**232.0**	**186.4**	461.4	343.2
			9,478.7		12,997.2
Off-balance sheet items:					
Credit-related contingent items and forward placements		**2,160.4**	**982.3**	3,642.1	1,597.3
Foreign exchange-related items		**3,310.4**	**10.0**	4,339.3	27.4
Derivative-related items		**3,905.8**	**3.6**	5,371.5	3.1
Repo counterparty risk			**–**		79.7
			995.9		1,707.5
Credit risk-weighted exposure			**10,474.6**		14,704.7
Market risk					
General market risk			**41.5**		314.7
Specific market risk			**82.8**		266.9
Market risk-weighted exposure			**124.3**		581.6
Operational risk					
Operational risk-weighted exposure			**550.5**		607.9
Total risk-weighted exposure	(b)		**11,149.4**		15,894.2
Risk asset ratio [(a)/(b) x 100]			**22.3%**		17.3%

33. 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 has initially adopted the basic indicator approach for determining the capital requirement for operational risk, although is planning to adopt the standardised approach for operational risk subject to approval by the CBB.

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

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 3.50 (2008: 3.75) by the CBB.

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 Group calculates the regulatory capital requirement for operational risk by applying an alpha co-efficient of 15 per cent to the average gross income for the preceding three financial years.

34. 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 2009 was US$16,638.7 million (2008: US$14,337.3 million).

35. RELATED PARTY TRANSACTIONS

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:-

	2009 **US$ millions**	2008 US$ millions
Short term employee benefits	**7.5**	5.3
Post-employment benefits	**0.5**	4.4
	8.0	9.7

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.

There were no other related party transactions.

36. FAIR VALUE OF FINANCIAL INSTRUMENTS

The Group's financial instruments are accounted for under the historical cost method with the exception of trading securities, available-for-sale 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.

Based on the valuation methodologies outlined below, the fair values of all on- and off-balance sheet financial instruments were not significantly different to their carrying amounts, other than term financing as referred to in note 36(c).

a) Trading and investment securities

The fair values of securities are based on quoted prices or valuation techniques with the exception of investments in unquoted equity investments for which fair values cannot be reliably measured, the fair values of which are based on their carrying amount.

b) 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 troubled sovereign debt are based on market bid prices. 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.

c) 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 2009 were US$2,958.2 million and US$461.7 million respectively (2008: US$2,206.7 million and US$491.2 million respectively).

d) 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.

e) 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.

36. 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) US$ millions	Valuation based on observable market data (level 2) US$ millions	Other valuation techniques (level 3) US$ millions
At 31st December 2009			
Financial assets:			
Trading securities	**50.2**	**–**	**–**
Investment securities	**1,868.0**	**–**	**24.9**
Derivative financial instruments	**–**	**60.6**	**–**
Financial liabilities:			
Derivative financial instruments	**–**	**95.3**	**–**
At 31st December 2008			
Financial assets:			
Trading securities	207.1	–	–
Investment securities	2,040.1	–	49.6
Derivative financial instruments	–	113.2	0.3
Financial liabilities:			
Derivative financial instruments	–	158.6	0.3

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. The majority of the Group's financial assets and liabilities that are carried at fair value are valued based on quoted market prices. At 31st December 2009, 95.7 per cent of financial assets carried at fair value were valued based on quoted prices (2008: 93.2 per cent).

During the year ended 31st December 2009, the value of investment securities whose measurement was determined by other valuation techniques (level 3 measurement) decreased by US$24.7 million. The decrease entirely 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 2009.

37. EARNINGS PER SHARE

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

	2009	2008
Net loss after tax (US$ millions)	**(152.6)**	(396.2)
Weighted average number of shares in issue (millions)	**2,500**	2,500
Basic earnings per share	**(US$0.06)**	(US$0.16)

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

38. PRINCIPAL SUBSIDIARIES

The principal subsidiary companies were as follows:-

	Country of incorporation	Ownership interest	
		31.12.09	31.12.08
Gulf International Bank (UK) Limited	United Kingdom	**100%**	100%
GIB Financial Services L.L.C.	Kingdom of Saudi Arabia	**100%**	100%
GIB Investment S.P.C.	Kingdom of Bahrain	**100%**	100%

39. AVERAGE CONSOLIDATED STATEMENT OF FINANCIAL POSITION

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

	31.12.09 US$ millions	31.12.08 US$ millions
Assets		
Cash and other liquid assets	**265.3**	222.3
Placements	**4,481.9**	5,549.4
Due from shareholders	**1,148.2**	13.2
Trading securities	**133.6**	435.2
Investment securities	**2,052.6**	7,714.6
Loans and advances	**11,228.1**	13,090.0
Other assets	**273.1**	386.1
Total assets	**19,582.8**	27,410.8
Liabilities		
Deposits from banks	**2,836.7**	4,451.8
Deposits from customers	**10,808.2**	13,681.8
Securities sold under agreements to repurchase	**1,026.8**	3,352.3
Other liabilities	**218.1**	897.2
Senior term financing	**2,219.7**	2,585.0
Subordinated term financing	**533.9**	550.0
Total liabilities	**17,643.4**	25,518.1
Total equity	**1,939.4**	1,892.7
Total liabilities & equity	**19,582.8**	27,410.8

40. PARENT COMPANY

The condensed unconsolidated financial statements of Gulf International Bank B.S.C. were as follows:-

a) Condensed statement of financial position

	31.12.09 US$ millions	31.12.08 US$ millions
Assets		
Cash and other liquid assets	**197.0**	154.3
Placements	**2,258.9**	943.4
Due from shareholders	**–**	4,832.0
Trading securities	**47.9**	174.6
Investment securities	**2,017.7**	2,219.8
Investments in subsidiaries	**235.7**	228.6
Loans and advances	**9,307.4**	13,009.5
Other assets	**195.4**	407.7
Total assets	**14,260.0**	21,969.9
Liabilities		
Deposits from banks	**2,326.0**	3,262.8
Deposits from customers	**5,557.4**	11,876.8
Securities sold under agreements to repurchase	**790.0**	1,464.8
Other liabilities	**288.3**	458.5
Senior term financing	**3,007.9**	2,431.5
Subordinated term financing	**511.0**	550.0
Total liabilities	**12,480.6**	20,044.4
Total equity	**1,779.4**	1,925.5
Total liabilities & equity	**14,260.0**	21,969.9

The investments in subsidiaries are accounted for at fair value. Gains and losses arising from changes in the fair values of the investments are accounted for in equity.

b) Condensed statement of income

	Year ended 31.12.09 US$ millions	Year ended 31.12.08 US$ millions
Net interest income	**193.3**	269.3
Fee and commission income	**20.3**	39.9
Trading income / (loss)	**17.2**	(59.9)
Realised profits on investment securities	**0.5**	37.0
Other income	**8.8**	7.7
Total income	**240.1**	294.0
Operating expenses	**77.6**	98.6
Net income before provisions and tax	**162.5**	195.4
Provisions for investment securities	**48.4**	(353.5)
Provisions for loans and advances	**(361.7)**	(201.7)
Net loss before tax	**(150.8)**	(359.8)
Taxation charge on overseas activities	**(1.7)**	(3.2)
Net loss	**(152.5)**	(363.0)

GIB is confident of its ability to maintain its market leadership and the important role it plays in the economic development of the region.

Basel 2 Pillar 3 Report

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EXECUTIVE SUMMARY

The Central Bank of Bahrain (CBB) 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.

Since 2006, GIB (the Group) has routinely been monitoring capital adequacy for internal capital management purposes based on both the Basel 2 standardised and the foundation internal ratings based (FIRB) approaches for credit risk, and the basic indicator and standardised approaches for operational risk, in addition to the internal models approach for market risk.

For regulatory purposes, GIB has initially adopted the standardised approach for credit risk. In time and subject to approval by the CBB, GIB plans to adopt the FIRB approach for credit risk, as it is more closely aligned to the Group's internal capital management methodologies. For market risk, GIB uses the internal model approach. GIB has initially adopted the basic indicator approach for determining the capital requirement for operational risk although is planning to adopt the standardised approach for operational risk when approved by the CBB.

This Risk Management and Capital Adequacy report encompasses the Basel 2 Pillar 3 disclosure requirements prescribed by the CBB based on the Basel Committee's Pillar 3 guidelines. The report contains a description of GIB's risk management and capital adequacy policies and practices, including detailed information on the capital adequacy process.

The disclosed tier 1 and total capital adequacy ratios comply with the minimum capital requirements under the CBB's Basel 2 framework.

GIB's total risk-weighted assets at 31st December 2009 amounted to US$11,149.4 million. Credit risk accounted for 94.0 per cent, market risk 1.1 per cent and operational risk 4.9 per cent of the total risk-weighted assets. Tier 1 and total regulatory capital were US$1,832.8 million and US$2,488.9 million respectively.

At 31st December 2009, GIB's tier 1 and total capital adequacy ratios were 16.4 per cent and 22.3 per cent respectively. GIB aims to maintain a tier 1 capital ratio above 8 per cent and a total capital ratio in excess of 12 per cent.

GIB views the Basel 2 Pillar 3 disclosures as an important contribution to increased risk transparency within the banking industry, and particularly important during market conditions characterised by high uncertainty. In this regard, GIB has provided more disclosure in this report than is required in accordance with the CBB's Pillar 3 guidelines in order to provide the level of transparency that is believed to be appropriate and relevant to the Group's various stakeholders and market participants.

All figures presented in this report are as at 31st December 2009 unless otherwise stated.

1. INTRODUCTION TO THE BASEL 2 FRAMEWORK

The new capital adequacy module of the Central Bank of Bahrain (CBB) rulebook was introduced with effect from 1st January 2008. The module includes a change of methodology from the previous (Basel 1) non-risk based method of calculating the capital adequacy requirements of banks incorporated in Bahrain. The Basel 2 framework provides a more risk sensitive approach to the assessment of risk and the calculation of regulatory capital, i.e. the minimum capital that a bank is required to maintain. The Basel 2 framework is intended to strengthen risk management practices and processes within financial institutions.

The CBB's Basel 2 framework is based on three pillars, consistent with the Basel 2 framework developed by the Basel Committee, as follows:-

- Pillar 1: the calculation of the risk weighted amounts (RWAs) and capital requirement.
- Pillar 2: the supervisory review process, including the Internal Capital Adequacy Assessment Process (ICAAP).
- Pillar 3: the disclosure of risk management and capital adequacy information.

1.1 Pillar 1

Pillar 1 prescribes the basis for the calculation of the regulatory capital adequacy ratio. Pillar 1 sets out the definition and calculations of the RWAs, and the derivation of the regulatory capital base. The capital adequacy ratio is calculated by dividing the regulatory capital base by the total RWAs.

1. INTRODUCTION TO THE BASEL 2 FRAMEWORK (continued)

1.1 Pillar 1 (continued)

The resultant ratio is to be maintained above a predetermined and communicated level. Under the previously applied Basel 1 Capital Accord, the minimum capital adequacy ratio for banks incorporated in Bahrain was 12 per cent compared to the Basel Committee's minimum ratio of 8 per cent.

With the imminent introduction of Pillar 2, the CBB will implement a minimum ratio threshold to be determined for each institution individually, as described in more detail in the Pillar 2 section on page 3 of this report. As at 31st December 2009, and pending the finalisation of the CBB's Pillar 2 guidelines, all banks incorporated in Bahrain were required to maintain a minimum capital adequacy ratio of 12 per cent.

The CBB also requires banks incorporated in Bahrain to maintain a buffer of 0.5 per cent above the minimum capital adequacy ratio. In the event that the capital adequacy ratio falls below 12.5 per cent, additional prudential reporting requirements apply and a formal action plan setting out the measures to be taken to restore the ratio above the target level is to be formulated and submitted to the CBB. Consequently, the CBB requires GIB to maintain an effective minimum capital adequacy ratio of 12.5 per cent. No separate minimum tier 1 ratio is required to be maintained under the CBB's Basel 2 capital adequacy framework. However, the maintenance of a strong tier 1 ratio is nevertheless a focus of GIB's internal capital adequacy assessment process, as it represents the core capital of the bank.

Under the CBB's Basel 2 capital adequacy framework, the RWAs are calculated using more sophisticated and risk sensitive methods than under the previous Basel 1 regulations. Credit risk and market risk are two essential risk types that were included under Basel I, while operational risk has been introduced as a new risk type in the CBB's Basel 2 capital adequacy framework. The table below summarises the approaches available for calculating RWAs for each risk type in accordance with the CBB's Basel 2 capital adequacy framework:-

CBB approaches for determining regulatory capital requirements		
Credit Risk	**Market Risk**	**Operational Risk**
Standardised Approach	Standardised Approach	Basic Indicator Approach
Foundation Internal Ratings Based Approach (FIRB)	Internal Models Approach	Standardised Approach

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

i) Credit Risk

For regulatory reporting purposes, GIB is using the standardised approach for credit risk. The standardised approach is similar to the basis under the previous Basel 1 capital adequacy regulations, except for the use of external ratings to derive RWAs and the ability to use a wider range of financial collateral.

The RWAs are determined by multiplying the credit exposure by a risk weight factor dependent on the type of counterparty and the counterparty's external rating, where available.

Internally, GIB also calculates the capital requirement under the more risk-sensitive and complex FIRB approach, although the resultant ratio is not being used for regulatory compliance purposes at present.

ii) Market Risk

For the regulatory market risk capital requirement, GIB is using the internal models approach based on a Value-at-Risk (VaR) model. The use of the internal models approach for the calculation of regulatory market risk capital has been approved by the CBB.

iii) Operational Risk

Under the CBB's Basel 2 capital adequacy framework, all banks incorporated in Bahrain are required to apply the basic indicator approach for operational risk unless approval is granted by the CBB to use the standardised approach. The CBB's Basel 2 guidelines do not currently permit the use of the advanced measurement approach (AMA) for operational risk. For regulatory reporting purposes, GIB is currently using the basic indicator approach, although internally the Group also calculates the capital requirement based on the more advanced standardised approach.

1. INTRODUCTION TO THE BASEL 2 FRAMEWORK (continued)

1.1 Pillar 1 (continued)

iii) Operational Risk (continued)

Under the basic indicator approach, the regulatory capital requirement is calculated by applying an alpha co-efficient of 15 per cent to the average gross income for the preceding three financial years. Under 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.

1.2 Pillar 2

Pillar 2 defines the process of supervisory review of an institution's risk management framework and, ultimately, its capital adequacy.

Under the CBB's Pillar 2 guidelines, each bank is to be individually assessed by the CBB and an individual minimum capital adequacy ratio is to be determined for each bank. The CBB is currently undertaking the assessment exercises, which will allow their setting of minimum capital ratios in excess of 8 per cent, based on the CBB's assessment of the financial strength and risk management practices of the institution. Currently, pending finalisation of the assessment process all banks incorporated in Bahrain are required to continue to maintain a 12 per cent minimum capital adequacy ratio as under the previous Basel 1 framework.

Pillar 2 comprises two processes:

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

The ICAAP incorporates a review and evaluation of risk management and capital relative to the risks to which the bank is exposed. GIB is currently developing its ICAAP around its economic capital framework which is designed to ensure that the Group has sufficient capital resources available to meet regulatory and internal capital requirements, even during periods of economic or financial stress. The ICAAP addresses all components of GIB's risk management, from the daily management of more material risks to the strategic capital management of the Group.

The supervisory review and evaluation process represents the CBB's review of the Group's capital management and an assessment of internal controls and corporate governance. The supervisory review and evaluation process is designed to ensure that institutions identify their material risks and allocate adequate capital, and employ sufficient management processes to support such risks.

The supervisory review and evaluation process also encourages institutions to develop and apply enhanced risk management techniques for the measurement and monitoring of risks in addition to the credit, market and operational risks addressed in the core Pillar 1 framework. Other risk types which are not covered by the minimum capital requirements in Pillar 1 include liquidity risk, interest rate risk in the banking book, business risk and concentration risk. These are covered either by capital, or risk management and mitigation processes under Pillar 2.

1.3 Pillar 3

In the CBB's Basel 2 framework, the third pillar prescribes how, when, and at what level information should be disclosed about an institution's risk management and capital adequacy practices.

The disclosures comprise detailed qualitative and quantitative information. The purpose of the Pillar 3 disclosure requirements is to complement the first two pillars and the associated supervisory review process. The disclosures are designed to enable stakeholders and market participants to assess an institution's risk appetite and risk exposures and to encourage all banks, via market pressures, to move toward more advanced forms of risk management.

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

In this report, GIB's disclosures are beyond the minimum regulatory requirements and provide disclosure of the risks to which it is exposed, both on- and off-balance sheet. The disclosures in this report are in addition to the disclosures set out in the consolidated financial statements presented in accordance with International Financial Reporting Standards (IFRS).

2. GROUP STRUCTURE AND OVERALL RISK AND CAPITAL MANAGEMENT

This section sets out the consolidation principles and the capital base of GIB as calculated in accordance with the Pillar 1 guidelines, and describes the principles and policies applied in the management and control of risk and capital.

2.1 Group structure

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

Under the CBB capital adequacy framework, subsidiaries reporting under a Basel 2 framework in other regulatory jurisdictions may, at the bank's discretion, be consolidated based on that jurisdiction's Basel 2 framework, rather than based on the CBB's guidelines. Under this aggregation consolidation methodology, the risk weighted assets of subsidiaries are consolidated with those of the rest of the Group based on the guidelines of their respective regulator to determine the Group's total risk weighted assets.

GIB's principal subsidiary, GIBUK, is regulated by the Financial Services Authority (FSA) of the United Kingdom, and has calculated its risk weighted assets in accordance with the FSA's guidelines.

The principal subsidiaries and basis of consolidation for capital adequacy purposes are as follows:-

Subsidiary	Domicile	Ownership	Consolidation basis
Gulf International Bank (UK) Limited	United Kingdom	100%	Aggregation
GIB Financial Services LLC	Saudi Arabia	100%	Full Consolidation
GIB Investment SPC	Bahrain	100%	Full Consolidation

No investments in subsidiaries are treated as a deduction from the Group's regulatory capital.

2.2 Risk and capital management

GIB maintains a prudent and disciplined approach to risk taking by upholding a comprehensive set of risk management policies, processes and limits, employing professionally qualified people with the appropriate skills, investing in technology and training, and actively promoting a culture of sound risk management at all levels. A key tenet of this culture is the clear segregation of duties and reporting lines between personnel transacting business and personnel processing that business. The Group's risk management is underpinned by its ability to identify, measure, aggregate and manage the different types of risk it faces.

The Board of Directors has created from among its members a Board Risk Policy Committee to review the Group's risk taking activities and report to the Board in this regard. The Board has the ultimate responsibility for setting the overall risk parameters and tolerances within which the Group conducts its activities, including responsibility for setting the capital ratio targets. The Board reviews the Group's overall risk profile and significant risk exposures as well as the Group's major risk policies, processes and controls.

The Management Committee, chaired by the Chief Executive Officer (CEO), has the primary responsibility for sanctioning risk taking policies and activities within the tolerances defined by the Board. The Group Risk Committee assists the Management Committee in performing its risk related functions.

The Group Risk Committee, under the chairmanship of the Managing Director – Risk Management (MD RM) and comprising the Group's most senior risk professionals, provides a forum for the review and approval of new products, risk measurement methodologies and risk control processes. The Group Risk Committee also reviews all risk policies and limits that require approval by the Management Committee. The Assets and Liabilities Committee (ALCO), chaired by the Chief Investment and Treasury Officer (CI&TO), provides a forum for the review of asset and liability activities within GIB. It co-ordinates the asset and liability functions and serves as a link between the funding sources and usage in the different business areas.

2. GROUP STRUCTURE AND OVERALL RISK AND CAPITAL MANAGEMENT (continued)

2.2 Risk and capital management (continued)

From a control perspective, the process of risk management is facilitated through a set of independent functions, which report directly to senior management. These functions include Credit Risk, Market Risk, Operational Risk, Financial Control and Internal Audit. This multi-faceted approach aids the effective management of risk by identifying, measuring and monitoring risks from a variety of perspectives.

Internal Audit is responsible for carrying out a risk-based programme of work designed to provide assurance that assets are being safeguarded. This involves ensuring that controls are in place and working effectively in accordance with Group policies and procedures as well as with laws and regulations. The work carried out by Internal Audit includes providing assurance on the effectiveness of the risk management functions as well as that of controls operated by the business units. The Audit Committee approves the annual audit plan and also receives regular reports of the results of audit work.

The Group's policy is to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future business development. 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 and subordinated term finance.

The Chief Financial Officer (CFO) is responsible for the capital planning process. Capital planning includes capital adequacy reporting, economic capital and parameter estimation, i.e. probability of default (PD) and loss given default (LGD) estimates, used for the calculation of economic capital. The CFO is also responsible for the balance sheet management framework.

The governance structure for risk and capital management is illustrated in the table below:-

Board of Directors		
Audit Committee	Board Risk Policy Committee	
Chief Executive Officer		
Management Committee (Chairman: CEO)	Group Risk Committee (Chairman: MD RM)	Asset and Liability Committee (Chairman: CI & TO)

The risk, liquidity and capital management responsibilities are illustrated in the table below:-

Chief Executive Officer	
Chief Financial Officer (CFO)	Managing Director – Risk Management (MD RM)
Balance Sheet management framework Capital management framework Market and operational risk monitoring and reporting Liquidity monitoring and reporting	Risk management framework and policies Group credit control Credit risk monitoring and reporting

2.3 Risk types

The major risks associated with the Group's business activities are credit, market, operational and liquidity risk. These risks together with a commentary on the way in which the risks are managed and controlled are set out below, based on the Basel 2 pillar in which the risks are addressed.

2.4 Risk in Pillar 1

Pillar 1, which forms the basis for the calculation of the regulatory capital requirement, addresses three specific risk types: credit, market and operational risk.

2. GROUP STRUCTURE AND OVERALL RISK AND CAPITAL MANAGEMENT (continued)

2.4 Risk in Pillar 1 (continued)

i) Credit risk

Credit risk is the risk that a customer, counterparty or an issuer of securities or other financial instruments fails to perform under its contractual payment obligations thus causing the Group to suffer a loss in terms of cash flow or market value. Credit risk is the predominant risk type faced by the Group in its banking, investment and treasury activities, both on- and off-balance sheet. Where appropriate, the Group seeks to minimise its credit exposure using a variety of techniques including, but not limited to, the following:-

- entering netting agreements with counterparties that permit the offsetting of receivables and payables
- obtaining collateral
- seeking third party guarantees of the counterparty's obligations
- imposing restrictions and covenants on borrowers

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 undertaken 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 counterparty, 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 credit decision for an individual counterparty is based 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. Overall exposures are evaluated to ensure broad diversification of credit risk. Potential concentration risks by product, industry, single obligor, credit risk rating and geography are regularly assessed with a view to improving overall portfolio diversification. Established limits and actual levels of exposure are regularly reviewed by the MD RM, Chief Credit Officer and other members of senior management. All credit exposures are reviewed at least once a year. Credit policies and procedures are designed to identify, at an early stage, exposures which require more detailed monitoring and review. The credit risk associated with foreign exchange and derivative instruments is assessed in a manner similar to that associated with on-balance sheet activities. The Group principally utilises derivative transactions to facilitate customer transactions and for the management of interest and foreign exchange risks associated with the Group's longer-term lending, borrowing and investment activities. Unlike on-balance sheet products, where the principal amount and interest generally represent the maximum credit exposure, the notional amount relating to a foreign exchange or derivative transaction typically exceeds the credit exposure by a substantial margin. The measure of credit exposure for foreign exchange and derivative instruments is therefore more appropriately considered to be the replacement cost at current market rates plus an add-on amount commensurate with the position's size, volatility and remaining life. Derivative contracts may also carry legal risk; the Group seeks to minimise these risks by the use of standard contract agreements.

ii) Market risk

Market risk is the risk of loss of value of a financial instrument or a portfolio of financial instruments as a result of adverse changes in market prices and rates, and market conditions such as liquidity. Market risk arises from the Group's trading, asset and liability management and investment activities.

The categories of market risk to which the Group is exposed are as follows:-

Interest rate risk results from exposure to changes in the level, slope, curvature and volatility of interest rates and credit spreads. The credit spread risk is the risk that the interest yield for a security will increase, with a reduction in the security price, relative to benchmark yields as a result of the general market movements for that rating and class of security. Interest rate risk is the principal market risk faced by the Group and arises from the Group's investment activities in debt securities, asset and liability management, and the trading of debt and off-balance sheet derivative instruments.

Foreign exchange risk results from exposure to changes in the price and volatility of currency spot and forward rates. The principal foreign exchange risk arises from the Group's foreign exchange forward and derivative trading activities.

Equity risk arises from exposures to changes in the price and volatility of individual equities or equity indices.

2. GROUP STRUCTURE AND OVERALL RISK AND CAPITAL MANAGEMENT (continued)

2.4 Risk in Pillar 1 (continued)

ii) Market risk (continued)

The Group seeks to manage exposure to market risk through the diversification of exposures across dissimilar markets and establishment of hedges in related securities or off-balance sheet derivative instruments. To manage the Group's exposures, in addition to the exercise of business judgment and management experience, the Group utilises limit structures including those relating to positions, portfolios, maturities and maximum allowable losses. A key element in the Group's market risk management framework is the estimation of potential future losses that may arise from adverse market movements. The Group utilises Value-at-Risk (VaR) to estimate such losses. The VaR is derived from quantitative models that use statistical and simulation methods that take account of all market rates and prices that may cause a change in a position's value. These include interest rates, foreign exchange rates and equity prices, their respective volatilities and the correlations between these variables. The Group's VaR is calculated on a Monte Carlo simulation basis using historical volatilities and correlations to generate a profit and loss distribution from several thousand scenarios.

The VaR takes account of potential diversification benefits of different positions both within and across different portfolios. Consistent with general market practice, VaR is computed for all financial instruments for which there are readily available daily prices or suitable proxies. VaR is viewed as an effective risk management tool and a valuable addition to the non-statistically based limit structure. It permits a consistent and uniform measurement of market risk across all applicable products and activities. Exposures are monitored against a range of limits both by risk category and portfolio and are regularly reported to and reviewed by senior management and the Board of Directors.

An inherent limitation of VaR is that past market movements may not provide an accurate prediction of future market losses. Historic analyses of market movements have shown that extreme market movements (i.e. beyond the 99 per cent confidence level) occur more frequently than VaR models predict. Stress tests are regularly conducted to estimate the potential economic losses in such abnormal markets. Stress testing combined with VaR provides a more comprehensive picture of market risk. The Group regularly performs stress tests that are constructed around changes in market rates and prices resulting from pre-defined market stress scenarios, including both historical and hypothetical market events. Historical scenarios include the 1997 Asian crisis, the 1998 Russian crisis, the events of 9/11 and the 2008 credit crisis. In addition, the Group performs stress testing based on internally developed hypothetical market stress scenarios. Stress testing is performed for all material market risk portfolios.

iii) Operational risk

Operational risk is the risk of loss arising from inadequate or failed internal processes, people and systems or from external events, whether intentional, unintentional or natural. It is an inherent risk faced by all businesses and covers a large number of potential operational risk events including business interruption and systems failures, internal and external fraud, employment practices and workplace safety, customer and business practices, transaction execution and process management, and damage to physical assets.

Whilst operational risk cannot be eliminated in its entirety, the Group endeavours to minimise the risk by ensuring that a strong control infrastructure is in place throughout the organisation. The various procedures and processes used to manage operational risk include effective staff training, appropriate controls to safeguard assets and records, regular reconciliation of accounts and transactions, close monitoring of risk limits, segregation of duties, and financial management and reporting. In addition, other control strategies, including business continuity planning and insurance, are in place to complement the control processes, as applicable.

The Group has an independent operational risk function. As part of the Group's Operational Risk Management Framework (ORMF), comprehensive risk assessments are conducted, which identify operational risks inherent in the Group's activities, processes and systems. The controls in place to mitigate these risks are also reviewed, and enhanced if necessary.

2. GROUP STRUCTURE AND OVERALL RISK AND CAPITAL MANAGEMENT (continued)

2.5 Risk in Pillar 2

Other risk types are measured and assessed in Pillar 2. GIB measures and manages these risk types although they are not included in the calculation of the regulatory capital adequacy ratio. Most of the Pillar 2 risks are included in GIB's calculation of internal economic capital. Pillar 2 risk types include liquidity risk, interest rate risk in the banking book, business risk and concentration risk.

i) 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. The risk arises from the timing differences between the maturity profiles of the Group's assets and liabilities. It includes the risk of losses arising from the following:-

- Forced sale of assets at below normal market prices
- Raising of deposits or borrowing funds at excessive rates
- The investment of surplus funds at below market rates

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 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 approved limits. 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 assets available in the event of 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; 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 a systemic or other crisis, while minimising adverse long term implications for the Group's business activities.

ii) Interest rate risk in the banking book

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.

iii) Business risk

Business risk represents the earnings volatility inherent in all businesses due to the uncertainty of revenues and costs associated with changes in the economic and competitive environment. Business risk is evaluated based on the observed volatility in historical profits and losses.

2. GROUP STRUCTURE AND OVERALL RISK AND CAPITAL MANAGEMENT (continued)

2.5 Risk in Pillar 2 (continued)

iv) Concentration risk

Concentration risk is the risk related to the degree of diversification in the credit portfolio, i.e. the risk inherent in doing business with large customers or not being equally exposed across industries and regions.

Concentration risk is captured in GIB's economic capital framework through the use of a credit risk portfolio model which considers single-name concentrations in the credit portfolio. Economic capital add-ons are applied where counterparty exposures exceed specified thresholds.

Potential concentration risks by product, industry, single obligor, and geography are regularly assessed with a view to improving overall portfolio diversification. Established limits and actual levels of exposure are regularly reviewed by senior management and the Board of Directors.

2.6 Monitoring and reporting

The monitoring and reporting of risk is conducted on a daily basis for market and liquidity risk, on a monthly or quarterly basis for credit risk, and on a quarterly basis for operational risk.

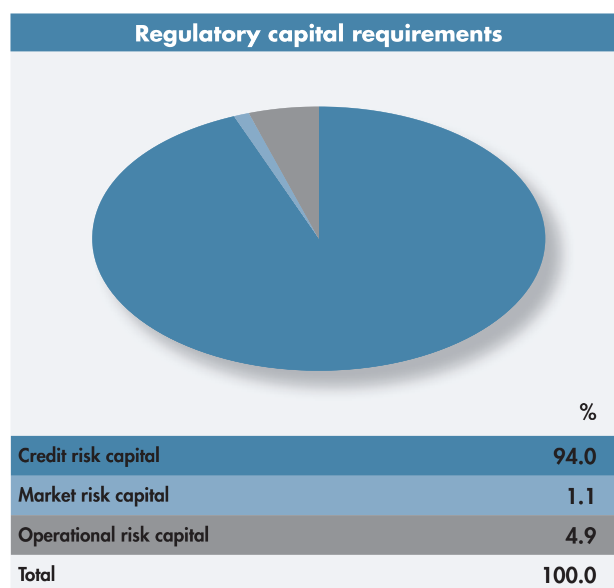
Risk reporting is regularly made to senior management and the Board of Directors. The Board of Directors receives internal risk reports covering market, credit, operational and liquidity risks.

Capital management, including regulatory and internal economic capital ratios, is reported to senior management and the Board of Directors on a monthly basis.

3. REGULATORY CAPITAL REQUIREMENTS AND THE CAPITAL BASE

This section describes the Group's regulatory capital requirements and capital base.

The composition of the total regulatory capital requirement was as follows:-



	%
Credit risk capital	94.0
Market risk capital	1.1
Operational risk capital	4.9
Total	100.0

3. REGULATORY CAPITAL REQUIREMENTS AND THE CAPITAL BASE (continued)

3.1 Capital requirements for credit risk

For regulatory reporting purposes, GIB calculates the capital requirements for credit risk based on the standardised approach. Under the standardised approach on- and off-balance sheet credit exposures are assigned to exposure categories based on the type of counterparty or underlying exposure. The exposure categories are referred to in the CBB's Basel 2 capital adequacy framework as standard portfolios. The primary standard portfolios are claims on sovereigns, claims on banks and claims on corporates. Following the assignment of exposures to the relevant standard portfolios, the RWAs are derived based on prescribed risk weightings. Under the standardised approach, the risk weightings are provided by the CBB and are determined based on the counterparty's external credit rating. The external credit ratings are derived from eligible external rating agencies approved by the CBB. GIB uses ratings assigned by Standard & Poor's, Moody's and Fitch.

An overview of the exposures, RWAs and capital requirements for credit risk analysed by standard portfolio is presented in the table below:-

	Rated exposure US$ millions	Unrated exposure US$ millions	Total exposure US$ millions	Average risk weight US$ millions	RWA US$ millions	Capital requirement US$ millions
Sovereigns	2,048.0	–	2,048.0	3%	56.9	6.8
PSEs	–	8.7	8.7	100%	8.7	1.0
Banks	5,038.8	337.4	5,376.2	29%	1,570.7	188.5
Corporates	1,492.4	7,626.8	9,119.2	91%	8,339.3	1,000.7
Equities	–	171.6	171.6	150%	257.4	30.9
Past due loans	–	91.5	91.5	100%	91.7	11.0
Other assets	2.7	151.5	154.2	97%	149.9	18.0
Total	**8,581.9**	**8,387.5**	**16,969.4**	**62%**	**10,474.6**	**1,256.9**

Exposures are stated after taking account of credit risk mitigants where applicable. The treatment of credit risk mitigation is explained in more detail in section 4.4(vii) of this report.

The unrated exposure to banks principally represents unrated subordinated loans to rated banks.

The definitions of each standard portfolio and the related RWA requirements are set out in section 4 of this report.

3.2 Capital requirements for market risk

GIB uses a Value-at-Risk (VaR) model to calculate the regulatory capital requirements relating to general market risk.

The VaR calculated by the internal model is subject to a multiplication factor determined by the CBB. GIB's multiplication factor has been set at 3.5 by the CBB. The multiplication factor was increased by the CBB from the regulatory minimum of 3.0 during 2008, based on the number of back testing exceptions recorded in the financial year ended 31st December 2007. The trading-related exposures that gave rise to the back testing exceptions in 2007 were liquidated during the year ended 31st December 2008.

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 theoretical 8 per cent minimum capital ratio, to give market risk-weighted exposure on a basis consistent with credit risk-weighted exposure.

3. REGULATORY CAPITAL REQUIREMENTS AND THE CAPITAL BASE (continued)

3.2 Capital requirements for market risk (continued)

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

	RWA US$ millions	Capital requirement US$ millions
Equity risk	32.1	3.9
Interest rate risk	7.9	0.9
Foreign exchange risk	1.5	0.2
Total general market risk	41.5	5.0
Total specific market risk	82.8	9.9
Total	**124.3**	**14.9**

The equity general market risk related to alternative investment funds managed by external managers. The funds have been redeemed and are in the process of liquidation.

3.3 Capital requirements for operational risk

For regulatory reporting purposes, the capital requirement for operational risk is calculated according to the basic indicator approach. Under this approach, the Group's average gross income over the preceding three financial years is multiplied by a fixed alpha coefficient. The alpha coefficient has been set at 15 per cent in the CBB's Basel 2 capital adequacy framework.

The capital requirement for operational risk at 31st December 2009 amounted to US$66.1 million.

3.4 Capital base

The regulatory capital base is set out in the table below:-

	Tier 1 US$ millions	Tier 2 US$ millions	Total US$ millions
Share capital	2,500	–	2,500
Share premium	7.6	–	7.6
Compulsory reserve	169.2	–	169.2
Voluntary reserve	106.7	–	106.7
Retained earnings	(950.7)	–	(950.7)
Unrealised gains on fair valuing AFS equity investments	–	5.7	5.7
Collective impairment provisions (subject to 1.25% RWA limitation)	–	139.4	139.4
Subordinated term finance	–	511.0	511.0
Tier 1 and tier 2 capital base	**1,832.8**	**656.1**	**2,488.9**

Tier 1 capital is defined as capital of the same or close to the character of paid up capital and comprises share capital, share premium, retained earnings and eligible reserves. Retained losses, including the losses for the current year, are included in tier 1 following the external audit. Eligible reserves exclude revaluation gains and losses arising on the remeasurement to fair value of available-for-sale securities and derivative cash flow hedging transactions, with the exception of unrealised gains and losses arising on the remeasurement to fair value of equity securities classified as available-for-sale. Unrealised gains on equity securities classified as available-for-sale are included in tier 2 capital.

Tier 2 capital comprises qualifying subordinated term finance, collective impairment provisions and 45 per cent of unrealised gains arising on the remeasurement to fair value of equity securities classified as available-for-sale.

3. REGULATORY CAPITAL REQUIREMENTS AND THE CAPITAL BASE (continued)

3.4 Capital base (continued)

The subordinated term finance facilities, amounting to US$511.0 million, 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 term finance facilities have been approved for inclusion in tier 2 capital for regulatory capital adequacy purposes by the CBB.

The CBB applies various limits to elements of the regulatory 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.

In accordance with the CBB's Basel 2 capital adequacy framework, securitisation exposures that are rated below BB- or that are unrated are to be deducted from regulatory capital rather than included in RWAs. At 31st December 2009, the Group had no exposure to securitisations.

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

4. CREDIT RISK – PILLAR THREE DISCLOSURES

This section describes the Group's exposure to credit risk and provides detailed disclosures on credit risk in accordance with the CBB's Basel 2 framework in relation to Pillar 3 disclosure requirements.

4.1 Definition of exposure classes

GIB has a diversified on- and off-balance sheet credit portfolio, the exposures of which are divided into the counterparty exposure classes defined by the CBB's Basel 2 capital adequacy framework for the standardised approach for credit risk. A high-level description of the counterparty exposure classes, referred to as standard portfolios in the CBB's Basel 2 capital adequacy framework, and the generic treatments, i.e. the risk weights to be used to derive the RWAs, are as follows:-

Sovereigns Portfolio

The sovereigns portfolio comprises exposures to governments and their respective central banks. The risk weights are 0 per cent for exposures in the relevant domestic currency, or in any currency for exposures to GCC governments. Foreign currency claims on other sovereigns are risk weighted based on their external credit ratings.

Certain multilateral development banks as determined by the CBB may be included in the sovereigns portfolio and treated as exposures with a 0 per cent risk weighting.

PSE Portfolio

Public sector entities (PSEs) are risk weighted according to their external ratings with the exception of Bahrain PSEs, and domestic currency claims on other PSEs which are assigned a 0 per cent risk weight by their respective country regulator.

Banks Portfolio

Claims on banks are risk weighted based on their external credit ratings. A preferential risk weight treatment is available for qualifying short term exposures. Short term exposures are defined as exposures with an original tenor of three months or less.

The Banks portfolio also includes claims on investment firms, which are risk weighted based on their external credit ratings although without any option for preferential treatment for short term exposures.

Corporates Portfolio

Claims on corporates are risk weighted based on their external credit ratings. A 100 per cent risk weight is assigned to exposures to unrated corporates. A preferential risk weight treatment is available for certain corporates owned by the Government of Bahrain, as determined by the CBB, which are assigned a 0 per cent risk weight.

4. CREDIT RISK – PILLAR THREE DISCLOSURES (continued)

4.1 Definition of exposure classes (continued)

Equities Portfolio

The equities portfolio comprises equity investments in the banking book, i.e. the investment securities portfolio. The credit (specific) risk for equities in the trading book is included in market risk RWAs for regulatory capital adequacy calculation purposes.

A 100 per cent risk weight is assigned to listed equities and funds. Unlisted equities and funds are risk weighted at 150 per cent. Investments in rated funds are risk weighted according to the external credit rating. Equity investments in securitisations are deducted from the regulatory capital base.

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

Past due exposures

All past due loan exposures, irrespective of the categorisation of the exposure if it were performing, are classified separately under the past due exposures asset class. A risk weighting of either 100 per cent or 150 per cent is applied depending on the level of provision maintained against the loan.

Other assets and holdings of securitisation tranches

Other assets are risk weighted at 100 per cent.

Securitisation tranches are risk weighted based on their external credit ratings. Risk weightings range from 20 per cent to 350 per cent. Exposures to securitisation tranches that are rated below BB- or are unrated are deducted from regulatory capital rather than subject to a risk weight.

4.2 External rating agencies

GIB uses ratings issued by Standard & Poor's, Moody's and Fitch to derive the risk weightings under the CBB's Basel 2 capital adequacy framework. Where ratings vary between rating agencies, the highest rating from the lowest two ratings is used to represent the rating for regulatory capital adequacy purposes.

4.3 Credit risk presentation under Basel 2

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

- Under the CBB's Basel 2 framework, off-balance sheet exposures are converted into credit exposure equivalents by applying a credit conversion factor (CCF). The off-balance sheet exposure is multiplied by the relevant CCF applicable to the off-balance sheet exposure category. Subsequently, the exposure is treated in accordance with the standard portfolios referred to in section 4.1 of this report in the same manner as on-balance sheet exposures.
- Credit risk exposure reporting under Pillar 3 is frequently reported by standard portfolios based on the type of counterparty. The financial statement presentation is based on asset class rather than the relevant counterparty. For example, a loan to a bank would be classified in the Banks standard portfolio under the capital adequacy framework although is classified in loans and advances in the consolidated financial statements.
- Certain eligible collateral is applied to reduce exposure under the Basel 2 capital adequacy framework, whereas no such collateral netting is applicable in the consolidated financial statements.
- Based on the CBB's Basel 2 guidelines, certain exposures are either included in, or deducted from, regulatory capital rather than treated as an asset as in the consolidated financial statements.
- Under the CBB's Basel 2 capital adequacy framework, external rating agency ratings are based on the highest rating from the lowest two ratings while for internal credit risk management purposes the Group uses the lowest rating.

4. CREDIT RISK – PILLAR THREE DISCLOSURES (continued)

4.4 Credit exposure

i) Gross credit exposure

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

	Gross credit exposure US$ millions	Average gross credit exposure US$ millions
Balance sheet items:		
Cash and other liquid assets	508.2	265.3
Placements	4,101.1	4,481.9
Due from shareholders	–	1,148.2
Trading securities	50.2	133.6
Investment securities	2,018.1	2,052.6
Loans and advances	9,298.1	11,228.1
Other assets, excluding derivative-related items	57.8	145.8
Total on-balance sheet credit exposure	**16,033.5**	**19,455.5**
Off-balance sheet items:		
Credit-related contingent items	2,160.4	2,800.8
Derivative and foreign exchange instruments	78.5	170.8
Total off-balance sheet credit exposure	**2,238.9**	**2,971.6**
Total credit exposure	**18,272.4**	**22,427.1**

The average gross credit exposure is based on daily averages during the year ended 31st December 2009.

Other assets principally comprise accrued interest, fees and commissions.

The gross credit exposure for derivative and foreign exchange instruments is the replacement cost (current exposure) representing the cost of replacing the contracts at current market rates should the counterparty default prior to the settlement date. The gross credit exposure reported in the table above does not include potential future exposure. Further details on the counterparty credit risk relating to off-balance sheet exposures are set out in section 7.3(i) of this report.

4. CREDIT RISK – PILLAR THREE DISCLOSURES (continued)

4.4 Credit exposure (continued)

ii) Credit exposure by geography

The classification of credit exposures by geography, based on the location of the counterparty, was as follows:-

	Placements & other liquid assets US$ millions	Securities US$ millions	Loans and advances US$ millions	Other assets US$ millions	Off balance sheet items US$ millions	Total US$ millions
GCC	1,752.7	1,338.7	8,810.9	45.3	1,669.2	13,616.8
Other MENA region	54.0	42.9	233.6	2.2	122.3	455.0
Europe	2,027.5	63.0	238.9	4.1	259.3	2,592.8
North America	530.0	582.5	0.2	5.8	188.1	1,306.6
Asia	245.1	41.2	14.5	0.4	–	301.2
Total exposure	**4,609.3**	**2,068.3**	**9,298.1**	**57.8**	**2,238.9**	**18,272.4**

The MENA region comprises the Middle East and North Africa.

iii) Credit exposure by industry

The classification of credit exposures by industry was as follows:-

	Placements & other liquid assets US$ millions	Securities US$ millions	Loans and advances US$ millions	Other assets US$ millions	Off balance sheet items US$ millions	Total US$ millions
Financial services	3,318.1	1,272.5	1,436.8	13.7	176.6	6,217.7
Energy, oil and petrochemical	–	268.2	3,056.9	13.8	388.5	3,727.4
Government	1,291.2	276.5	312.1	6.6	31.7	1,918.1
Trading and services	–	–	1,202.0	6.0	626.2	1,834.2
Construction	–	–	596.6	1.0	566.4	1,164.0
Transportation	–	13.1	799.7	1.8	54.6	869.2
Manufacturing	–	–	589.2	2.0	275.9	867.1
Real estate	–	–	741.3	7.0	28.5	776.8
Communication	–	16.2	435.2	1.7	23.8	476.9
Equity investments	–	221.8	–	–	4.9	226.7
Other	–	–	128.3	4.2	61.8	194.3
Total exposure	**4,609.3**	**2,068.3**	**9,298.1**	**57.8**	**2,238.9**	**18,272.4**

4. CREDIT RISK – PILLAR THREE DISCLOSURES (continued)

4.4 Credit exposure (continued)

iv) Credit exposure by internal rating

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

	Placements & other liquid assets US$ millions	Securities US$ millions	Loans and advances US$ millions	Other assets US$ millions	Off balance sheet items US$ millions	Total US$ millions
Neither past due nor impaired						
Rating grades 1 to 4-	4,573.3	1,769.9	6,132.8	39.9	1,425.4	13,941.3
Rating grades 5+ to 5-	36.0	29.5	1,858.6	11.9	637.5	2,573.5
Rating grades 6+ to 6-	–	30.2	570.1	3.3	136.1	739.7
Rating grade 7	–	16.9	128.5	1.5	14.6	161.5
Rating grade 8	–	–	–	–	20.4	20.4
Equity investments	–	204.9	–	–	4.9	209.8
Carrying amount	4,609.3	2,051.4	8,690.0	56.6	2,238.9	17,646.2
Past due but not impaired						
Rating grades 1 to 7	–	–	26.7	–	–	26.7
Rating grade 8	–	–	171.4	–	–	171.4
Carrying amount	–	–	198.1	–	–	198.1
Past due and individually impaired						
Rating grade 8	–	–	9.3	–	–	9.3
Rating grade 9	–	–	81.9	–	–	81.9
Carrying amount	–	–	91.2	–	–	91.2
Individually impaired but not past due						
Rating grades 1 to 7	–	–	257.2	0.9	–	258.1
Rating grade 8	–	–	36.3	0.3	–	36.6
Rating grade 9	–	–	25.3	–	–	25.3
Equity investments	–	16.9	–	–	–	16.9
Carrying amount	–	16.9	318.8	1.2	–	336.9
Total	**4,609.3**	**2,068.3**	**9,298.1**	**57.8**	**2,238.9**	**18,272.4**

The analysis is presented prior to the application of any credit risk mitigation techniques, for example, the off-balance sheet exposures relating to grade 8 counterparties are fully collateralised by cash.

The Group's internal rating system is commented on in more detail in section 8.1 of this report.

4. CREDIT RISK – PILLAR THREE DISCLOSURES (continued)

4.4 Credit exposure (continued)

v) Credit exposure by maturity

The maturity profile of funded credit exposures based on contractual maturity dates was as follows:-

	Placements & other liquid assets US$ millions	Securities US$ millions	Loans and advances US$ millions	Other assets US$ millions	Total US$ millions
Within 3 months	4,608.3	215.5	2,031.5	50.6	6,905.9
4 months to 1 year	1.0	218.0	1,582.2	7.2	1,808.4
Years 2 to 5	–	1,012.6	3,406.6	–	4,419.2
Years 6 to 10	–	340.0	1,418.7	–	1,758.7
Years 11 to 20	–	110.6	756.9	–	867.5
Over 20 years and other	–	171.6	102.2	–	273.8
Total exposure	**4,609.3**	**2,068.3**	**9,298.1**	**57.8**	**16,033.5**

An analysis of off-balance sheet exposure is set out in section 7 of this report.

Securities exposure over 20 years comprises equity investments, net of total collective provisions.

vi) Equities held in the banking book

Equity investments included in investment securities in the consolidated balance sheet are included in the equities standard portfolio in the Pillar 1 credit risk capital adequacy framework. Such equity investments principally comprise investments of a private equity nature, both direct investments and investments in funds managed by external specialist managers and international investment banks.

At 31st December 2009, equity investments held in the banking book amounted to US$171.6 million, of which US$62.2 million comprised managed funds. Unlisted equities, which principally represent private equity investments, are stated at cost less provision for impairment. There are no active markets or other appropriate methods from which to derive reliable fair values for these investments. The Group intends to exit these investments principally by means of IPOs or private placements.

During the year ended 31st December 2009, the total realised gains on equity investments amounted to US$0.5 million. At 31st December 2009, unrealised gains on equity investments amounted to US$12.6 million. 45 per cent of the unrealised gains, or US$5.7 million, was included in tier 2 capital in accordance with the CBB's Basel 2 capital adequacy framework.

vii) Credit risk mitigation

The credit exposure information presented in section 4 of this report represents gross exposures prior to the application of any credit risk mitigation techniques. Collateral items and guarantees which can be used for credit risk mitigation under the capital adequacy framework are referred to as eligible collateral. Only certain types of collateral and some issuers of guarantees are eligible for preferential risk weights for regulatory capital adequacy purposes. Furthermore, the collateral management process and the terms in the collateral agreements have to fulfil the CBB's prescribed minimum requirements (such as procedures for the monitoring of market values, insurance and legal certainty) set out in their capital adequacy regulations.

The reduction of the capital requirement attributable to credit risk mitigation is calculated in different ways, depending on the type of credit risk mitigation, as follows:-

- Adjusted exposure amount: GIB uses the comprehensive method for financial collateral such as cash, bonds and stocks. The exposure amount is adjusted with regard to the financial collateral. The size of the adjustment depends on the volatility of the collateral and the exposure. GIB uses volatility adjustments specified by the CBB, known as supervisory haircuts, to reduce the benefit of collateral and to increase the magnitude of the exposure.

4. CREDIT RISK – PILLAR THREE DISCLOSURES (continued)

4.4 Credit exposure (continued)

vii) Credit risk mitigation (continued)

- Substitution of counterparty: The substitution method is used for guarantees, whereby the rating of the counterparty is substituted with the rating of the guarantor. This means that the credit risk in respect of the customer is substituted by the credit risk of the guarantor and the capital requirement is thereby reduced. Hence, a fully guaranteed exposure will be assigned the same capital treatment as if the loan was initially granted to the guarantor rather than to the customer.

Description of the main types of risk mitigation

GIB uses a variety of risk mitigation techniques in several different markets which contribute to risk diversification and credit protection. The different credit risk mitigation techniques such as collateral, guarantees, credit derivatives, netting agreements and covenants are used to reduce credit risk. All credit mitigation activities are not necessarily recognised for capital adequacy purposes since they are not defined as eligible under the CBB's Basel 2 capital adequacy framework, e.g. covenants and non-eligible tangible collateral such as unquoted equities.

Exposures secured by eligible financial collateral, guarantees and credit derivatives, presented by standard portfolio were as follows:-

	Exposure before credit risk mitigation US$ millions	Of which secured by: Eligible collateral US$ millions	Eligible guarantees or credit derivatives US$ millions
Sovereigns	2,048.0	–	452.3
Banks	5,379.4	3.2	465.3
Corporates	9,613.7	486.0	129.7

Guarantees and credit derivatives

Only eligible providers of guarantees and credit derivatives may be recognised in the standardised approach for credit risk. Guarantees issued by corporate entities may only be taken into account if their rating corresponds to A- or better. The guaranteed exposures receive the risk weight of the guarantor.

GIB uses credit derivatives as credit risk protection only to a very limited extent as the credit portfolio is considered to be well diversified.

Collateral and valuation principles

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. In general, lending is based on the customer's repayment capacity rather than the collateral value. However, collateral is considered the secondary alternative if the repayment capacity proves inadequate. Collateral is not usually held against securities or placements.

Types of eligible collateral commonly accepted

The Group holds collateral against loans and advances in the form of physical assets, cash deposits, securities and guarantees.

4.5 Impaired credit facilities and provisions for impairment

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. 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 re-organisation, 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. For equity securities classified as available-for-sale, a significant or prolonged decline in fair value below cost is considered in determining whether a security is impaired.

4. CREDIT RISK – PILLAR THREE DISCLOSURES (continued)

4.5 Impaired credit facilities and provisions for impairment (continued)

Provisions for impairment are determined based on the difference between the net carrying amount and the recoverable amount of a financial asset. The recoverable amount is measured as the present value of expected future cash flows, including amounts recoverable from guarantees and collateral.

Provisions for impairment are also measured and recognised on a collective basis in respect of impairments that exist at the reporting 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.

i) Impaired loan facilities and related provisions for impairment

Impaired loan facilities and the related provisions for impairment were as follows:

	Gross exposure US$ millions	Impairment provisions US$ millions	Net exposure US$ millions
Corporates	645.1	270.4	374.7
Financial institutions	159.0	123.7	35.3
Total	**804.1**	**394.1**	**410.0**

Impaired loan facilities of US$804.1 million include loans amounting to US$440.0 million that were not past due but for which specific provisions had been established as a matter of prudency. 54.7 per cent of impaired loan facilities were therefore current in terms of both principal and interest.

The impaired loan facilities were to counterparties in the GCC.

ii) Provisions for impairment – loans and advances

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

	Specific provisions				
	Corporates US$ millions	Financial institutions US$ millions	Total US$ millions	Collective provisions US$ millions	Total provisions US$ millions
At 1st January 2009	84.4	9.8	94.2	180.0	274.2
Amounts utilised	(1.8)	–	(1.8)	–	(1.8)
Charge for the year	187.8	113.9	301.7	60.0	361.7
At 31st December 2009	**270.4**	**123.7**	**394.1**	**240.0**	**634.1**

Higher 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 at 31st December 2009 equated to a speculative-grade mean default rate of 13.9 per cent, exceeding the previous historical high corporate default levels witnessed in July 1991.

iii) Impaired investment securities and related provisions for impairment

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

	Gross exposure US$ millions	Impairment provisions US$ millions	Net exposure US$ millions
Equity investments	84.1	67.2	16.9
Total	**84.1**	**67.2**	**16.9**

Total specific impairment provisions of US$67.2 million represented 79.9 per cent of the gross impaired investment securities exposure.

4. CREDIT RISK – PILLAR THREE DISCLOSURES (continued)

4.5 Impaired credit facilities and provisions for impairment (continued)

iv) Provisions for impairment – investment securities

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

	Specific provisions				Collective provisions	Total provisions
	SIVs US$ millions	Equities US$ millions	CDOs US$ millions	Total US$ millions	US$ millions	US$ millions
At 1st January 2009	564.5	68.5	9.5	642.5	134.0	776.5
Exchange rate movements	(1.1)	0.3	–	(0.8)	–	(0.8)
Amounts utilised	(563.4)	(8.0)	(9.3)	(580.7)	(49.5)	(630.2)
Charge / (release) for the year	–	6.4	(0.2)	6.2	(54.2)	(48.0)
At 31st December 2009	**–**	**67.2**	**–**	**67.2**	**30.3**	**97.5**

As referred to in note 9(b) of the consolidated financial statements, the specific provisions for SIVs were fully utilised on the write off of the Group's entire investment in SIVs. The US$49.5 million utilisation of collective provisions arose on the settlement of credit default swap transactions. The release of US$54.2 million of collective provisions arose on the sale of a significant portion of the investment securities portfolio as commented on in more detail in note 7 to the consolidated financial statements.

4.6 Past due facilities

In accordance with guidelines issued by the CBB, credit facilities are placed on non-accrual status and interest income suspended when either principal or interest is overdue by 90 days whereupon unpaid and accrued interest is reversed from income. Interest on non-accrual facilities is included in income only when received. Credit facilities classified as past due are assessed for impairment in accordance with the IFRS guidelines as set out in section 4.5 of this report. A specific provision is established only where there is objective evidence that a credit facility is impaired.

i) Loans

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

	Secured		Unsecured	
	Gross US$ millions	Carrying amount US$ millions	Gross US$ millions	Carrying amount US$ millions
Corporates	198.1	198.1	238.3	73.2
Financial institutions	–	–	125.9	18.0
Total	**198.1**	**198.1**	**364.2**	**91.2**

The past due loans were to counterparties in the GCC.

The secured past due loan facilities were fully secured by shares listed on recognised stock exchanges. The market value of the collateral represented 134 per cent of the principal amount of the secured past due loan facilities.

Non-specific loan provisions of US$240.0 million represented 263.2 per cent of the net carrying amount of unsecured past due loans.

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

	Less than 1 year US$ millions	2 to 3 years US$ millions	Over 3 years US$ millions	Total US$ millions
Corporates	432.4	4.0	–	436.4
Financial institutions	125.0	–	0.9	125.9
Total	**557.4**	**4.0**	**0.9**	**562.3**

4. CREDIT RISK – PILLAR THREE DISCLOSURES (continued)

4.6 Past due facilities (continued)

ii) Investment securities

There were no debt securities for which either principal or interest was over 90 days past due.

4.7 Restructured loan facilities

There were no restructured loan facilities during the year ended 31st December 2009.

5. MARKET RISK – PILLAR THREE DISCLOSURES

5.1 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.

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, and equity 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.

5.2 VaR model

A key element in the Group's market risk management framework is the estimation of potential future losses that may arise from adverse market movements. Exposure to general market risk is calculated utilising a VaR model. The use of the internal model approach for the calculation of the capital requirement for general market risk has been approved by the CBB. The multiplication factor to be applied to the Value-at-Risk calculated by the internal model has been set at 3.5 by the CBB. The multiplication factor was increased by the CBB from the regulatory minimum of 3.0 during 2008, based on the number of back testing exceptions recorded in the financial year ended 31st December 2007. The trading-related exposures that gave rise to the back testing exceptions in 2007 were liquidated during the year ended 31st December 2008.

An inherent limitation of VaR is that past market movements may not provide an accurate prediction of future market losses. Historic analyses of market movements have shown that extreme market movements (i.e. beyond the 99 per cent confidence level) occur more frequently than VaR models predict. Stress tests are therefore regularly conducted to estimate the potential economic losses in such abnormal markets. Stress testing combined with VaR provides a more comprehensive picture of market risk. The Group regularly performs stress tests that are constructed around changes in market rates and prices resulting from pre-defined market stress scenarios, including both historical and hypothetical market events. Historical scenarios include the 1997 Asian crisis, the 1998 Russian crisis, the events of 9/11 and the 2008 credit crisis. In addition, the Group performs stress testing based on internally developed hypothetical market stress scenarios. Stress testing is performed for all material market risk portfolios.

A key objective of asset and liability management is the maximisation of net interest income through the proactive management of the asset and liability repricing profile based on anticipated movements in interest rates. VaR-based limits are utilised to control fluctuations in interest earnings resulting from changes in interest rates. The asset and liability repricing profile of the various asset and liability categories are set out in section 8 of this report.

5. MARKET RISK – PILLAR THREE DISCLOSURES (continued)

5.2 VaR model (continued)

For internal risk management purposes, the Group measures losses that are anticipated to occur within a 95 per cent confidence level. Internally, the Group measures VaR utilising a one month assumed holding period for both trading and banking book positions. For regulatory capital adequacy purposes, the figures are calculated using the regulatory VaR basis at a 99 per cent confidence level (2.33 standard deviations) and a ten-day holding period using one-year unweighted historical daily movements in market rates and prices. Correlations across broad risk categories are excluded for regulatory capital adequacy purposes.

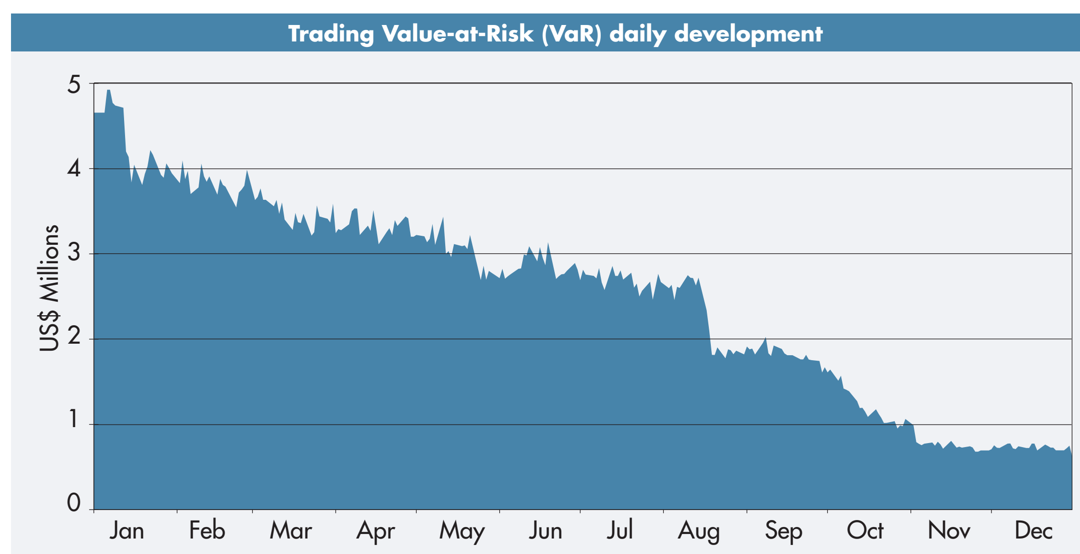
The VaR by risk class for the Group's trading positions as calculated in accordance with the regulatory parameters set out above, was as follows:-

	31.12.09 US$ millions	Average US$ millions	High US$ millions	Low US$ millions
Equity risk	0.6	2.3	4.0	0.6
Interest rate risk	0.1	0.4	1.4	0.1
Foreign exchange risk	–	0.1	0.2	–
Total diversified risk	**0.6**	**2.5**	**4.9**	**0.6**

The equity market risk principally related to alternative investment funds managed by external managers. At 31st December 2009, the funds had been redeemed and were in the process of liquidation.

The Group conducts daily VaR back testing both for regulatory compliance purposes and for the internal evaluation of VaR against actual trading profits and losses. During the year ended 31st December 2009, there were no instances of a daily trading loss exceeding the trading VaR at the close of business on the previous business day.

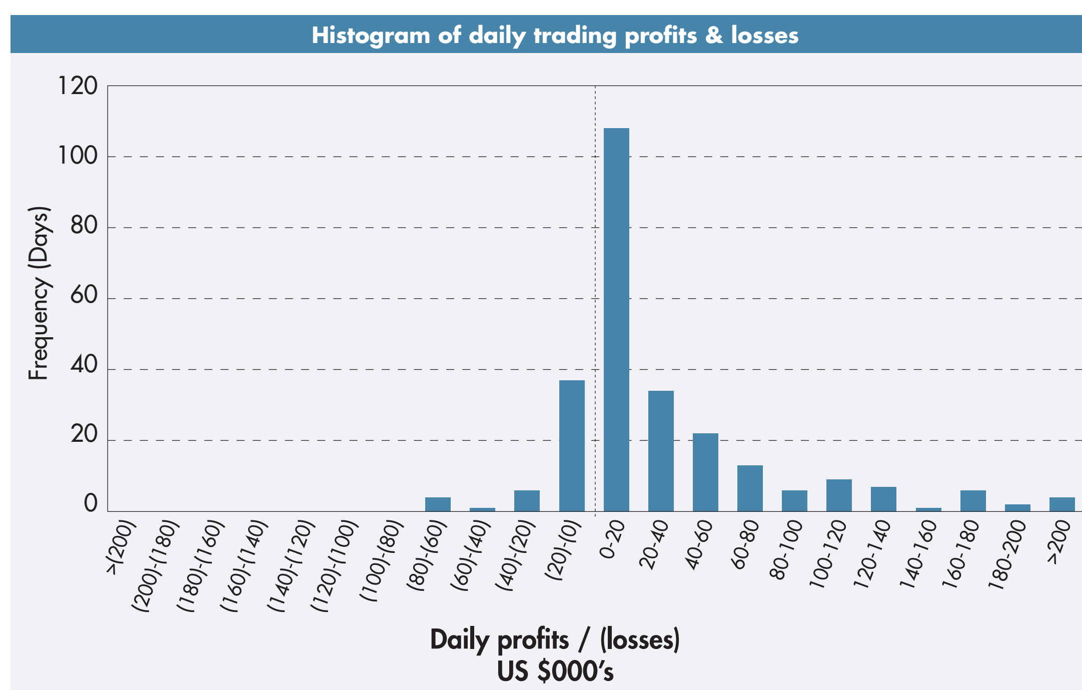
The graph below sets out the total VaR for all the Group's trading activities at the close of each business day throughout the year ended 31st December 2009:-



5. MARKET RISK – PILLAR THREE DISCLOSURES (continued)

5.2 VaR model (continued)

The daily trading profits and losses during the year ended 31st December 2009 are summarised as follows:-



5.3 Sensitivity analysis

The sensitivity of the interest rate risk in the banking book to changes in interest rates is set out in section 8.2(iii) of this report.

The Group is also exposed to the impact of changes in credit spreads on the fair value of available-for-sale debt securities. Credit spread risk is managed within VaR limits and through the use of models to evaluate the sensitivity of changes in equity to movements in credit spreads. Based on the available-for-sale debt securities held at 31st December 2009, a one basis point increase in credit spreads would result in a US$0.5 million decrease in fair value.

6. OPERATIONAL RISK – PILLAR THREE DISCLOSURES

6.1 Operational risk

Whilst operational risk cannot be eliminated in its entirety, the Group endeavours to minimise it by ensuring that a strong control infrastructure is in place throughout the organisation. The various procedures and processes used to manage operational risk include effective staff training, appropriate controls to safeguard assets and records, regular reconciliation of accounts and transactions, close monitoring of risk limits, segregation of duties, and financial management and reporting. In addition, other control strategies, including business continuity planning and insurance, are in place to complement the procedures, as applicable.

As part of the Group's Operational Risk Management Framework (ORMF), comprehensive risk self-assessments are conducted, which identify the operational risks inherent in the Group's activities, processes and systems. The controls in place to mitigate these risks are also reviewed, and enhanced as necessary. A database of measurable operational risk events is maintained, together with a record of key risk indicators, which can provide an early warning of possible operational risk.

6. OPERATIONAL RISK – PILLAR THREE DISCLOSURES (continued)

6.1 Operational risk (continued)

The capital requirement for operational risk is calculated for regulatory purposes according to the basic indicator approach, in which the Group's average gross income for the preceding three financial years is multiplied by an alpha coefficient of 15 per cent as prescribed by the CBB.

The operational risk capital requirement is based on gross income from the preceding three financial years. Consequently, the operational risk capital requirement is updated only on an annual basis.

7. OFF-BALANCE SHEET EXPOSURE AND SECURITISATIONS

Off-balance sheet exposures are divided into two exposure types in accordance with the calculation of credit risk RWAs in the CBB's Basel 2 capital adequacy framework:-

- Credit-related contingent items: Credit-related contingent items comprise guarantees, credit commitments and unutilised approved credit facilities.
- Derivative and foreign exchange instruments: Derivative and foreign exchange 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.

In addition to counterparty credit risk measured within the Basel 2 credit risk framework, derivatives also incorporate exposure to market risk and carry a potential market risk capital requirement, as commented on in more detail in section 5 of this report.

For the two off-balance exposure types, there are different possible values for the calculation base of the regulatory capital requirement, as commented on below:-

7.1 Credit-related contingent items

For credit-related contingent items, the nominal value is converted to an exposure at default (EAD) through the application of a credit conversion factor (CCF). The CCF factor is 50 per cent or 100 per cent depending on the type of contingent item, and is intended to convert off-balance sheet notional amounts into an equivalent on-balance sheet exposure.

Credit commitments and unutilised approved credit facilities represent commitments that have not been drawndown or utilised at the reporting date. The nominal amount provides the calculation base to which a CCF is applied for calculating the EAD. The CCF ranges between 0 per cent and 100 per cent depending on the approach, product type and whether the unutilised amounts are unconditionally cancellable or irrevocable.

The table below summarises the notional principal amounts, RWAs and capital requirements for each credit-related contingent category:-

	Notional principal amount US$ millions	RWA US$ millions	Capital requirement US$ millions
Direct credit substitutes	171.6	161.4	19.4
Transaction-related contingent items	808.7	322.4	38.7
Short-term self-liquidating trade-related contingent items	234.3	48.3	5.8
Commitments, including undrawn loan commitments and underwriting commitments under note issuance and revolving facilities	945.8	450.2	54.0
Total	**2,160.4**	**982.3**	**117.9**

Commitments may be drawndown on demand.

7. OFF-BALANCE SHEET EXPOSURE AND SECURITISATIONS (continued)

7.1 Credit-related contingent items (continued)

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 2009, the Group held cash collateral, guarantees, counter-indemnities or other high quality collateral in relation to credit-related contingent items amounting to US$115.1 million.

7.2 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 activity to hedge its own exposure to market risk. 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 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.

The aggregate notional amounts for derivative and foreign exchange instruments at 31st December 2009 are set out below:

	Trading US$ millions	Hedging US$ millions	Total US$ millions
Interest rate contracts:-			
Interest rate swaps and swaptions	2,505.1	1,131.5	3,636.6
Options, caps and floors purchased	24.3	–	24.3
Options, caps and floors written	24.3	–	24.3
Financial futures	–	181.6	181.6
	2,553.7	1,313.1	3,866.8
Foreign exchange contracts:-			
Unmatured spot, forward and futures contracts	419.5	2,890.9	3,310.4
Credit contracts:-			
Protection sold	39.0	–	39.0
Total	**3,012.2**	**4,204.0**	**7,216.2**

7. OFF-BALANCE SHEET EXPOSURE AND SECURITISATIONS (continued)

7.3 Counterparty credit risk

Counterparty credit risk is the risk that a counterparty to a contract in the interest rate, foreign exchange, equity and credit markets defaults prior to the maturity of the contract. The counterparty credit risk for derivative and foreign exchange instruments is subject to credit limits on the same basis as other credit exposures. Counterparty credit risk arises in both the trading book and the banking book.

i) Counterparty credit risk calculation

For regulatory capital adequacy purposes, GIB uses the current exposure method to calculate the exposure for counterparty credit risk for derivative and foreign exchange instruments in accordance with the credit risk framework in the CBB's Basel 2 capital adequacy framework. Credit exposure comprises the sum of current exposure (replacement cost) and potential future exposure. The potential future exposure is an estimate, which reflects possible changes in the market value of the individual contract during the remaining life of the contract, and is measured as the notional principal amount multiplied by a risk weight. The size of the risk weight depends on the risk categorisation of the contract and the contract's remaining life. Netting of potential future exposures on contracts within the same legally enforceable netting agreement is done as a function of the gross potential future exposure.

The EAD, RWAs and capital requirements for the counterparty credit risk of derivative and foreign exchange instruments analysed by standard portfolio, is presented in the table below:-

	Exposure at Default (EAD)				
	Current exposure US$ millions	Future exposure US$ millions	Total exposure US$ millions	RWA US$ millions	Capital requirement US$ millions
Banks	21.3	35.1	56.4	13.2	1.6
Corporates	57.2	0.1	57.3	0.4	–
Total	**78.5**	**35.2**	**113.7**	**13.6**	**1.6**

ii) Mitigation of counterparty risk exposure

Risk mitigation techniques are widely used to reduce exposure to single counterparties. The most common risk mitigation technique for derivative and foreign exchange-related exposure is the use of master netting agreements, which allow the Group to net positive and negative replacement values of contracts under the agreement in the event of default of the counterparty.

The reduction of counterparty credit risk exposure for derivative and foreign exchange instruments through the use of risk mitigation techniques is demonstrated as follows:-

	Current exposure US$ millions	Effect of netting agreements US$ millions	Netted current exposure US$ millions
Counterparty credit risk exposure	78.5	(16.5)	62.0

7.4 Securitisations

Securitisations are defined as structures where the cash flow from an underlying pool of exposures is used to secure at least two different stratified risk positions or tranches reflecting different degrees of credit risk. Payments to the investors depend upon the performance of the underlying exposures, as opposed to being derived from an obligation of the entity originating those exposures.

At 31st December 2009, the Group had no exposure, net of specific provisions, to securitisation tranches.

7. OFF-BALANCE SHEET EXPOSURE AND SECURITISATIONS (continued)

7.4 Securitisations (continued)

The Group provides collateral management services to five collateralised debt obligations (CDOs) issued between 2002 and 2006. The CDOs are intended to extract relative value from a wide range of asset classes across a broad spectrum of credit ratings. The underlying collateral of the CDOs includes leveraged loans, residential and commercial real estate, consumer finance, lending to small and medium sized enterprises, and other receivables. In order to ensure granularity, each CDO holds between 80 and 140 individual investments providing diversification by size, asset class, industry, geography, credit rating and date of issue.

At 31st December 2009 the underlying investments in the CDOs for which the Group acted as collateral manager amounted to US$1.6 billion. At 31st December 2009, GIB did not hold any exposure to CDOs managed by the Group.

The Fitch rating agency reaffirmed the Group's CDO asset manager rating of CAM 2- in May 2008.

8. INTERNAL CAPITAL INCLUDING OTHER RISK TYPES

GIB manages and measures other risk types that are not included under Pillar 1 in the CBB's Basel 2 framework. These are principally covered in the Group's internal economic capital model.

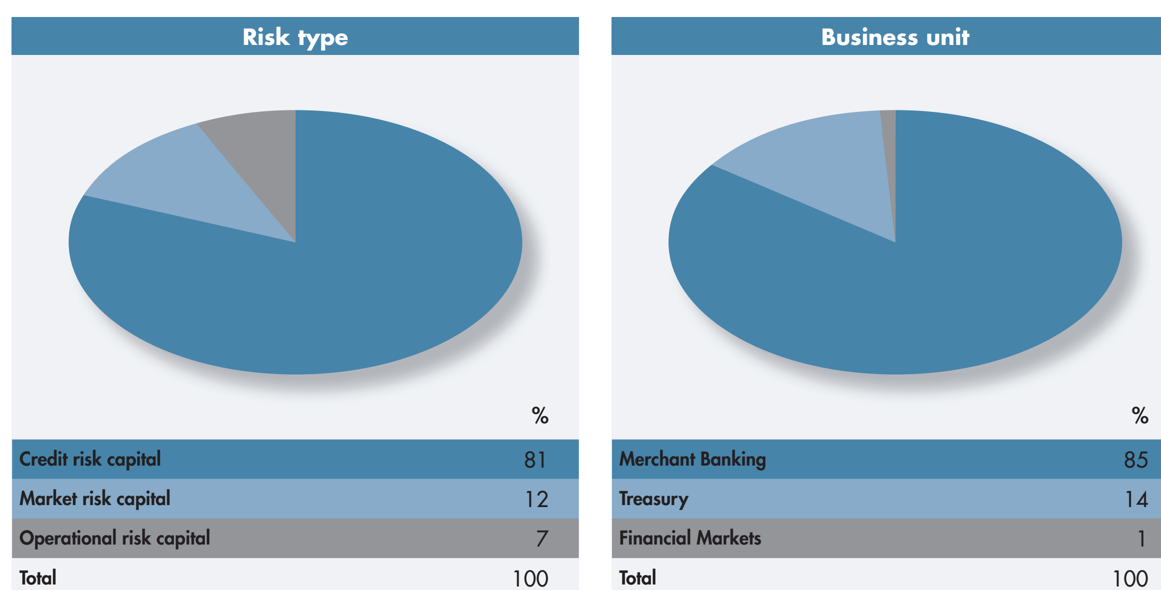
This section describes GIB's economic capital model and discusses the treatment of the other risk types that are not addressed in Pillar 1 of the CBB's Basel 2 framework.

8.1 Economic capital model

For many years, GIB has applied economic capital and risk-adjusted return on capital (RAROC) methodologies which are used for both decision making purposes and performance reporting and evaluation.

GIB calculates economic capital for the following major risk types: credit, market and operating risk. Operating risk includes business risk. Additionally, the economic capital model explicitly incorporates concentration risk, interest rate risk in the banking book and business risk.

The composition of economic capital by risk type and business unit was as follows:-



Risk type	%
Credit risk capital	81
Market risk capital	12
Operational risk capital	7
Total	100

Business unit	%
Merchant Banking	85
Treasury	14
Financial Markets	1
Total	100

8. INTERNAL CAPITAL INCLUDING OTHER RISK TYPES (continued)

8.1 Economic capital model (continued)

The primary differences between economic capital and regulatory capital under the CBB's Basel 2 framework are summarised as follows:-

- In the economic capital methodology, the confidence level for all risk types is set at 99.88 per cent, compared to 99.0 per cent in the CBB's Basel 2 framework.
- Credit risk is calculated using GIB's estimates of probability of default, loss given default and exposures at default, rather than the regulatory values in the standardised approach.
- The economic capital model utilises GIB's embedded internal rating system, as described in more detail later in this section of the report, to rate counterparties rather than using the ratings of credit rating agencies or the application of a 100 per cent risk weighting for unrated counterparties.
- Concentration risk is captured in the economic capital model through the use of an internal credit risk portfolio model and add-on factors where applicable.
- The economic capital model applies a capital charge for interest rate risk in the banking book.
- The economic capital model applies a business risk capital charge where applicable.

Internal rating system

The economic capital model is based on an internal credit rating system. The internal credit rating system is used throughout the organisation and is inherent in all business decisions relating to the extension of credit. A rating is an estimate that exclusively reflects the quantification of the repayment capacity of the customer, i.e. the risk of customer default.

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 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 illustrated below:-

Internal rating grade	Internal classification	Historical default rate range (percentage)	Fitch and Standard & Poor's	Moody's
Investment grade				
Rating grade 1	Standard	0.00 - 0.00	AAA	Aaa
Rating grade 2	Standard	0.00 - 0.04	AA	Aa
Rating grade 3	Standard	0.06 - 0.09	A	A
Rating grade 4	Standard	0.15 - 0.34	BBB	Baa
Sub-investment grade				
Rating grade 5	Standard	0.57 - 1.38	BB	Ba
Rating grade 6	Standard	2.56 - 8.84	B	B
Rating grade 7	Standard	25.67	CCC	Caa
Classified				
Rating grade 8	Substandard	25.67	CC	Ca
Rating grade 9	Doubtful	25.67	C	C
Rating grade 10	Loss	–	D	–

8. INTERNAL CAPITAL INCLUDING OTHER RISK TYPES (continued)

8.1 Economic capital model (continued)

The external rating mapping does not intend to reflect that there is a fixed relationship between GIB's internal rating grades and those of the external agencies as the rating approaches differ.

The historical default rates represent the range of probability of defaults (PDs) between the positive and negative modifiers for each rating grade based on Standard & Poor's one year default rates for the 28 years from 1981 to 2008 for senior unsecured obligations. The default rates represent the averages over the 28 year period and therefore reflect the full range of economic conditions prevailing over that period.

8.2 Other risk types

i) Liquidity risk

The Group has established approved 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 14 day period. 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 funding base is enhanced through term financing, amounting to US$3,007.9 million at 31st December 2009. Access to available but uncommitted short-term funding from the Group's established breadth of Middle East and international relationships provides additional comfort. In addition to the stable funding base, the Group maintains a stock of liquid and marketable securities that can be readily sold or repoed.

At 31st December 2009, 53.4 per cent of total assets were contracted to mature within one year. With regard to deposits, retention records demonstrate that there is considerable divergence between their contractual and effective maturities.

US$6,609.1 million or 65.8 per cent of the Group's deposits at 31st December 2009 were from GCC countries, and a further US$2,540.5 million or 25.2 per cent were from other Middle East and North African countries. Total deposits from counterparties in Middle East and North African countries therefore represented 91.0 per cent of total deposits at 31st December 2009. Historical experience has shown that GIB's deposits from counterparties in the Middle East region are more stable than deposits derived from the international interbank market, which at 31st December 2009 were only US$899.9 million, or 9.0 per cent of the Group's deposit base. At 31st December 2009 placements with counterparties in non-MENA countries were 3.1 times the deposits received, demonstrating that the Group is a net lender of funds in the international interbank market.

ii) Concentration risk

Concentration risk is the credit risk stemming from not having a well diversified credit portfolio, i.e. the risk inherent in doing business with large customers or being overexposed in particular industries or geographic regions. GIB's internal economic capital methodology for credit risk addresses concentration risk through the application of a single-name concentration add-on.

Under the CBB's single obligor regulations, banks incorporated in Bahrain are required to obtain the CBB's approval for any planned exposure to a single counterparty, or group of connected counterparties, exceeding 15 per cent of the regulatory capital base. At 31st December 2009, the following single obligor exposures exceeded 15 per cent of the Group's regulatory capital base (i.e. exceeded US$373.3 million):-

8. INTERNAL CAPITAL INCLUDING OTHER RISK TYPES (continued)

8.2 Other risk types (continued)

ii) Concentration risk (continued)

	On-balance sheet exposure US$ millions	Off-balance sheet exposure US$ millions	Total exposure US$ millions
Counterparty A	633.8	66.0	699.8
Counterparty B	120.0	330.0	450.0
Counterparty C	388.8	–	388.8

This exposure had been approved by the CBB in accordance with the CBB's single obligor regulations. Under the CBB's regulations single obligors include entities in which there is an ownership interest of 20 per cent or more. This is a significantly lower threshold than that used to determine control under IFRS.

iii) Interest rate risk in the banking book

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 Group does not maintain material foreign currency exposures or equity exposures in the banking book. Equities held in the banking book are commented in more detail in section 4.4(vi) of this report.

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.

The repricing profile of the Group's financial assets and liabilities are set out in the table below:-

	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
Cash and other liquid assets	480.6	27.6	–	–	–	508.2
Placements	4,101.1	–	–	–	–	4,101.1
Trading securities	–	–	–	–	50.2	50.2
Investment securities:-						
- Fixed rate	–	–	–	151.5	–	151.5
- Floating rate	1,672.7	52.6	–	–	(30.3)	1,695.0
- Equities and equity funds	–	–	–	–	171.6	171.6
Loans and advances	7,755.9	1,706.6	60.4	15.2	(240.0)	9,298.1
Other assets	–	–	–	–	232.0	232.0
Total assets	14,010.3	1,786.8	60.4	166.7	183.5	16,207.7
Deposits	8,822.7	663.6	559.2	4.0	–	10,049.5
Securities sold under agreements to repurchase	565.0	–	–	–	–	565.0
Other liabilities	–	–	–	–	294.9	294.9
Term financing	2,208.9	1,260.0	50.0	–	–	3,518.9
Equity	–	–	–	–	1,779.4	1,779.4
Total liabilities & equity	11,596.6	1,923.6	609.2	4.0	2,074.3	16,207.7
Interest rate sensitivity gap	**2,413.7**	**(136.8)**	**(548.8)**	**162.7**	**(1,890.8)**	**–**
Cumulative interest rate sensitivity gap	**2,413.7**	**2,276.9**	**1,728.1**	**1,890.8**	**–**	**–**

8. INTERNAL CAPITAL INCLUDING OTHER RISK TYPES (continued)

8.2 Other risk types (continued)

iii) Interest rate risk in the banking book (continued)

The repricing profile is based on the remaining period to the next interest repricing date and the balance sheet categories in the consolidated financial statements.

The repricing profile of placements incorporates the effect of interest rate swaps used to lock-in a return on the Group's net free capital funds. 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.

Interest rate exposure beyond one year amounted to only US$166.7 million or 1.0 per cent of total assets. This exposure represented the investment of the net free capital funds in fixed rate government securities. At 31st December 2009 the modified duration of these fixed rate government securities was 3.55. 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$54,000.

Based on the repricing profile at 31st December 2009, 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 (100 basis points) increase in interest rates across all maturities would result in a reduction in net income before tax for the following year and in the Group's equity by approximately US$5.6 million and US$10.9 million respectively. 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.

iv) Business risk

Business risk represents the earnings volatility inherent in all businesses due to the uncertainty of revenues and costs due to changes in the economic and competitive environment.

For economic capital purposes, business risk is calculated based on the annualised cost base of applicable business areas.

9. CAPITAL ADEQUACY RATIOS AND OTHER ISSUES

9.1 Capital adequacy ratios

The Group's policy is to maintain a strong capital base so as to preserve investor, creditor and market confidence and to sustain the future development of the business. The impact of the level of capital on shareholders' return is also 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 and subordinated term finance.

The capital adequacy ratios of GIB's principal subsidiary, GIBUK, and the Group were as follows:-

	GIBUK	Group
Total RWAs (US$ millions)	584.0	11,149.4
Capital base (US$ millions)	201.5	2,488.9
Tier 1 capital (US$ millions)	201.5	1,832.8
Tier 1 ratio (per cent)	**34.5%**	**16.4%**
Total ratio (per cent)	**34.5%**	**22.3%**

9. CAPITAL ADEQUACY RATIOS AND OTHER ISSUES (continued)

9.1 Capital adequacy ratios (continued)

GIB aims to maintain a minimum tier 1 ratio in excess of 8 per cent and a total capital adequacy ratio in excess of 12 per cent. The CBB's current minimum total capital adequacy ratio for banks incorporated in Bahrain is set at 12 per cent. The CBB does not prescribe a minimum ratio requirement for tier 1 capital.

Strategies and methods for maintaining a strong capital adequacy ratio

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

The evaluation of the strategic planning projections have historically given rise to capital injections. The capital planning process triggered the raising of additional tier 2 capital through a US$400 million subordinated debt issue in 2005 to enhance the total regulatory capital adequacy ratio, and a US$500 million capital increase in March 2007 to provide additional tier 1 capital to support planned medium term asset growth. A further US$1.0 billion capital increase took place in December 2007 to enhance capital resources and compensate for the impact of provisions relating to exposures impacted by the global credit crisis.

9.2 ICAAP considerations

Pillar 2 in the CBB's Basel 2 framework covers two main processes: the ICAAP and the supervisory review and evaluation process. The ICAAP involves an evaluation of the identification, measurement, management and control of material risks in order to assess the adequacy of internal capital resources and to determine an internal capital requirement reflecting the risk appetite of the institution. The purpose of the supervisory review and evaluation process is to ensure that institutions have adequate capital to support the risks to which they are exposed and to encourage institutions to develop and apply enhanced risk management techniques in the monitoring and measurement of risk.

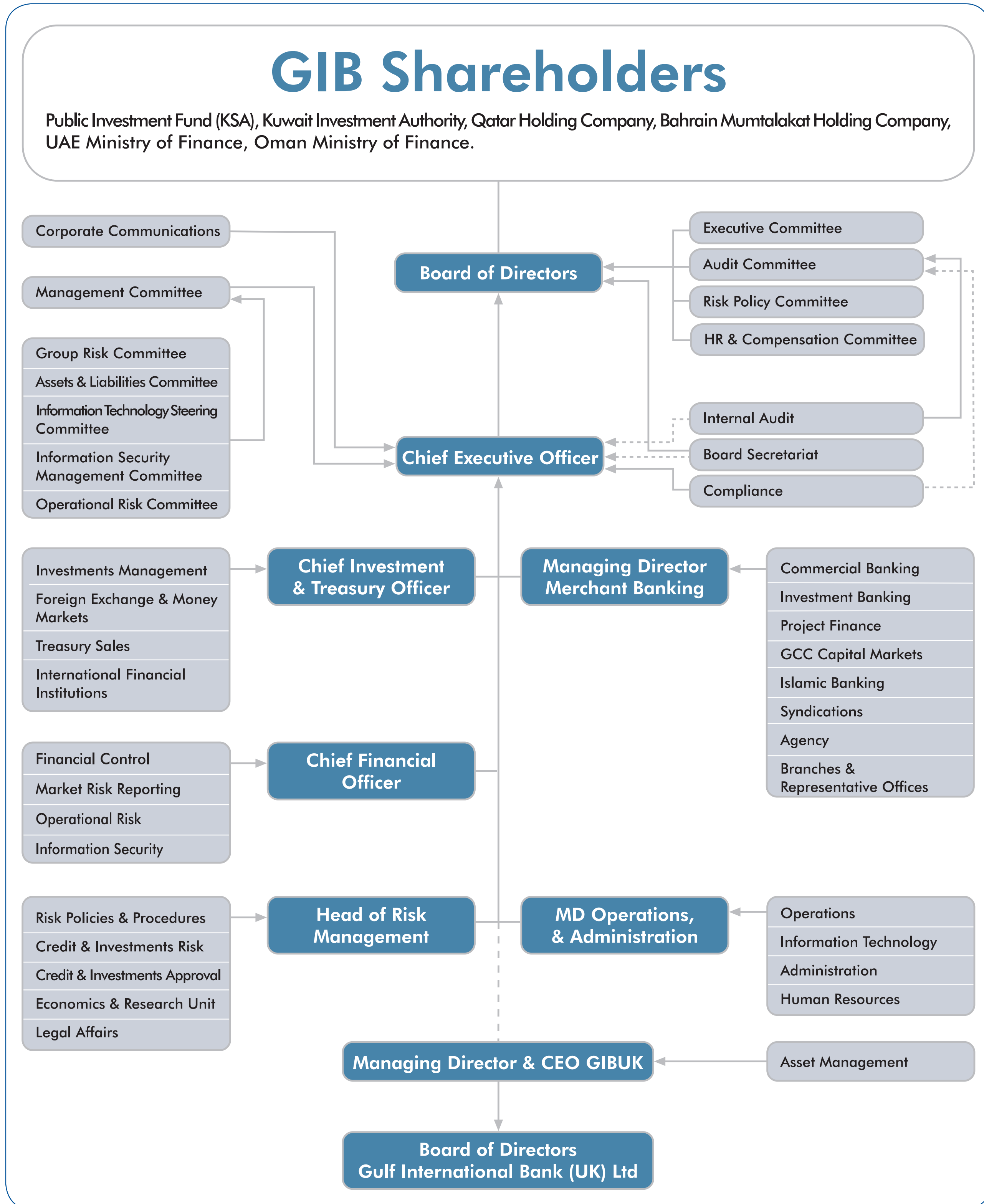
GIB's regulatory capital base exceeded the CBB's minimum requirement of 12 per cent throughout the year ended 31st December 2009. Based on the results of capital adequacy stress testing and capital forecasting, GIB considers that the buffers held for regulatory capital adequacy purposes are sufficient and that GIB's internal minimum capital targets of 8 per cent for tier 1 capital and 12 per cent for total capital are adequate given its current risk profile and capital position. The Group's regulatory capital adequacy ratios set out in section 9.1 of this report significantly exceeded the minimum capital targets and are high by international comparison.

GIB uses its internal capital models, economic capital, and capital adequacy calculations based on the CBB's FIRB approach for credit risk when considering internal capital requirements both with and without the application of market stress scenarios. As a number of Pillar 2 risk types exist within GIB's economic capital framework (i.e. interest rate risk in the banking book, concentration risk and business risk), GIB uses its existing internal capital measurements as the basis for determining additional capital buffers. GIB considers the results of its capital adequacy stress testing, along with economic capital and RWA forecasts, to determine its internal capital requirement and to ensure that the Group is adequately capitalised in stress scenarios reflecting GIB's risk appetite.

10. GLOSSARY OF ABBREVIATIONS

ALCO	Assets and Liabilities Committee
AMA	Advanced Measurement Approach
Basel Committee	Basel Committee for Banking Supervision
CBB	Central Bank of Bahrain
CCF	Credit Conversion Factor
CDO	Collateralised Debt Obligation
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CI & TO	Chief Investment and Treasury Officer
EAD	Exposure at Default
FIRB Approach	Foundation Internal Ratings Based Approach
FSA	Financial Services Authority (of the United Kingdom)
GCC	Gulf Cooperation Council
GIB	Gulf International Bank B.S.C.
GIBUK	Gulf International Bank (U.K.) Limited
The Group	Gulf International Bank B.S.C. and subsidiaries
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
LGD	Loss Given Default
MD RM	Managing Director - Risk Management
MENA	Middle East and North Africa
ORMF	Operational Risk Management Framework
PD	Probability of Default
PSE	Public Sector Entities
RAROC	Risk-adjusted Return on Capital
RMBS	Residential Mortgage-Backed Securities
RWA	Risk Weighted Amount
SIV	Structured Investment Vehicle
VaR	Value-at-Risk

Organisation and Corporate Governance Chart



Biographies of the Board and Senior Management

BOARD OF DIRECTORS

H.E. Jammaz bin Abdullah Al-Suhaimi ❶
Chairman

H.E. Al-Suhaimi holds a Bachelor's degree in Electrical Engineering from the University of Washington in Seattle, USA. He joined GIB as Chairman of the Board of Directors in 2008 and was re-elected in 2009. Prior to that, he served between 2004 and 2006 as Chairman and Chief Executive of the Capital Market Authority, the regulatory body for the capital market in the Kingdom of Saudi Arabia. During the period 1989-2004, he was Deputy Governor of the Saudi Arabian Monetary Agency. He initially joined SAMA as Director-General for Banking Control. He had also held various senior management positions in the government including that of Deputy Director General of the Saudi Industrial Development Fund (1982-1984). H.E. Al-Suhaimi has held Board memberships in many leading public and private organizations such as the Saudi Arabian General Investment Authority, the General Petroleum and Minerals Organisation, the National Company for Cooperative Insurance and the London-based Saudi International Bank (which merged with GIB in 1999).

Mr. Mansour bin Saleh Al Maiman ❶ ❹
Vice Chairman

BA in Accounting and Business Administration, King Saud University (1973), and MBA from the University of Dallas, USA (1980). He joined GIB's Board of Directors in 2009. Mr. Al Maiman is currently Deputy Minister of Finance and Secretary General of the Public Investment Fund in Saudi Arabia (since 1998). Prior to that he was Assistant Deputy Minister for Budget and Administration (1993-1998). Mr. Al Maiman is a Board Member of Ma'aden, Southern Cement Company, the Saudi Stock Exchange, Saudi Arabian Railways Company and Saudi Credit & Savings Bank.

H.E. Dr. Hamad bin Sulaiman Al-Bazai ❶ ❸

BA in Administrative Sciences, King Saud University, Saudi Arabia, MS and Ph.D. in Economics, Colorado State University, USA. Dr. Al-Bazai was appointed to the Board in 1999. He is currently the Vice Minister of Finance in the Kingdom of Saudi Arabia. Prior to that he served as Deputy Minister of Finance for Economic Affairs. Dr. Al-Bazai is a Member of the Preparatory Committee of the Supreme Petroleum Council and a Board Member of the Human Resources Development Fund, the Southern Region Cement Company and the Higher Education Fund.

Professor Abdullah bin Hassan Al-Abdul-Gader ❷ ❹

Dr. Al-Abdul-Gader has BS in Business Administration (1981) and MBA (1983) from King Fahd University of Petroleum and Minerals and Ph.D. in Business Administration from the University of Colorado, USA (1988). He joined GIB's Board of Directors in 2009. Dr. Al-Abdul-Gader has been a Professor at King Fahd University of Petroleum and Minerals since 1981. Between 2004-2009, he was a Commissioner at the Saudi Capital Market Authority. He has wide experience as Board Member in public companies and professional associations in Saudi Arabia such Saudi Telecom, Saudi Computer Society, and Saudi Organization of Certified Public Accountants.

Mr. Sulaiman bin Abdullah Al-Hamdan ❶ ❸

Bachelor of Arts in Administrative Science, King Saud University (1979) and MBA from the University of New Haven, USA (1985). He joined GIB's Board of Directors in 2009. Mr. Al-Hamdan is the Chief Executive Officer of National Air Services (NAS) in Saudi Arabia (since 2008). Prior to that he held various positions at the Saudi British Bank, including that of Deputy Managing Director and General Manager Personal Banking. He worked at the Saudi Fund for Development between (1979-1985). Mr. Al-Hamdan sits on the boards of directors of Middle East Specialised Cables (MESC), Saudi Hollandi Capital and Al Ahlia Cooperative Insurance Company.

Mr. Abdulla bin Mohammed Al Zamil ❷ ❸

BA in Industrial Engineering, University of Washington, USA (1987) and MBA in Financial and Business Administration from King Fahd University of Petroleum and Minerals (1992). Mr. Al Zamil joined GIB's Board of Directors in 2009. He is currently the Chief Executive Officer of Zamil Industrial Investment Company. He was the Company's Chief Operating Officer between 2004-2009. Prior to this he was Senior Vice President at Zamil Air Conditioners. He started his career at Zamil Air Conditioners in 1987 as an industrial engineer. Mr. Al Zamil is Chairman of Zamil Hudson Company, Armacell Zamil Middle East Co. and Gulf Electronic Management & Systems Co. He is a Board Member of many other companies, including Zamil New Delhi Infrastructure Private Ltd. in India, Bahrain Industrial Group and Middle East Air Conditioners Co.

Mr. Khaled bin Saleh Al-Mudaifer ❷ ❹

BSc in Engineering (1984) and MBA (1987) from King Fahd University of Petroleum and Minerals. He joined GIB's Board of Directors in 2009. Currently Mr. Al-Mudaifer is the Vice President-Phosphate SBU and New Business Development at the Saudi Arabian Mining Company (Ma'aden). He joined the company in 2006 as Vice President for Industrial Affairs. Prior to that, he was General Manager and Board Secretary of Qassim Cement Company (1993-2006). Between 1987-1993, he held various positions at the Eastern Petrochemical Company (Sharq), including that of Vice President-Finance. Mr. Al-Mudaifer is a member of Qassim Region Council, Board and Executive Committee Member of Saudi Arabian Railroad Company, Board Member and Executive Committee Chairman of Ma'aden Phosphate Company and Chairman of Ma'aden Infrastructure Company.

❶ **Executive Committee Member**
❷ **Audit Committee Member**
❸ **Risk Policy Committee Member**
❹ **HR & Compensation Committee Member**

SENIOR MANAGEMENT

Dr. Yahya A. Alyahya
Chief Executive Officer

Dr. Alyahya served on the Board of The World Bank Group as Executive Director representing Saudi Arabia from 1999 to 2006. During that period he served in many capacities, most notably as Dean of Executive Directors and Chairman of the Board Steering Committee (03-06); Chairman of the Personnel Committee and Member of the Budget Committee (02-03); Vice Chairman of the Audit Committee and Member of the Governance Committee (00-02). Prior to that Dr. Alyahya served as Advisor to the Governor, Saudi Arabian Monetary Agency (99); General Manager of E.A. Juffali & Bros. in Riyadh (94-99); Founder and Director General, The Institute of Banking, SAMA, in Riyadh (89-94); Professor of Industrial and Systems Engineering at King Saud University, Riyadh (86-89) and the University of Michigan, USA (83-86); Lecturer on Matching Problems and Algorithms at the Indian Statistical Institute, Bangalore, India (82); and a Project Analyst at the Saudi Industrial Development Fund, Riyadh (75). Dr. Alyahya has also served on the Boards and Board Committees of many organizations, most notably Saudi Re (first reinsurer in SA) (07-08), Gulf Investment Corporation (GIC) (06-08), National Commercial Bank (NCB) (08), Gulf International Bank (GIB) (99-01); Saudi Engineering Society (79-99); Audit Committee of AlBank AlSaudi AlFaransi (97-99) and Saudi Agricultural Bank (92-95). Dr. Alyahya holds a PhD in Industrial and Systems Engineering from The University of Michigan, Ann Arbor (83) and is a graduate of the UPM (75). Currently, Dr. Alyahya is Chief Executive Officer of Gulf International Bank since January, 2009. He also chairs the Board of Shuaibah Water and Electricity Company (first IWPP in SA), and sits on the Board of Oger Telecom.

Mr. Stephen Williams
Managing Director-Chief Financial Officer

Chartered Accountant, Member of the Institute of Chartered Accountants in England and Wales (ICAEW). BSc Economics, University College Cardiff, UK. Mr. Williams joined GIB in 1987. He was appointed Group Financial Controller in 2000 and Chief Financial Officer in 2008. He is directly responsible for Groupwide statutory, regulatory and management reporting; financial and balance sheet planning; market, operational and liquidity risk management; and information security. Mr. Williams was responsible for GIB's Basel 2 implementation project and was a member of the Institute for International Finance's (IIF) Working Group on Capital Adequacy. Mr. Williams is a member of GIB's Management Committee, Group Risk Committee, Assets and Liabilities Committee, Information Systems Committee, and is the chairman of the Information Security Committee and Operational Risk Committee. Prior to joining GIB, Mr. Williams worked for KPMG in London and the Middle East.

Mr. Antoine Dijkstra
Managing Director-Chief Investment and Treasury Officer

Mr. Dijkstra graduated in Economics at the Erasmus University Rotterdam and completed his doctorates at the same institution. He also attended the executive course at INSEAD (France) in 2005. He joined GIB in 2008 as Managing Director and Chief Investment & Treasury Officer. Between 2006 and June 2008, he was a Senior Managing Director at Bear Stearns International in London. He is also a member of the Supervisory Board at Brink's NV, a member of the Board of the Trust Fund of the Erasmus University Rotterdam and member of the Board of Zegora Investments in Zurich. Between 2000 and 2006, he was a member of the Managing Board of NIB Capital NV in the Netherlands with responsibility for the Strategic Business Units Financial Markets, Real Estate Markets, Investment Management and Wealth Management. He is also a former member of the Board of Harcourt Investment Consulting.

Mr. Abbas Ameeri*
Managing Director-Merchant Banking

Mr. Ameeri has banking experience of 25 years at GIB, where he worked within the credit and banking groups. He is responsible for GIB's total relationship efforts within the GCC, including ministries of finance, government agencies, corporations, financial institutions and investment companies. He also supervises other activities, including project and structured finance, syndications and Islamic banking, as well as the activities of GIB's branches in Riyadh, Jeddah, London and New York and the two representative offices in Abu Dhabi and Beirut. Mr. Ameeri is a member of GIB's Management Committee, the Credit Committee and the Assets and Liabilities Committee.

**Mr. Ameeri retired from GIB in October 2009.*

Mr. Hassan Abdulghani
Managing Director-Operations and Administration

Mr. Abdulghani joined GIB more than 30 years ago, where he worked within various departments and business units and headed the Singapore Branch. He completed many specialised and advanced training programmes in credit and operations, including the Darden Executive Management Program from the University of Virginia, USA. Mr. Abdulghani was appointed Managing Director in 2007, and his responsibilities cover the Bank's operations, information technology, human resources and administration services. Apart from being responsible for establishing Riyadh Branch, Mr. Abdulghani served as head of the Human Resources Group, GCC Branches & Syndications, Financial Institutions and other areas. Mr. Abdulghani is a member of GIB's Management Committee, the Group Risk Committee, Information Systems Committee and Information Security Committee.

Mr. Masood Zafar
Acting Head of Risk Management and Chief Credit Officer

Chartered Accountant, Fellow of the Institute of Chartered Accountants in England and Wales. Mr. Zafar joined GIB in 1982 in Internal Audit. He was appointed Chief Internal Auditor in 1987. In 2004 he was appointed Chief Credit Officer reporting to the Chief Operating Officer and Head of Risk. Mr. Zafar is a member of the Management Committee, the Group Risk Committee, the Asset and Liabilities Committee and the Operational Risk Committee. Prior to joining GIB Mr. Zafar worked for Ernst and Young in London and for KPMG in Bahrain.

Matthew C. Snyder
Managing Director and CEO, GIBUK

BA in Political Science, CW Post College, USA and MA in International Politics, Long Island University, USA. Mr. Snyder first joined GIB's principal subsidiary Gulf International Bank (UK) Ltd. (then Saudi International Bank) in 1993. From 1982 to 1993 he was President and Chief Executive Officer of AI International, a US-based diversified, private industrial company. He previously worked for eleven years in the New York offices of Schroders, a London-based merchant bank. He is currently the CEO of Gulf International Bank (UK) Ltd.

Group Corporate Directory

General Management

Dr. Yahya Alyahya
Chief Executive Officer
Stephen Williams
Managing Director - Chief Financial Officer
Antoine Dijkstra
Managing Director - Chief Investment & Treasury Officer
Hassan Abdulghani
Managing Director - Operations & Administration
Masood Zafar
Acting Head of Risk Management and Chief Credit Officer
Matthew Snyder
Managing Director & CEO - GIBUK

Merchant Banking

Commercial Banking

M. Chandrasekaran
Head of Commercial Banking
Ali Al-Derazi
Head of UAE, Bahrain, Kuwait and Eastern Province of KSA
Ali A. Wahab
Head of Oman & Qatar
Fadel AlMeer
Country Head - Saudi Arabia
Haroon Alireza
Jeddah Branch Manager

Structured Finance

M. Chandrasekaran
Head of Structured Finance
Ravi Krishnan
Project Finance & Advisory
Rajan Malik
Syndications & Agency
Iftikhar Ali
Islamic Banking

International Banking

Asghar Ali Baba
Head of International Banking
Charbel Khazen
London Branch
Gregga Baxter
New York Branch
Hassan Yaseen
Beirut Representative Office

Investment Banking

Srinivas Vemparala
Head of Investment Banking
Maneesh Ajmani
GCC Private Equity
Fakhre Fazli
Corporate Finance - GCC
Khalid Al-Ghamdi
GIB Financial Services, Saudi Arabia

Asset Management (GIBUK)

Uday Patnaik
Chief Investment Officer
Alex Gracian
Equity Portfolio Management
Anthony Chisnall
Head of Investor Relations

Treasury

Steven Moulder
Head FX, MM, Fixed Income & Derivatives
Yaser Humaidan
Head of Investments
Ali Al-Qaseer
Head of International Financial Institutions

Risk Management & Finance

Russell Bennett
Head of Financial Management
Rahul Thomas
Head of Market Risk
Michael Cowling
Head of Information Security and Operational Risk
Shane Panjvani
Head of Operational Risk
Sameer Al-Jishi
Head of Information Security
Julian Anthony
Chief Financial Officer - GIBUK

Support Functions

Ali Buhejji
Operations - Bahrain
Ali Ashoor
Administration Services - Bahrain
Sanjay Narkar
Head of Information Technology - Bahrain
Dimitri Varvitsiotis
IT Applications - Bahrain
Ebrahim Al-Rafaei
IT Operations - Bahrain
Rashed Abdul-Rahim
Operations & Administration - Saudi Arabia
David Maskall
Operations - GIBUK

Human Resources

Cornel Fourie
Chief Human Resources Officer
Jamal Hijris
Human Resources - Bahrain
Darshan Singh
Human Resources Development

Audit, Legal & Compliance

Hassan Al-Mulla
Group Chief Auditor
Umera Ali
Legal Counsel
Georges Djandji
Head of Compliance - Bahrain
Toby Billington
General Councel & Head of Corporate Office/Company Secretary - GIBUK

Corporate Communications

Abdulla Naneesh
Head of Corporate Communications & Acting Secretary to the Board

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