# 1 Overview

Effective January 2008, the Central Bank of Bahrain (CBB) introduced a new Public Disclosure (PD) module in accordance with the Basel-II Pillar 3 guidelines.

This report sets out to outline the qualitative and quantitative public disclosure requirements that SICO adheres to in order to enhance corporate governance and financial transparency through better public disclosure.

Basel II framework is composed of the following 3 pillars:

- Pillar 1: Describes the minimum capital requirements which includes the calculation of the capital adequacy ratio
- Pillar 2: Described supervisory review processes which includes the Internal Capital Adequacy Process
- Pillar 3: Describes Market discipline which includes disclosure of risk management process and capital adequacy information

The information presented herein pertain to Securities and Investment Company BSC (c) ( "SICO", or the "Bank") consolidated with its subsidiaries, and in addition to the disclosures set out in the consolidated financial statements for the year ended December 31st 2010.

This report outlines the description of the Bank's risk management framework, and capital adequacy policies and practices, including detailed information on the capital adequacy measurement process. The information presented herein pertains to Securities and Investment Company BSC (c) consolidated with its subsidiaries (together termed as "SICO" or the "Bank") and should be read in conjunction with the risk and capital management disclosures provided by the Bank in their annual report for the year ended 31 December 2010.

SICO's disclosed tier-1 and total capital adequacy ratios are in full compliance and well within the minimum capital requirements under the CBB's Basel-II framework.

## 1.1 Basis and Frequency of Disclosures

This disclosure document has been prepared by SICO in accordance with the CBB's requirements of Pillar 3 as set out in its Rulebook Volume 1, PD Module. Unless otherwise stated, all figures are as at 31 December 2010, the financial year-end. Future disclosures will be issued on an annual basis and published as soon as practicable after the publication of the Audited Financial Statements and certain prescribed quantitative disclosures will be made semi-annually on the website.

## 1.2 Scope

SICO is a wholesale bank incorporated in Bahrain and is regulated by the CBB. The Basel II Framework therefore applies to the Bank and its subsidiary companies (together "the Group"). There is a regulatory requirement to calculate and maintain minimum regulatory capital ratios on both a solo as well as consolidated basis.

The principal subsidiary that is fully consolidated into the financial statements of SICO is SICO Funds Services Company BSC (c) ("SFS"), also incorporated in Bahrain, which provides custody and administration services. There is no restriction on the transfer of funds or regulatory capital within the Group.

## 1.3 Changes to Capital Structure

During the year ended 31 December 2010, the share capital of the Bank increased by BD 108 thousand pursuant to allocation of 1,086,598 shares under the Employee Stock Option Plan (ESOP) for the year 2009. The Bank has complied with all externally imposed capital requirements throughout the year. The movement in the issued and fully paid up capital during the year is set out below:

| (BHD 000) | 2010 | 2009 |
|---|---|---|
| **Issued and fully paid:-** | | |
| At 1 January | 42,420 | 42,346 |
| Bonus shares issued during the year | - | - |
| Rights issue during the year | - | - |
| Issue of shares to the employee share incentive scheme during the year | 108 | 74 |
| **At 31 December** | **42,528** | **42,420** |

## 2 Approach for Capital requirement

Effective 1 January 2008 the Bank is required to comply with the provisions of the revised Capital Adequacy Module of the CBB (revised based on the Basel II framework) in respect of regulatory capital. The Bank has adopted the standardized approach to credit and market risk management, and the basic indicator approach for the operational risk management.

As at 31 December 2010, the Bank's total risk weighted assets amounted to BD 85,922; Tier 1 Capital amounted to BD 51,238 and total regulatory capital amounted to BD 55,507. Accordingly, Tier 1 and Total Capital Adequacy Ratio was 59.63% and 64.60% respectively. These ratios exceed the minimum capital requirements under the CBB's Basel II framework.

Despite the potential impact on shareholder return, the bank upheld its policy to maintain a strong and stable capital base in order to protect investor, creditor and market confidence and to sustain future development of the business. However, the Bank also recognizes the need to strike a balance between the higher returns that might be possible with greater gearing and the advantages and security afforded by a sound capital position.

## 2.1 Capital Adequacy (consolidated capital structure)

Tier 1 and Tier 2 Capital as at 31 December were as follows:-

| BHD 000's | 2010 | 2009 |
|---|---|---|
| **Tier 1 Capital** | | |
| Issued and fully paid ordinary shares | 42,528 | 42,420 |
| Statutory Reserve | 3,594 | 3,286 |
| General Reserve | 1,359 | 1,050 |
| Share Premium | 588 | 560 |
| Retained Earnings Brought forward | 3,483 | 3,209 |
| Gross unrealized loss arising from fair valuing equity securities | (214) | (480) |
| Securitization Exposures subject to deduction | (100) | (100) |

| | | |
|---|---|---|
| **TOTAL TIER 1 capital** | **51,238** | **49,945** |
| | | |
| **Tier 2 Capital** | | |
| Current interim profits | 3,910 | 3,152 |
| 45% of gross unrealized gains arising from fair valuing equity securities | 459 | 217 |
| Securitization Exposures subject to deduction | (100) | (100) |
| **TOTAL TIER 2 CAPITAL** | **4,269** | **3,269** |

The Bank's regulatory capital position was as follows:

*Based on year end balances:-*

| BHD 000's | **2010** | **2009** |
|---|---|---|
| **Risk weighted exposure** | | |
| Credit risk | 42,800 | 42,007 |
| Market risk | 28,042 | 8,186 |
| Operational risk | 15,080 | 14,431 |
| **Total risk weighted assets** | **85,922** | **64,624** |
| Tier 1 Capital | 51,238 | 49,945 |
| Tier 2 Capital | 4,269 | 3,269 |
| **Total regulatory capital** | **55,507** | **53,214** |
| Tier 1 Capital Adequacy Ratio | 59.63% | 77.28% |
| **Total Capital adequacy ratio** | **64.60%** | **82.34%** |

## 2.2 Regulatory Capital requirements for Market Risk

2010

| Asset Categories for Market Risk | Period | | Year end | |
|---|---|---|---|---|
| BHD 000's | **Minimum** | **Maximum** | **Actual Risk Weighted Assets** | Requirement @ 12% |
| Interest Rate Position Risk | 397 | 682 | 439 | 53 |
| Equities Position Risk | 52 | 1,617 | 1,617 | 194 |
| Foreign Exchange Risk | 182 | 283 | 188 | 23 |
| *Total minimum capital for market risk* | | | *2,244* | *270* |
| Multiplier | | | 12.5 | 12.5 |
| **Total market risk weighted exposures under the STA** | | | **28,043** | **3,375** |

2009

| Asset Categories for Market Risk | Period | | Year end | |
|---|---|---|---|---|
| BHD 000's | Minimum | Maximum | Actual Risk Weighted Assets | Requirement @ 12% |
| Interest Rate Position Risk | 104 | 786 | 358 | 43 |
| Equities Position Risk | 75 | 1,084 | 75 | 9 |
| Foreign Exchange Risk | 69 | 3,893 | 222 | 27 |
| *Total minimum capital for market risk* | | | *655* | *79* |
| Multiplier | | | 12.5 | 12.5 |
| **Total market risk weighted exposures under the STA** | | | **8,186** | **988** |

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

- *Equity Positions in the Banking Book*

BHD '000s
2010

| Asset Category | Gross exposure | Provision for impairment | Net Risk Weighted assets (RWA) | Regulatory capital requirement @ 12% on RWA |
|---|---|---|---|---|
| Listed Equities | 3,600 | - | 3,600 | 432 |
| Unlisted equities | 1,511 | - | 2,267 | 272 |
| Investment in Rated Funds: (ECAI A+ to A-) | 4,980 | - | 1,035 | 124 |
| Investment in unrated funds: | | | | |
| - Listed | 1,141 | - | 1,141 | 137 |
| - Unlisted | 7,976 | - | 11,964 | 1,436 |
| - Unlisted rated (ECAI AAA to A-) funds in Trading portfolio reclassified as banking book | - | - | - | - |
| **Total** | **19,208** | **-** | **20,007** | **2,401** |

BHD '000s
2009

| Asset Category | Gross exposure | Provision for impairment | Net Risk Weighted assets (RWA) | Regulatory capital requirement @ 12% on RWA |
|---|---|---|---|---|
| Listed Equities | 4,706 | - | 4,706 | 565 |
| Unlisted equities | 377 | - | 566 | 68 |
| Investment in Rated Funds: (ECAI A+ to A-) | 961 | - | 230 | 28 |
| Investment in unrated funds: | | | | |
| - Listed | 747 | - | 747 | 90 |
| - Unlisted | 4,692 | - | 7,038 | 845 |
| - Unlisted rated (ECAI AAA to A-) funds in Trading portfolio reclassified as banking book | 2,355 | - | 684 | 82 |
| **Total** | **13,838** | **-** | **13,971** | **1,678** |

| *BHD 000s* | *2010* | *2009* |
|---|---|---|
| Realized net gains on sale of available for sale securities | 1,181 | 299 |
| Dividend income on available-for-sale securities | 423 | 113 |

- Movements in the provision for impairment during the year is as follows:-

| BHD 000's | 2010 | 2009 |
|---|---|---|
| Balance at the beginning of the year | - | 2,173 |
| (Write off) / Charge for the year | - | (2,173) |
| **Balance at end of the year** | **-** | **-** |

- As at 1 January 2009, the Bank had an impairment provision of BD 2,173 on its available-for-sale investment securities. During the year 2009, the entire provision was charged off on sale of the respective securities. None of the other exposures as at 31 December 2010 are either past due, impaired or restructured.

- The sectoral and geographical distribution of provision for impairment as at 31 December is as follows:-

| **Distribution by Sector** BHD 000's | 2010 | 2009 |
|---|---|---|
| Commercial Banks | - | - |
| Other Banks | - | - |
| Services | - | - |
| Managed Funds | - | - |
| Others | - | - |
| **Total Provision for Impairment** | - | - |

| **Geographical Distribution** | 2010 | 2009 |
|---|---|---|
| GCC Countries | - | - |
| USA | - | - |
| Europe | - | - |
| Total Provision for Impairment | - | - |

## 2.3 Regulatory Capital requirement for Credit risk

**Standardized Approach**

2010

| Asset Categories for Credit Risk<br>BHD 000's | Gross exposure | | Credit Risk Weighted Assets (RWA) | Capital Requirement (@ 12% of RWA) | *Average gross exposure for the year* |
|---|---|---|---|---|---|
| | **On-balance sheet (Funded)** | **Off-balance sheet (Unfunded)** | | | |
| Total Claim on sovereigns | 132 | - | 132 | 16 | *2,209* |
| Claims on Bahraini Public Sector Entities | 500 | - | 500 | 60 | 500 |
| Treasury Bills | - | | - | - | - |
| Claims on banks | 38,679 | 6,342 | 45,021 | 5,402 | *41,662* |
| Claims on Corporates | 1,736 | 391 | 2,127 | 255 | *4,400* |
| Investments in Securities | 18,923 | 285 | 19,208 | 2,305 | *17,797* |
| Investments in Real Estate Sector | 1,135 | 130 | 1,265 | 152 | *1,163* |
| Delivery-versus-payment transactions | 792 | - | 792 | 95 | *492* |
| Other Assets | 901 | 302 | 1,203 | 144 | *1,609* |
| **TOTAL credit risk weighted exposures under STA** | **62,798** | **7,450** | **70,248** | **8,429** | ***69,832*** |

2009

| Asset Categories for Credit Risk<br>BHD 000's | Gross exposure | | Credit Risk Weighted Assets (RWA) | Capital Requirement (@ 12% of RWA) | *Average gross exposure for the year* |
|---|---|---|---|---|---|
| | **On-balance sheet (Funded)** | **Off-balance sheet (Unfunded)** | | | |
| Total Claim on sovereigns | 3,040 | - | - | - | *2,981* |
| Claims on Bahraini Public Sector Entities | 500 | - | - | - | 500 |
| Treasury Bills | - | - | - | - | - |
| Claims on banks | 52,510 | - | 20,829 | 2,449 | *93,533* |
| Claims on Corporates | 4,650 | - | 4,650 | 558 | *4,794* |
| Investments in Securities | 13,838 | 1,837 | 13,970 | 1,676 | *12,467* |
| Investments in Real Estate Sector | 969 | - | 1,938 | 233 | *450* |
| Delivery-versus-payment transactions | 512 | - | 7 | 1 | *605* |
| Other Assets | 613 | 604 | 613 | 74 | *3,345* |
| **TOTAL credit risk weighted exposures under STA** | **76,632** | **2,441** | **42,007** | **4,991** | ***118,675*** |

The on-balance sheet and off-balance sheet gross exposures have been risk weighted using the applicable risk weights and CCF"s (credit conversion factors). The exposures are not backed by collaterals and hence no benefit for credit risk mitigation is applicable.

## 2.4 Regulatory Capital requirement for Operational risk

| BHD 000's<br>Gross Income for the last three years:- | Actual Risk weighted Assets<br>2010 | 2009 |
|---|---|---|
| 2005 | - | - |
| 2006 | - | 5,029 |
| *2007* | 15,029 | 15,029 |
| 2008 | 3,031 | 3,031 |
| 2009 | 6,068 | |
| Average of the three years | 8,043 | 7,696 |
| *Alpha coefficient* | *15%* | *15%* |
| *K-BIA* (3 year average multiplied by alpha) | *1,206* | *1,154* |
| **Operational Risk weighted exposure under BIA** (K-BIA * 12.5) | **15,080** | **14,431** |
| **Requirement @ 12% of RWA** | **1,810** | **1,732** |

## 2.5 Internal Capital Adequacy Assessment Process (ICAAP)

SICO has a capital management framework in place that is intended to ensure that there is adequate capital to support the financial stability vis-à-vis the risks associated with the various business activities and its capital adequacy ratio is well above the regulatory requirements. There is a comprehensive Internal

Capital Adequacy Assessment Process (ICAAP) that includes Board and senior management oversight, monitoring, reporting and internal control reviews, to identify the various risks that are not covered under Pillar 1 risks and to regularly assess the overall capital adequacy considering the pillar 2 risks alongside the planned business strategies. The key pillar 2 risks covered under the ICAAP process include settlement risk, concentration risk, liquidity risk, interest rate risk in the banking book and also other risks that are generally intangible nevertheless significant, such as strategic, reputational, legal and compliance risk, etc., The ICAAP process also includes stress testing on the Bank's capital adequacy to determine capital requirement under extraordinary circumstances and planning to ensure that the Bank is adequately capitalized in line with the overall risk profile.

## 2.6 Interest Rate Risk in the banking book

The Bank continues to have exposure in the Fixed Income book during 2010.Therefore monitoring the interest rate risk continues to be relevant and, management monitors this closely. Investment decisions are driven by careful selection to identify potential opportunities to provide reasonable returns apart from safe deployment of capital. The conservative investment banking business philosophy drives SICO not to deploy customer funds for proprietary investments or lending. Liabilities are always in the shortest maturity bucket to avoid any negative maturity gaps Consequently, Interest Rate Risk in the banking book and liquidity risk are not significant from the asset-liability mismatch perspective. Safeguarding liquidity is a paramount concern for SICO.

A 200 bp increase or decrease in market interest rates would affect the value of the debt instruments in the banking book as follows:-

| BHD 000's | 200bp increase | 200 bp decrease |
|---|---|---|
| As at 31 December 2010 | (256) | (289) |
| As at 31 December 2009 | (653) | 719 |

## 2.7 Capital allocation

The allocation of capital between specific operations and activities is primarily driven by regulatory requirements. The Bank's capital management policy seeks to maximise return on a risk adjusted basis while satisfying all the regulatory requirements. The Bank's policy on capital allocation is subject to regular review by the Board.

*The contents of these Basel II Pillar 3 disclosures have been reviewed by SICO's external auditors KPMG in accordance with an Agreed Upon Procedures engagement as required under Para PD-A.2.4 of the PD Module of the CBB Rulebook Volume 1.*