



YOUR PARTNER IN ARAB FINANCE WORLDWIDE

PILLAR 3 DISCLOSURES

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British Arab Commercial Bank Limited

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Organisation Chart

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1. OVERVIEW

1.1. Background

The European Union Capital Requirements Directive (“the Directive”) came into effect on 1 January 2007. It introduced consistent capital adequacy standards and an associated supervisory framework in the EU based on the Basel II rules agreed by the G-10.

Implementation of the Directive in the UK was by way of rules introduced by the Financial Services Authority (“the FSA”)¹. The Basel II Framework is structured around three pillars: Pillar 1 (minimum capital requirements), Pillar 2 (supervisory review) and Pillar 3 (market discipline). The disclosure requirements of Pillar 3 are designed to promote market discipline by providing market participants with key information on a Firm’s risk exposures and risk management processes. Pillar 3 aims to complement the minimum capital requirements described under Pillar 1 and the supervisory review process of Pillar 2.

British Arab Commercial Bank Limited (“BACB” or “the Bank”) adopted the Standardised Approach to credit risk, the Basic Indicator Approach (“BIA”) to operational risk and the standard Position Risk Requirement (“PRR”) rules for market risk from 1 January 2008. BACB also became subject to Pillars 2 and 3 from that date.

1.2. Basis and Frequency of Disclosures

This disclosure document has been prepared for BACB in accordance with the requirements of Pillar 3 as set out in Chapter 11 of the BIPRU.

Unless otherwise stated, all figures are as at 31 December 2008, our financial year-end.

Future disclosures will be issued on an annual basis and published as soon as practicable after the publication of the Annual Report and Accounts.

1.3. Scope

BACB is a UK registered bank that is regulated by the FSA.

BACB has a small number of subsidiary companies (together referred to as “the Group”). Of its subsidiaries, BACB (Jersey) Limited is regulated by The Jersey Financial Services Commission, and its other subsidiaries are dormant. BACB (Jersey) Limited has the sole purpose of issuing listed debt securities on behalf of the Group, and the Bank has guaranteed its obligations under those issued securities.

BACB calculates and maintains regulatory capital ratios based on its own balance sheet. Capital held in the Bank’s subsidiary companies amounts to £1,020, and there is therefore no material difference between the amount of capital determined by, and available in support of the Bank’s own activities, and the amount which would be determined if the subsidiaries were included. While there would be no regulatory

¹ FSA Handbook – General Prudential sourcebook (“GENPRU”) and Prudential sourcebook for Banks, Building Societies and Investment Firms (“BIPRU”).

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restriction to transferring this capital within the Group, in practice this would involve the winding up of those subsidiary companies.

This document generally refers to the Group, and the information presented in this document is in respect of the Group except where it is relevant to consider the position of the Bank in isolation.

1.4. Location and Verification

These disclosures have been reviewed by the Group's Audit Committee and approved by the Board at their meetings on 5 March 2009, and are published on the Group's corporate website (www.bacb.co.uk). The disclosures have not been subjected to external audit except where they are equivalent to those prepared under accounting requirements for inclusion in the Group's Annual Report and Accounts.

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2. RISK MANAGEMENT OBJECTIVES AND POLICIES

2.1. Background

The Group has an established risk management culture, long-standing written policies and procedures, and follows a documented control framework, the maintenance of which falls within the general responsibility of the Group's Audit Committee, a sub-committee of the Board of Directors ("the Board").

The Board has overall responsibility for the determination of the risk appetite of the Group. They determine the high level risk framework, monitor the utilisation of limits and the operation of the control processes. The Group maintains a cautious approach to risk management and overall risk appetite is conservative. Risks are measured, controlled and limited through clear governance structures, supported by written policies and procedures.

Key elements within these controls are the Internal Audit and the Risk Management departments.

The Internal Audit department undertakes an ongoing risk based review programme covering all areas of the Group's operations. The Manager Internal Audit reports to the Audit Committee and to the Chief Executive.

The Risk Management Department ("RMD") is responsible for identifying, monitoring and managing the risks faced by the Group. The RMD is also responsible for the implementation of appropriate policies and monitoring programmes to manage the Group's exposure to potential losses arising in all areas of risk. RMD also has responsibility for review and amendment of the Group's internal credit gradings, market and operational risk management practices.

2.2. Governance

The Group's governance policies are set by the Board and are implemented by Executive Management. The Board normally meets 4 times a year. It approves plans and performance targets for the group, the appointment of senior executives and the delegation of authorities. The Board has constituted a number of high level committees governed by clear terms of reference, include the following:-

- Management Committee – Chaired by the Chairman, this committee carries the authority of the Board other than for a number of specified matters requiring consideration by the full Board. The Management Committee meets 4 times a year, and exercises the powers and authorities of the Board in so far as they concern the management and day-to-day running of the Group in accordance with the policies and directions determined by the Board. Directors participating in Management Committee are regarded by the Group as being Executive Directors. The Chief Executive serves as a member of this committee, together with his deputy.
- Audit Committee – Directors not involved in the Management Committee are regarded by the Group as being non-Executive Directors, and are eligible to sit on the Audit Committee. The Committee meets 4 times a year to consider the Group's financial reporting, the nature and scope of audit reviews, and the effectiveness of the systems of internal control, compliance and risk

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management. The Group's external auditors are invited to attend the meetings of the Audit Committee, and normally will do so.

- Credit Committee. The Board have delegated authority to approve the granting of credit applications to the Chief Executive (CEO) subject to certain limits. The CEO is authorised to delegate up to 80% of these limits to certain senior executives subject to notification to the Board. Applications above those limits must be referred to the Credit Committee for their consideration and approval. The Credit Committee comprises the directors who serve on Management Committee other than the Chief Executive, or their delegates. The Committee does not have a regular cycle of meetings, rather it normally considers specific applications as they arise by circulation of papers. Decisions of the committee must be unanimous to be valid.
- Compensation Committee. Determines the executive remuneration policies of the Group.

The Board has also delegated powers to the Group's Executive Management, led by the Chief Executive and his Deputy. These Executives are empowered in writing through their job descriptions. Executive Management in turn have constituted a number of sub-committees to manage particular aspects of the Group's business. These include

- Asset and Liability Committee ("ALCO"). The Committee monitors the Group's performance within the framework of authorities handed down by Management Committee and the Board, and against the plans agreed with those committees. It is responsible for overseeing the Group's continuing compliance with law, regulations and market practices, and is responsible for considering the risks to which the Group is exposed (other than those relating to credit risk – see below), and for directing the Group's response to those risks.
- Risk Committee. The committee reviews the credit risks to which the Group is exposed. It ensures that these are within the policies laid down by the Board, and identifies developments or trends within individual customers to whom the group is exposed, or to groups of such customers in order to identify required or desirable changes in policy for recommendation to the Board. The committee also reviews the processes by which credit applications are considered to ensure that they remain robust.

Appendix 1 to this report shows the outline governance structures within the Group. The individuals who served on the Board during 2008, together with the details of the committees on which they served, and those who served as Executive managers, are shown in the Group's 2008 Annual Report and Financial Statements.

Decisions on matters of strategic significance or high importance can only be taken by the Board. For the avoidance of doubt, the Board has drawn up a Schedule of Reserved Matters listing specified matters which must always be referred to them for review and approval. Matters agreed by the Board include all policies that dictate the Group's risk appetite.

A key mechanism for determining risk appetite is the Group's planning process. This process starts from the preparation by Management every three years of a Strategic Plan (which is approved by the Board) through which a fundamental review of the Group's operations is undertaken. The drawing up of this plan involves all of the senior

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management. As a part of that process the Executive Management will review the Group's current risk appetite, and will propose possible amendment to the Board.

This Strategic Plan forms the basis for the preparation of annual operating plans. This latter process is the mechanism by which the proposals in the Strategic Plan are implemented in practice, though tactical changes in risk appetite may also be developed through this process. These changes will be subject to review and approval by the Board as a part of their approval of that annual plan.

In the light of these strategic and annual operating plans, the Group's risks are reviewed annually through the Internal Capital Adequacy Assessment Process ("ICAAP"). The output of this process is a formal report ("the ICAAP report") which is submitted to the Group's Board for review and approval. The ICAAP identifies all the risks which may bear on the Group's solvency and either evaluates what level of capital should be held against each, or else considers the appropriate remediation policies. This process is informed in part by stress and scenario tests.

2.3. Risk management process

Risk is inherent to the Bank's business and the ability to identify, control, monitor and mitigate each type of risk to which the bank is exposed is vital to ensure financial stability and future success. Principal risks to which the bank is exposed include credit, operational, market, business, compliance and reputational risks. These risks are documented within a Risk Register and an overview of the controls in place to mitigate them is contained in a high level statement of the systems and controls in place to identify, measure and manage risk described as the Control Objectives Statement.

Maintenance and review of the Group's risk management policies and Group-wide procedures is the responsibility of RMD. Policies that define and implement the Group's risk appetite, including those dealing with concentration risk, sectoral lending and market risk are reviewed annually by RMD, considered in ALCO or Risk Committee and submitted to the Board for approval.

Risk management policies are documented in the Group's General Instructions Manual ("GINs"), a high level manual, maintenance of which also falls within the responsibility of RMD. GINs are subject to annual formal review by management and adherence is mandatory for all employees. Amendments to this manual require the approval of Executive Management and RMD. Compliance with the policies and procedures set out in GINs is monitored by the Group's Internal Audit department

Operational processes are documented, where necessary in departmental desk manuals that are also subject to annual review and senior management approval. This ensures that primary responsibility for the identification of risk lies with operational areas with oversight and governance being provided by RMD.

At the operational level, the policies and procedures contained in GINs and desk manuals ensure compliance with the Group's legal and regulatory obligations as well as ensuring the confidentiality and security of information, the safeguarding of items of value and the maintenance of appropriate segregation of duties through physical and logical system controls.

The Group's ALCO and Risk Committee play an important role in the identification, monitoring and management of risk and through the review of risk management policies.

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Internal Audit also has a significant role in the bank's risk management process by providing independent and objective assurance on the adequacy and effectiveness of the bank's risk management, control and governance processes, as designed and represented by management. It carries out an annual risk-based programme of work, which has been approved by the bank's Audit Committee, designed to evaluate and improve the bank's risk management and control environment. The result of Internal Audit's work, including management's progress in addressing identified issues, is formally reported to the Audit Committee on a quarterly basis.

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3. CAPITAL RESOURCES

3.1. Total available capital

At 31 December 2008 and throughout the year the Group complied with the capital requirements that were in force as set out by the FSA.

The Group's regulatory capital base and capital adequacy ratio at 31 December were as follows:

	£'000s
Tier 1 Capital	168,195
Tier 2 Capital	68,093
Total eligible capital at 31 December	<u>236,288</u>
Risk Weighted Assets	<u>1,435,200</u>
Capital Adequacy Ratio	16.5%

The amounts of regulatory capital shown above differ from the balances shown in the Group's balance sheet in light of adjustments in respect of certain reserves, which arise on the application of IFRS. They also differ from the amounts reported to the FSA as at 31 December as the total above includes the retained profits for 2008 which cannot be included in the amounts reported to the FSA until such time as the financial statements for the subject year are approved.

3.2. Tier 1 Capital

Tier 1 capital comprises ordinary share capital plus reserves. Adjustments are made in respect of certain revaluation reserves in accordance with the FSA regulatory rules. In addition, the amount of the dividend which will be paid in respect of the accounting year has also been excluded.

	£'000s
Ordinary Share Capital	79,453
Reserves	94,935
Total Capital	<u>174,388</u>
Less: Dividend payable	(7,000)
Other regulatory adjustments	807
Tier 1 Capital	<u>168,195</u>

3.3. Tier 2 Capital

Tier 2 capital comprises perpetual subordinated debt (upper Tier 2) and term subordinated debt due 2018 (lower Tier 2), each issued on terms which qualify for inclusion in capital resources. Tier 2 capital was made up as follows:-

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	£'000s
Permanent issued subordinated debt	30,494
Collective Impairments	2,293
Other adjustments	1,025
Total Upper Tier 2	<u>33,812</u>
Term issued subordinated debt	34,281
Total Tier 2 capital	<u><u>68,093</u></u>

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4. CAPITAL ADEQUACY

4.1. Capital management

The Bank has adopted the Standardised approach to credit risk, the Basic Indicator approach to operational risk and the standard FSA regulatory rules to market risk since 1 January 2008 in order to calculate the Basel II Pillar 1 minimum capital requirement.

In the opinion of the Group's Board, the amount of capital required by the Group is the same as the amount required by the Bank.

As part of the ICAAP process (as described below), the Board have identified a number of other risks faced by the Group which do not attract capital under the Pillar 1 rules. The Group has allocated additional capital requirement for these additional Pillar 2 risks ("the Pillar 2 capital requirement"). The total capital requirement of the Group is determined as the sum of the Pillar 1 and the Pillar 2 capital requirements as follows:-

	Ref	£'000
Pillar 1 Capital Requirement	4.3	121,815
Pillar 2 Capital Requirement	4.5	<u>47,111</u>
Total Capital Requirement		168,926
Capital in place	3.1	236,288
Headroom		<u><u>67,362</u></u>

The policy of the Group is to maintain a degree of headroom above the total required capital level. A minimum margin of 10% will be maintained at all times and the headroom of £67,362,000 at 31 December 2008 leaves some scope to accommodate growth in risk weighted assets ("RWAs") as part of the Group's overall growth strategy.

The FSA has imposed an Interim Capital Guidance ("ICG") requirement on the Group pending its review of the Group's own assessments. The ICG requirement is somewhat higher than the assessment set out above, and the Group is managing its capital in accordance with this latter requirement pending completion of the FSA review process.

The Board's policy is to grow capital resources organically through profit retentions. However, it is envisaged that additional capital would be forthcoming from shareholders to support the Group's strategic objectives if capital retention proved insufficient.

4.2. Internal Capital Adequacy Assessment Process

The Group undertakes an Internal Capital Adequacy Assessment Process (ICAAP) which is an internal assessment of its capital needs.

As noted above, the ICAAP process takes account of both Pillar 1 capital requirements, making use of the various standardised approaches set out in the FSA's BIPRU rules, but also considers the amounts of capital which are required to support other risks faced by the Group (the Pillar 2 risks).

The outcome of the ICAAP is presented in an ICAAP Report detailing all material risks to determine the capital requirement over a three-year horizon, and includes stressed scenarios to satisfy the regulatory requirements. Where capital is deemed as not being

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able to mitigate a particular risk, alternative management actions are identified and described within the ICAAP Report.

The ICAAP report is reviewed by the Group's ALCO before being presented to the Board (with whom ultimate responsibility lies) for challenge and approval. The FSA has set Individual Capital Guidance (ICG) for the Group which came into effect from 1 January 2008.

4.3. Minimum capital requirement: Pillar 1

BACB's overall minimum capital resource requirement under Pillar 1 is calculated by adding the credit risk charge to that required for operational risk and market risk.

The following table shows both the Group's overall minimum capital requirement and capital adequacy position under Pillar 1 at 31 December 2008:

	£'000
Credit Risk	114,816
Market Risk	
Interest Rate PRR	198
Option PRR	-
Foreign Exchange PRR	278
	476
Counterparty risk capital component	1,768
Operational Risk	4,755
Total Pillar 1 capital requirement	121,815
Capital in place	236,288
Excess of capital in place over minimum requirement under Pillar 1	114,473

PRR – Position Risk Requirement

4.4. Credit risk component

The following table shows BACB's overall minimum capital requirement for credit risk under the standardised approach (expressed as 8% of the risk weighted exposure amounts for each of the applicable standardised credit risk exposure classes) at 31 December 2008:

	Capital Requirement		Exposure Value
	At 31 December 2008		Average during 2008
	£'000	£'000	£'000
Central governments or central banks	6,100	205,629	180,993
Multilateral development banks	-	1,988	1,877
Institutions	46,022	2,391,147	2,100,252
Corporates	58,512	992,424	825,514
Secured on real estate property	47	582	421
Other items	4,135	51,910	40,497
Total	114,816	3,643,680	3,149,554

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Note: The amount of the exposure value in the table above does not agree to the Maximum Credit Exposure totals in section 3.1 as the totals above have been adjusted by way of credit conversion factors in accordance with the FSA regulatory rules. The average exposure value is calculated using the four returns submitted to the FSA during the year.

Under the Standardised approach BACB uses Standard and Poor's, Moody's and Fitch Ratings as External Credit Assessment Institutions (ECAIs) across all its portfolios. Credit ratings are mapped to credit quality steps using the standard table as follows:-

Credit quality Step	S&P Rating	Moody's rating	Exposure value £'000	Exposure values after mitigation £'000
Central Governments or Central Banks				
1	AAA to AA-	Aaa to Aa3	74,694	74,694
2	A+ to A-	A1 to A3	0	0
3	BBB+ to BBB-	Baa1 to Baa3	61,424	61,424
4	BB+ to BB-	Ba1 to Ba3	0	0
5	B+ to B-	B1 to B3	6,171	6,171
Unrated			63,340	39,362
			<u>205,629</u>	<u>181,651</u>
Multilateral Development banks			1,988	1,988
Institutions				
1	AAA to AA-	Aaa to Aa3	1,739,656	1,739,656
2	A+ to A-	A1 to A3	255,824	255,824
3	BBB+ to BBB-	Baa1 to Baa3	100,811	100,811
4	BB+ to BB-	Ba1 to Ba3	30,495	30,495
5	B+ to B-	B1 to B3	4,706	2,841
Unrated			259,655	130,274
			<u>2,391,147</u>	<u>2,259,901</u>
Corporates				
1	AAA to AA-	Aaa to Aa3	910	910
2	A+ to A-	A1 to A3	28,482	28,482
3	BBB+ to BBB-	Baa1 to Baa3	29,971	29,971
4	BB+ to BB-	Ba1 to Ba3	18,400	18,400
5	B+ to B-	B1 to B3	0	0
Unrated			914,661	667,880
			<u>992,424</u>	<u>745,643</u>
Secured on real estate			582	582
Other items			51,910	51,910
			<u><u>3,643,680</u></u>	<u><u>3,241,675</u></u>

¹ Exposure value is the amount after applying credit conversion factors to off balance sheet exposures in accordance with the FSA regulatory rules.

² Mitigation comprises eligible financial collateral

4.5. Capital Requirement: Pillar 2

In addition to the capital required in respect of Pillar 1 risks, the Group uses an internal model to allocate additional capital in respect of other risks not addressed under Pillar 1 minimum capital requirements. These include the following:-

- **Concentration Risk.** The standardized approach to credit risk does not take account of geographic or sectoral concentrations of credit exposure. Stress tests undertaken by the Group indicate that an additional capital add on should be allocated to address these specific concentration risks.
- **Pension fund risk.** There is a risk that the liabilities associated with the pension arrangements made by the Group for its staff may increase.
- **Interest rate risk.** Large changes in interest rates could give rise to losses for which capital should be allocated.
- **Liquidity Risk.** In the event of liquidity stress the Group may be required to sell assets at a discount to carrying book value.
- **Market risk.** The Pillar 1 allocation for market risk is based on actual positions and exposures at reporting dates. At present, the Group has limits in place for market risk which are higher than the average amount of risk actually taken

At 31 December 2008 the Group has allocated £47,111,000 of capital to cover these additional risks.

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5. SOURCES OF RISK

5.1. Credit Risk

The Group is exposed to credit risk in its on and off-balance sheet activities, and in its daily settlements. The Group manages credit risk by establishing country and individual counterparty limits, and limits for closely related counterparties, within the terms of the Group's credit policies, based upon analyses undertaken by the Group's Institutional & Corporate Banking ("ICB") department of relevant political, economic and financial information.

The Group is also a third-party member of the Continuous Linked Settlement ("CLS") system, which eliminates counterparty settlement risk on eligible trades.

Such assessments are the subject of independent review and challenge by the Group's Risk Management department ("RMD").

Based on the initial review of ICB, and with the support of RMD, applications for new credit facilities, and for changes in credit limits, whether for individual counterparties, or for groups of counterparties, are submitted for approval.

Credit limits are established for all transactions which give rise to credit risk. In the case of loans and advances, the amount at risk is the maximum book value. For guarantees, letters of credit and other commitments not appearing on the Group's balance sheet, the amount at risk is the gross amount of the commitment or potential commitment given. For derivatives, the amount at risk is the current mark-to-market value of the contract (if positive) plus an add-on the size of which is determined by the type of contract, and the time to maturity. For certain derivatives, it may also be appropriate to have in place separate settlement limits in recognition that the credit exposure on the day of settlement may equate to the underlying notional amount of the contract involved.

Approvals are granted in accordance with a documented hierarchy. Credit approval authority has been delegated by the Board to the Chief Executive, who may delegate up to a maximum of 80% of that authority to each of a small number of senior executives, subject to notification of delegation to the Board. Requests for credit facilities which exceed the CEO's approval limit must be submitted to the Credit Committee.

A schedule of all credit approvals granted, whether by Executive Management or by the Credit Committee, is submitted to Management Committee for their review.

Once approved, all credit limits are subject to annual review by ICB and RMD and are submitted for re-approval under delegated internal credit authorities.

The Group employs a credit grading system to facilitate monitoring of the quality of the overall portfolio and individual segments thereof, including movements in the portfolio over time. The results of this analysis are reviewed by the Risk Committee. The results of credit grading are also taken into account as part of the credit approval process, as are the prospective and historic returns on risk adjusted capital (RoRAC) arising from the relationship, and the proposed transaction.

At 31 December 2008 credit risks assessed in accordance with that methodology were as follows:-

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	Maximum exposure to credit risk £'000
Low	2,208,587
Satisfactory	1,193,467
Fair	768,408
Watchlist	11,451
Substandard	0
Doubtful	34
Loss	0
Total credit exposures	<u>4,181,947</u>

Credit risk mitigation

The Group seeks to mitigate credit risk in a number of ways. In each case the gross potential exposure is included in the assessment of the maximum exposure to credit risk, but the existence of the collateral will be taken into account in determining the size of the limits which the Group is prepared to entertain.

The existence of collateral will also be taken into account for capital requirement purposes where the type of collateral, and the manner in which it is managed, fulfil the minimum requirements in the capital adequacy regulations. These regulations restrict the types of collateral which may be recognised for this purpose, and also require procedures for the monitoring and management of the collateral, and for legal certainty.

Principal types of credit risk mitigation

The following risk mitigation techniques are taken into account in determining capital requirements:-

- **Cash.** A number of the credit facilities extended by the group require that full or partial cash collateral be placed with the Group by way of security. The Group ensures that documentation for such facilities is robust and has obtained opinions from external counsel that such documentation is legally enforceable in all relevant jurisdictions. At 31 December 2008 the value of cash collateral held by the Group on terms under which set off can be applied in the event of default by the counterparty was £402,005,000.
- **Reverse Repo transactions.** A part of the Group's surplus funds are placed with other institutions by way of reverse repurchase transactions executed in accordance with market standard terms. Such transactions involve the lending of money secured by AAA rated EEA or equivalent government securities. At 31 December 2008 the value of loans undertaken on this basis was £100,818,000. Such facilities are entered into for short periods, and the requirement to make adjustments to the balances as a result of valuation changes (margining) does not normally arise.

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- Eligible guarantees. The Group also participates in lending activities under EEA and equivalent government sponsored guarantee schemes. In such cases the Group regards its credit risk as being to these guarantee providers rather than to the underlying borrower.

Collateral may also be taken in the form of personal guarantees given by individuals associated with the obligor counterparty, or covenants such as financial ratios or other performance obligations embedded into loan documentation. These type of guarantees or mitigation are not recognised for regulatory capital purposes.

Cash collateral is held on terms which ensure that the cash cannot be paid away before the maturity of the secured exposure. Both logical systems, and operational controls are in place to prevent the inadvertent payment away of such collateral funds, and clear management information is in place both in real time and at end of day to monitor the balances of collateral in relation to the varying amount of the exposure, and to prevent the granting of new exposures which exceed the amount of collateral held.

The Group has not used on and off balance sheet netting.

Credit risk exposures

The Group provides facilities to 514 counterparties encompassing exposure to 58 countries and territories.

The following tables summarise the various concentrations of credit risk assumed by the Group.

Regional concentrations of credit risk arising from operations were as follows:

£'000	Other				Impairment	Total
	United Kingdom	European Union	Middle East and Africa	Other Countries		
Central Governments or Central Banks	10,621	47,953	169,726	4,201	0	232,500
Multilateral Development Banks	0	0	20,074	1,988	0	22,062
Institutions	1,255,711	715,763	730,715	185,994	0	2,888,183
Corporates	108,354	128,458	739,969	67,589	(5,749)	1,038,621
Secured on real estate mortgages	582	0	0	0	0	582
Impairments	0	0	(5,749)	0	0	
Total	<u>1,375,268</u>	<u>892,173</u>	<u>1,654,734</u>	<u>259,771</u>	<u>(5,749)</u>	<u>4,181,947</u>

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By industry, concentrations of credit risk were as follows:

£'000	Gross exposure	Impairments	Net exposure
Central Governments or Central Banks			
Central Governments	2,425	0	2,425
Central Banks	104,101	0	104,101
Public administration	125,974	0	125,974
Multilateral Development Banks	22,062	0	22,062
Institutions			
Banks	2,763,795	0	2,763,795
UK Building Societies	43,782	0	43,782
Other financial intermediaries	80,606	0	80,606
Corporates			
Commodities	56,305	0	56,305
Construction and engineering	110,550	0	110,550
Energy	411,695	0	411,695
Non-bank credit grantors	139,411	0	139,411
Telecommunications	68,184	0	68,184
Transport and storage	47,863	0	47,863
Other	210,362	(5,749)	204,613
Secured on real estate mortgages	582	0	582
Total	4,187,696	(5,749)	4,181,947

The residual maturity of the Group's exposures at 31 December 2008 was as follows

£'000	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Total
Central Governments or Central Banks	34,488	11,359	58,304	67,525	60,823	232,500
Multilateral Development Banks	13,580	0	0	8,482	0	22,062
Institutions	1,363,812	416,206	683,109	425,055	0	2,888,183
Corporates	210,718	98,049	168,544	186,706	374,605	1,038,621
Secured on real estate mortgages	582	0	0	0	0	582
Total	1,623,180	525,614	909,958	687,768	435,427	4,181,947

At 31 December 2008 the Group had no exposures to asset classes such as US sub-prime mortgages that became impaired as a result of the credit problems that emerged in the market during 2007, and which continued through 2008.

Counterparty Credit Risk

Counterparty Credit Risk ("CCR") in the context of this disclosure is the risk that the counterparty to a derivative transaction could default before the settlement of the

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transaction's cash flows. The duration of the derivative and the credit quality of the counterparty are both factored into the internal capital and credit limits for counterparty credit exposures. No netting of derivative transactions is undertaken.

The Group measures exposure value on counterparty credit exposure under the CCR mark to market method. This exposure value is derived by adding the gross positive fair value of the contract (replacement cost) to the contracts potential credit exposure, which is derived by applying a multiple based on the contracts residual maturity to the notional value of the contract.

The Group's exposures to CCR arise in respect of forward foreign exchange contracts, foreign exchange options and interest rate swaps (including cross-currency interest rate swaps).

Derivatives are used both to hedge existing or anticipated positions in the Group's balance sheet, but also as part of the Group's trading activities. All such contracts have been entered into in accordance with standard market terms.

No collateral has been either received or provided in respect of derivative contracts. No collateral would need to be provided in the event of a downgrade in the Group's credit rating. The Group does not employ netting arrangements in respect of derivative contracts.

	Gross positive fair values of contracts	Potential credit exposure	Total derivative credit exposure
Foreign Exchange contracts	11,099	16,189	16,189
Interest rate swaps	5,417	5,828	5,828
Foreign Exchange options	556	86	86
Total	17,072	22,103	22,103

5.2. Market risks

Banking and trading

As part of its banking activities, and for the purpose of providing efficient services to its customers, the Group holds and issues financial instruments including derivative contracts. The Group's objectives in holding such instruments, or entering into such contracts, may either be characterised as being in pursuance of its principal banking activities, or as a trading activity carried on as an adjunct to its banking activities.

The Group's trading activities are accounted for on a mark-to-market basis, and financial assets, financial liabilities and derivatives which form part of such activities are accounted for at fair value through the profit and loss account. In identifying activities to be accounted for on this basis, the Group takes into consideration the following factors:

- The Group's motive for trading that instrument, and in particular where the purpose is to sell or repurchase in the short term, or
- where the instruments formed part of a portfolio for which there is evidence of a recent actual pattern of short term profit-taking, or

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- where it is a derivative other than a financial guarantee contract, or a designated and effective hedging instrument.

The Group's trading activities are limited to transactions in financial instruments, mainly comprising the trading of foreign exchange and debt securities. Market risk relates primarily to exchange and interest rate risks. Exposures to those markets, together with a description of the risk management policies arising from both banking and trading activities are set out below. Market risk exposures are measured and monitored daily and are formally reviewed monthly by the Group's ALCO.

Exchange rate risk

The Group makes loans, and takes deposits, in a number of currencies. Payments made on behalf of customers in one currency may be met from balances held in another currency. Further, the Group is active in the international foreign exchange markets, both for own account trading, and for the management of Group assets and liabilities.

The Group manages its exposures to foreign exchange risk by way of limits on the size of permitted positions, both intra-day and overnight. Overnight positions are protected by stop-loss orders placed with reputable correspondent banks. The size of the position limits is consistent with the amount of profit that the Group is prepared to place at risk in the foreign exchange markets.

All of the Group's exposure to exchange rate risk is managed by the Group's Treasury department on a continuous basis. Subject to such positions as the traders in the Treasury may wish to assume from day to day within their delegated limits, it is the policy of the group not to have any structural positions in any currency other than the functional currency, Sterling.

The Group allocates capital to its foreign exchange positions in accordance with the FSA Foreign Currency PRR² rules

Interest rate risk

The Group is exposed to changes in interest rates in various currencies arising from gaps in the future dates of repricing of assets, liabilities and derivative instruments. The Group manages that risk by calculating sensitivity of changes in the present value of committed future cash flows to a 0.01% change in interest rates using a methodology called the Present Value of a Basis Point ('PVBP'). Limits are placed on the overall amount of calculated PVBP, and the size of those limits is consistent with the amount of profit that the Group is prepared to place at risk in the interest rate market. The Group considers the impact of changes in future interest rates on its future income streams by reference to these interest rate gaps.

Interest rate risk arises in both the banking book and in the trading book. The PVBP methodology is used to monitor and manage the level of interest rate risk from both these sources.

² Position Risk Requirement

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As with exchange rate risk, it is the policy of the Group to centralise the management of interest rate risk within the Group's Treasury department. The traders within that department manage the gaps between repricings of receivables and payables on a continuous basis either by seeking to influence or control maturity dates of loans and deposits, or else by using derivative contracts.

A structural position does exist in the interest rate book as the group holds more interest bearing financial assets than interest bearing financial liabilities. This surplus arises as a part of the funding for the assets is derived from the Group's capital funds. This structural position gives rise to interest income which is not matched by interest expense, and this stream of income is designated as being income from shareholders' funds.

Certain structural funding costs including the margins on longer term borrowings, and the cost of floor provisions in issued subordinated debt are also deducted from this stream of income.

A notional pool of assets is identified as being the source of this income, and these notional assets are excluded from the PVBP calculations. Responsibility for managing this notional pool rests with the Group's ALCO who lend the funds to the Treasury department. The Treasury may or may not match-fund those placements depending on their own appetite at the time.

Interest rate risk in the banking book does not give rise to a capital charge under the Pillar 1 capital calculations, though the Group does make an allocation for this risk in its Pillar 2 assessment (See paragraph 4.5 above). Interest rate risk in the trading books gives rise to specific and general interest rate PRR which is determined using the standard PRR rules.

Sensitivity to interest rate risk

A simultaneous change in interest rates of 0.5% in all currencies, and in all maturities on 1 January 2009 would increase or (reduce) the present value of the gaps in the banking book as follows:-

£'000	Change in fair value	
	Increase 0.5%	Decrease 0.5%
US Dollar book	-277,655	278,826
Sterling book	-13,557	13,706
Euro Book	-157,684	159,061
Other books	-10,327	10,360
Total	<u>-459,223</u>	<u>461,953</u>

However, income from shareholders' funds from the notional pool of financial assets associated with non-interest bearing liabilities not included in the gaps above, and from the change in costs arising from the funding of interest rate floor provisions embedded in the Group's issued subordinated debt would also change during 2009 as a result of such changes in rates. Such earnings would change as follows:-

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	Change in income in 2009	rates	rates
		£'000	£'000
Sterling		275,973	-275,973
Total		<u>275,973</u>	<u>-275,973</u>

5.3. Other risks

Liquidity risk

The Group is exposed to the risk that it will be unable to meet its obligations as they fall due, arising from the differing maturity profiles of its assets and liabilities. The Group controls that risk by placing limits on the mismatch of maturity dates, and by holding stocks of liquid assets which could be sold at short notice if the need arose.

In measuring its liquidity, the Group regards £834,782,000 of its holdings of debt securities as being immediately available funds on the grounds that they can be sold (either outright, or as part of a repurchase transaction) at short notice at a price close to their current market value (after deducting a prudent discount). These debt securities comprise certificates of deposit or senior Eurobonds issued by prime financial institutions. In addition, certain liabilities are regarded as having a longer term maturity than their contractual terms imply in the light of their behavioural characteristics.

The FSA has entered into consultation with the financial services industry (CP 08/22) over changes which it proposes in the way that it expects institutions to manage their liquidity risks. The Group expects that the outcome of implementation of the FSA's proposed rules, if promulgated as currently proposed, will require changes in the manner in which the Group manages this risk.

Operational risk

Operational Risk is defined as:

“The risk of loss resulting from inadequate or failed processes, people and systems, or from external events”.

The operational risks facing the Group have been carefully analysed and comprehensive risk management policies, procedures and controls are in place to minimise their impact. These procedures and controls are documented in formal procedure manuals, accessible by all staff and are regularly updated. Overall management of operational risk falls within the responsibility of the Group's Risk Management department.

Key elements of the control environment are the strict segregation of duties, clearly defined authority levels and expenditure controls and strict safeguards over the integrity of and access to all types of confidential data. Secure offsite storage arrangements for key magnetic data and paper records are in place.

Underpinning the Group's operational controls is the existence of an independent Internal Audit department and comprehensive contingency planning and disaster recovery arrangements that include the availability of a separate site where replicated systems and office facilities are available and can be invoked rapidly. These arrangements are subject to regular testing in accordance with documented procedures.

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Semi-annual reviews of potential areas of operational risk are undertaken by departmental managers and following analysis of the results, issues arising are reported to the Group's Audit Committee. In addition, a reporting system is in place to capture and analyse instances of operational loss "near misses" which are similarly reported to the Group's Audit Committee. Where control weaknesses are identified as a result, changes to procedures are made.

Operational losses³ are closely monitored and reported to the Group's ALCO.

Operational losses in 2008 amounted to £18,000.

Reputational risk

Reputational risk is recognised as a key risk area and strong policies are in place to minimise the potential impact. These include comprehensive Know Your Customer (KYC) requirements, environmental, defence and sectoral lending policies and a risk based due diligence programme. Electronic transaction screening and a behavioural monitoring system are also in place to prevent inadvertent involvement in money laundering, terrorist financing or fraud.

Other risks

The Group is exposed to a range of other operational risks. In each case various risk mitigation techniques are adopted to control the risk. These risks include the following:-

- Legal risks. The Group enters into contracts both in the course of its ordinary business, but also as part of its banking activities. Specialist staff are employed to review and negotiate contract documents, and external legal counsel is also sought where appropriate.
- Settlement and confirmation risk. The Group seeks to employ, retain and train its staff to ensure that they are competent to carry out such procedures. Suitable computer systems to support such operations are maintained, and operational procedures are documented, and subject to regular review by Internal Audit.
- Litigation risks. Disputes arise from time to time in the course of the Group's business. Such disputes are subject to early identification, and escalation to senior executives qualified to manage their resolution. External counsel's opinions and assistance is sought as required.
- Pension Fund Risk. The Group offers defined benefit pension arrangements to some of its staff. There are risks that the liabilities associated with these arrangements may be higher than expected, or that the assets may not grow as expected. The Group recognises that these are long term obligations, and seeks to manage the risks through the use of conservative assumptions, and investment strategies designed to reduce the various risks.

³ A loss resulting from inadequate or failed internal processes, people and systems or external events other than costs or losses arising in the ordinary course of business

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6. NON TRADING BOOK EXPOSURES IN EQUITIES

The Group has exposure to equities by way of a small number of long term investments. These comprise two strategic investments in unquoted financial companies in the North African region, and two investments in venture capital equity investment funds managed by specialist fund managers whose objective is to invest in growing companies in that same region.

The two direct investments are as follows:-

Company	Holding	
Banque d'Affaires de Tunisie:	2,474 ordinary shares of Tunisian Dinars 100	8.64%
International Company for Leasing SAE:	1,296,000 ordinary shares of Egyptian Pounds 10	6.76%

The Group's objective in holding these investments is to seek long term investment growth. The Group also participates in the Board's of each of these companies, and seeks to gain access to intelligence regarding developments in the relevant local markets thereby.

The objective of the investment in the venture capital funds is to achieve long term capital growth by way of participation in growing companies in that region.

The investments are held in the Groups' balance sheet as Available for Sale assets. In the case of the direct investments the Group has estimated fair value based on the audited net assets of the companies involved. In the case of the investment funds the valuation is the amount invested as the funds are new, and have not had sufficient time to record any change in valuation.

At 31 December 2008 the carrying value of those investments in the Group's balance sheet (which is the same as estimated fair value) was as follows:-

	Fair value of investments £'000
Equity shares	2,375
Equity investment funds	2,630
	<hr/>
	5,005
	<hr/>

There were no sales or liquidations of investments during the year. At 31 December 2008 £1,025,000 was included in Tier 2 capital by way of unrealised fair value gains on these investments.

7. IMPAIRMENT PROVISIONS**7.1. Summary of accounting policy**

The Group's accounting policy for the determination of impairments is set out in Note 2j of its annual report and financial statements. A summary of the main provisions of the policy is set out below.

The Group assesses at each balance sheet date whether there is objective evidence that a financial asset or portfolio of financial assets is impaired. A financial asset or a portfolio of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or portfolio of financial assets that can be reliably estimated. Objective evidence that a financial asset or portfolio of assets is impaired includes observable data that comes to the attention of the Group.

The Group first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If the Group determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a portfolio of financial assets with similar credit risk characteristics and collectively assesses them for impairment.

Once a financial asset or portfolio of similar assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the loss.

If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognised in the income statement.

For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics (i.e. on the basis of the Group's grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors).

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from the realisation of security have been received.

If in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed to the extent it is now excessive by reducing the loan impairment allowance account. The amount of any reversal is recognised in the income statement.

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In the case of available-for-sale assets, the Group assesses at each balance sheet date whether there is objective evidence that a financial asset or a portfolio of financial assets is impaired. If any such evidence exists for available-for-sale financial assets, the cumulative loss, measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in profit or loss, is removed from equity and recognised in the income statement.

7.2. Past due amounts

The Group's normal policy is to assume that payments which are due to be paid on a particular date will be settled, and adjusts its books accordingly. However, the Group closely monitors and actively manages receivables which are not paid on their due date (past due amounts), and expects to identify such amounts either on the day it was due for large sum amounts (using real time settlement enquiry systems), or else on the morning of the following day following completion of correspondent account reconciliations (nostro reconciliation).

There are many reasons why an amount may not be settled on the due date, the most common of which being delays in the settlement process which arise in the normal course of business. In such cases settlement normally takes place within a very short period of the contractual date, and interest or "good value" claims will arise to ensure that the Group is held harmless.

Delays may also be indicative of other difficulties being experienced by the payment obligor. In such cases the Group's policy is to re-book the amount as an overdue balance and to immediately contact the counterparty with a view to establishing the reason for the delay.

Overdue amounts are reported to appropriate levels of management to ensure that appropriate actions are being taken. If the reasons for the delay are indicative of difficulty being experienced by the counterparty, then all of the balances due from that counterparty will be classified as being on "watchlist", resulting in increased management scrutiny and action.

7.3. Summary of position at 31 December 2008

The Group is active primarily in the wholesale markets. Accordingly, its portfolio of financial assets comprises a relatively small number of individually significant claims, rather than a large number of individually insignificant claims as would be the case for similar financial institutions acting in retail markets. This means that each claim due to the Group is subject to individual impairment review at the reporting date taking account of the factors described above.

Collective impairments arise in respect of groups of exposures to certain countries which are assessed to represent a higher risk based on economic, political and financial sector factors, and where the pricing in secondary markets for claims arising in those countries is higher than would represent a normal credit spread, and therefore provides evidence for impairment.

At 31 December 2008 two facilities comprising amounts due to the Group from corporates in the Middle East and African region of £3,456,000 were determined to be impaired. No collateral was held in respect of these facilities, but £3,456,000 was

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covered by personal guarantees issued by the owners of both of the borrowing companies.

The Group holds no financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

At 31 December 2008, no amounts were past due which was in respect of unimpaired financial assets.

The movement in impairments during the year was as follows:

£'000	Individual	Collective	Total
Loans and advances to customers			
Balance at 1 January	2,748	1,534	4,282
Exchange translation and other movements	1,487	576	2,063
Effect of discounting	(33)	0	(33)
Provisions written off	(1,388)	0	(1,388)
Profit and loss account			
New allowances	767	183	950
Recoveries of amounts written off in previous periods	(125)	0	(125)
	642	183	825
Balance at 31 December	3,456	2,293	5,749

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Appendix 1

Organisation Chart

