



YOUR PARTNER IN ARAB FINANCE WORLDWIDE

PILLAR 3 DISCLOSURES

Approved by the Board 5 March 2010

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# British Arab Commercial Bank plc

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Pillar 3 disclosures

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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”)<sup>1</sup>. 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 PLC (“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 2009, our financial year-end.

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

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

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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 & Risk Committee and approved by the Board at their meeting on 5 March 2010, and are published on the Group's corporate website ([www.bacb.co.uk](http://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.

## 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 & Risk 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 this framework are the Risk Management and Internal Audit departments.

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.

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

### 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 normally 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 & Risk 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 & Risk Committee. The Committee normally 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 management. The Group's external auditors are invited to attend the meetings of the Audit & Risk Committee, and normally will do so. During 2009 this committee was renamed (previously named the Audit Committee) and its terms of reference widened. This reflected the

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recommendations of the Walker Review published during the year which proposed that Boards of directors in banks should ensure an increased focus on risk matters.

- 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 2009, together with the details of the committees on which they served, and those who served as executive managers, are shown in the Group's 2009 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. Executive management prepare regular strategic and annual plans involving detailed reviews of the Group's various business lines. 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.

In the light of these strategic and annual operating plans, the Group's risks are also 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

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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. 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 liquidity, concentration risk, sectoral lending and market risk are reviewed annually by RMD, considered in ALCO or Risk Committee and submitted to the Audit & Risk Committee for review and subsequently 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.

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 & Risk 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 & Risk Committee on a quarterly basis.

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## 3. CAPITAL RESOURCES

### 3.1. Total available capital

At 31 December 2009 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<sup>2</sup>:

	<b>2009</b>	<b>2008</b>
	<b>£'000s</b>	<b>£'000s</b>
Tier 1 Capital	167,702	168,195
Tier 2 Capital	59,792	68,093
Total eligible capital at 31 December	<u>227,494</u>	<u>236,288</u>
Risk Weighted Assets	<u>1,266,237</u>	<u>1,435,200</u>
Capital Adequacy Ratio	18.0%	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 the year 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.

	<b>2009</b>	<b>2008</b>
	<b>£'000s</b>	<b>£'000s</b>
Ordinary Share Capital	79,453	79,453
Reserves	89,820	95,960
Total Capital	<u>169,273</u>	<u>175,413</u>
Less: Dividend payable	0	(7,000)
Other regulatory adjustments	<u>(1,571)</u>	<u>(218)</u>
Tier 1 Capital	<u>167,702</u>	<u>168,195</u>

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<sup>2</sup> In this table Risk Weighted Assets is the total value of the Group's on and off balance sheet exposures, weighted in accordance with the rules set out in the standardized approach to credit risk.

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#### 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 in US Dollars and on terms which qualify for inclusion in capital resources. Tier 2 capital was made up as follows:-

	<b>2009</b>	<b>2008</b>
	<b>£'000s</b>	<b>£'000s</b>
Permanent issued subordinated debt	27,544	30,494
Collective Impairments	0	2,293
Other adjustments	1,283	1,025
Total Upper Tier 2	<u>28,827</u>	<u>33,812</u>
Term issued subordinated debt	<u>30,965</u>	<u>34,281</u>
Total Tier 2 capital	<u>59,792</u>	<u>68,093</u>

## 4. CAPITAL MANAGEMENT

### 4.1. Overview

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.

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 £73,313,000 at 31 December 2009 (2008: £67,362,000) leaves some scope to accommodate growth in risk weighted assets ("RWAs") as part of the Group's overall growth strategy and also provides a buffer against adverse exchange rate developments.

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

The ICAAP report is reviewed annually by the Group's ALCO before being presented to the Board (with whom ultimate responsibility lies) for challenge and approval.

### 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.

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

	2009 £'000	2008 £'000
Credit Risk	101,299	114,816
Market Risk		
Interest Rate PRR	113	198
Foreign Exchange PRR	58	278
	171	476
Counterparty risk capital component	1,530	1,768
Operational Risk	5,910	4,755
Total Pillar 1 capital requirement	108,910	121,815
Capital in place	227,494	236,288
Excess of capital in place over minimum requirement under Pillar 1	118,584	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:

	<b>Capital Requirement</b>		<b>Exposure Value</b>	
	<b>At 31 December 2009</b>		<b>Average during 2009</b>	
	£'000	£'000	£'000	£'000
Central governments or central banks	3,876	215,259	372,646	
Multilateral development banks	-	-	-	
Institutions	54,302	2,870,933	2,889,635	
Corporates	40,782	642,730	704,375	
Secured on real estate property	47	582	582	
Other items	2,292	29,027	30,202	
<b>Total</b>	<b>101,299</b>	<b>3,758,531</b>	<b>3,997,440</b>	

  

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

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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	2009		2008	
			Exposure value £'000	Exposure values after mitigation <sup>2</sup> £'000	Exposure value <sup>1</sup> £'000	Exposure values after mitigation <sup>2</sup> £'000
<b>Central Governments or Central Banks</b>						
1	AAA to AA-	Aaa to Aa3	134,718	134,718	74,694	74,694
2	A+ to A-	A1 to A3	0	0	0	0
3	BBB+ to BBB-	Baa1 to Baa3	39,850	19,925	61,424	61,424
4	BB+ to BB-	Ba1 to Ba3	0	0	0	0
5	B+ to B-	B1 to B3	5,858	0	6,171	6,171
Unrated			34,833	12,161	63,340	39,362
			<u>215,259</u>	<u>166,804</u>	<u>205,629</u>	<u>181,651</u>
<b>Multilateral Development banks</b>			0	0	1,988	1,988
<b>Institutions</b>						
1	AAA to AA-	Aaa to Aa3	1,997,192	1,596,006	1,739,656	1,739,656
2	A+ to A-	A1 to A3	451,851	347,262	255,824	255,824
3	BBB+ to BBB-	Baa1 to Baa3	108,867	84,066	100,811	100,811
4	BB+ to BB-	Ba1 to Ba3	28,339	5,699	30,495	30,495
5	B+ to B-	B1 to B3	2,732	10	4,706	2,841
Unrated			281,952	157,318	259,655	130,274
			<u>2,870,933</u>	<u>2,190,361</u>	<u>2,391,147</u>	<u>2,259,901</u>
<b>Corporates</b>						
1	AAA to AA-	Aaa to Aa3	756	592	910	910
2	A+ to A-	A1 to A3	15,226	7,613	28,482	28,482
3	BBB+ to BBB-	Baa1 to Baa3	25,327	3,973	29,971	29,971
4	BB+ to BB-	Ba1 to Ba3	12,717	0	18,400	18,400
5	B+ to B-	B1 to B3	0	0	0	0
Unrated			588,704	115,631	914,661	667,880
			<u>642,730</u>	<u>127,809</u>	<u>992,424</u>	<u>745,643</u>
<b>Secured on real estate</b>			582	145	582	582
<b>Other items</b>			29,027	29,027	51,910	51,910
			<u><u>3,758,531</u></u>	<u><u>2,514,146</u></u>	<u><u>3,643,680</u></u>	<u><u>3,241,675</u></u>

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

<sup>2</sup> 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 2009 the Group has allocated £45,271,000 (2008: £47,111,000) of capital to cover these additional risks.

## 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 credit risks (net of eligible collateral and provisions) assessed in accordance with that methodology were as follows:-

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	2009	2008
	Maximum exposure to credit risk	Maximum exposure to credit risk
	£'000	£'000
Low	2,615,416	2,208,587
Satisfactory	1,015,623	1,193,467
Fair	602,621	768,408
Watchlist	21,538	11,451
Substandard	0	0
Doubtful	3,174	34
Loss	0	0
<b>Total credit exposures</b>	<b>4,258,372</b>	<b>4,181,947</b>

### 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 2009 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 £239,380,000 (2008: £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 2009 the value of loans undertaken on this basis was £nil (2008: £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.
- Eligible guarantees. The Group also participates in lending activities under EEA and equivalent government sponsored guarantee schemes. In such cases the Group regards

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# British Arab Commercial Bank plc

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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 461 counterparties encompassing exposure to 63 countries and territories (*2008: 514 counterparties in 58 countries*).

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:

	United Kingdom	Other European Union	Middle East and Africa	Other Countries	Impairment	Total
	£'000s	£'000s	£'000s	£'000s	£'000s	£'000s
<b>31 December 2009</b>						
Central Governments or Central Banks	82,847	32,288	128,173	3,967	(1,944)	245,331
Multilateral Development Banks	0	0	10,381	0	0	10,381
Institutions	1,393,942	968,311	740,726	229,720	(26,298)	3,306,401
Corporates	47,779	108,815	496,463	49,479	(6,859)	695,677
Secured on real estate mortgages	582	0	0	0	0	582
Impairments	0	0	(35,101)	0	0	
Total	<u>1,525,150</u>	<u>1,109,414</u>	<u>1,340,642</u>	<u>283,166</u>	<u>(35,101)</u>	<u>4,258,372</u>

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	<i>United Kingdom</i>	<i>Other European Union</i>	<i>Middle East and Africa</i>	<i>Other Countries</i>	<i>Impairment</i>	<i>Total</i>
<i>31 December 2008</i>	<i>£'000s</i>	<i>£'000s</i>	<i>£'000s</i>	<i>£'000s</i>	<i>£'000s</i>	<i>£'000s</i>
<i>Central Governments or Central Banks</i>	10,621	47,952	169,726	4,201	0	232,500
<i>Multilateral Development Banks</i>	0	0	20,074	1,988	0	22,062
<i>Institutions</i>	1,255,711	715,763	730,715	185,994	0	2,888,183
<i>Corporates</i>	108,354	128,458	739,969	67,589	(5,749)	1,038,621
<i>Secured on real estate mortgages</i>	582	0	0	0	0	582
<i>Impairments</i>	0	0	(5,749)	0	0	
<i>Total</i>	<u>1,375,268</u>	<u>892,173</u>	<u>1,654,735</u>	<u>259,772</u>	<u>(5,749)</u>	<u>4,181,948</u>

By industry, concentrations of credit risk were as follows:

	<b>Gross exposure</b>	<b>Impairments</b>	<b>Net exposure</b>
<b>31 December 2009</b>	<b>£'000</b>	<b>£'000</b>	<b>£'000</b>
<b>Central Governments or Central Banks</b>			
Central Governments	67,716	0	67,716
Central Banks	83,095	0	83,095
Public administration	96,464	(1,944)	94,520
<b>Multilateral Development Banks</b>	10,381	0	10,381
<b>Institutions</b>			
Banks	3,145,055	(12,562)	3,132,493
UK Building Societies	138,662	0	138,662
Other financial intermediaries	48,982	(13,736)	35,246
<b>Corporates</b>			
Commodities	8,022	0	8,022
Construction and engineering	85,967	0	85,967
Energy	275,041	0	275,041
Non-bank credit grantors	73,444	0	73,444
Transport and storage	86,083	0	86,083
Other	173,979	(6,859)	167,120
<b>Secured on real estate mortgages</b>	582	0	582
<b>Total</b>	<u>4,293,473</u>	<u>(35,101)</u>	<u>4,258,372</u>

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	<i>Gross exposure</i> £'000	<i>Impairments</i> £'000	<i>Net exposure</i> £'000
<b>31 December 2008</b>			
<b>Central Governments or Central Banks</b>			
<i>Central Governments</i>	2,425	0	2,425
<i>Central Banks</i>	104,101	0	104,101
<i>Public administration</i>	125,974	0	125,974
<b>Multilateral Development Banks</b>	22,062	0	22,062
<b>Institutions</b>			
<i>Banks</i>	2,763,795	0	2,763,795
<i>UK Building Societies</i>	43,782	0	43,782
<i>Other financial intermediaries</i>	80,606	0	80,606
<b>Corporates</b>			
<i>Commodities</i>	56,305	0	56,305
<i>Construction and engineering</i>	110,550	0	110,550
<i>Energy</i>	411,695	0	411,695
<i>Non-bank credit grantors</i>	139,411	0	139,411
<i>Transport and storage</i>	47,863	0	47,863
<i>Other</i>	278,546	(5,749)	272,797
<b>Secured on real estate mortgages</b>	582	0	582
<b>Total</b>	<u>4,187,697</u>	<u>(5,749)</u>	<u>4,181,948</u>

The residual maturity of the Group's exposures were as follows

	<b>Up to 1 month</b> £'000	<b>1-3 months</b> £'000	<b>3-12 months</b> £'000	<b>1-5 years</b> £'000	<b>Over 5 years</b> £'000	<b>Total</b> £'000
<b>31 December 2009</b>						
Central Governments or Central Banks	19,457	35,348	47,722	115,284	29,464	247,275
Multilateral Development Banks	10,381					10,381
Institutions	1,989,966	602,681	444,419	231,850	63,783	3,332,699
Corporates	139,993	59,469	98,277	209,482	195,315	702,536
Secured on real estate mortgages	582					582
<b>Total</b>	<u>2,160,379</u>	<u>697,498</u>	<u>590,418</u>	<u>556,616</u>	<u>288,562</u>	<u>4,293,473</u>

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	<i>Up to 1 month</i>	<i>1-3 months</i>	<i>3-12 months</i>	<i>1-5 years</i>	<i>Over 5 years</i>	<i>Total</i>
<i>31 December 2008</i>	<i>£'000</i>	<i>£'000</i>	<i>£'000</i>	<i>£'000</i>	<i>£'000</i>	<i>£'000</i>
<i>Central Governments or Central Banks</i>	34,489	11,359	58,304	67,525	60,823	232,500
<i>Multilateral Development Banks</i>	13,580	0	0	8,482	0	22,062
<i>Institutions</i>	1,363,813	416,206	683,109	425,055	0	2,888,183
<i>Corporates</i>	210,717	98,049	168,544	186,706	374,605	1,038,621
<i>Secured on real estate mortgages</i>	582	0	0	0	0	582
<i>Total</i>	<u>1,623,181</u>	<u>525,614</u>	<u>909,957</u>	<u>687,768</u>	<u>435,428</u>	<u>4,181,948</u>

At 31 December 2009 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 2009 (2008: £nil).

### 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 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 and interest rate options, and 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.

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	Gross positive fair values of contracts	Potential credit exposure	Total derivative credit exposure
<b>31 December 2009</b>			
Foreign Exchange contracts	9,436	16,671	16,671
Interest rate swaps	1,850	2,449	2,449
Interest rate floors	118	645	645
Foreign Exchange options	1,161	0	0
<b>Total</b>	<b>12,565</b>	<b>19,765</b>	<b>19,765</b>
<b>31 December 2008</b>			
<i>Foreign Exchange contracts</i>	<i>11,099</i>	<i>16,189</i>	<i>16,189</i>
<i>Interest rate swaps</i>	<i>5,417</i>	<i>5,828</i>	<i>5,828</i>
<i>Interest rate floors</i>	<i>0</i>	<i>0</i>	<i>0</i>
<i>Foreign Exchange options</i>	<i>556</i>	<i>86</i>	<i>86</i>
<b>Total</b>	<b>17,072</b>	<b>22,103</b>	<b>22,103</b>

## 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
- 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.

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### **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 PRR<sup>3</sup> 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.

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.

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<sup>3</sup> Position Risk Requirement

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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 would increase or (reduce) the present value of the gaps in the banking book as follows:-

	Change in fair value	
	Increase 0.5%	Decrease 0.5%
<b>31 December 2009</b>	£	£
US Dollar book	(257,431)	258,646
Sterling book	(819)	814
Euro Book	(145,395)	147,037
Other books	(17,475)	17,507
Total	<u>(421,120)</u>	<u>424,004</u>
<b>31 December 2008</b>	£	£
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:-

Change in income	2009		2008	
	Increase in rates	Reduction in rates	Increase in rates	Reduction in rates
	£	£	£	£
Sterling	635,000	-635,000	276,000	-276,000
Total	<u>635,000</u>	<u>-635,000</u>	<u>276,000</u>	<u>-276,000</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.

During 2009 the FSA engaged in a major consultation with the industry, culminating in the issue of new regulatory rules embodied within their Policy Statement 09/16: “Strengthening liquidity standards”.

The Group’s Executive Management participated extensively in the consultation process with a view to ensuring that the new requirements were fully understood and embedded into the Group’s business model.

The new requirements encompass four principal concepts (as they affect the Group).

- Self-sufficiency. Entities are required to maintain all their liquidity resources within designated liquidity groups defined around management, legal entity and geographic boundaries. The Group operates as a single entity in the UK, and this requirement therefore has little practical effect for it.
- Systems and Controls framework. The new requirements set out the FSA’s comprehensive expectations regarding systems and controls which the FSA required be in place by 1 December 2009. These requirements detail requirements under a number of headings including involvement of the governing body, stress testing and contingency funding plans.
- Quantitative requirements. Banks will be expected to make changes to balance sheet structures including the establishment of portfolios of high quality liquid assets (termed the Liquid Asset Buffer), and the determination of maturity transformation in the light of liquidity risk tolerance, itself informed by the results of the stress tests. The FSA will agree a transition period of a number of years during which these requirements will be complied with.
- Reporting requirements. New and more demanding reporting requirements will be introduced in 2010.

#### Systems and Controls requirements

The Group has undertaken a “gap analysis” of the Group’s controls and procedures against the new requirements. New reporting systems and Management Information have been developed, and a full engagement with the governing body undertaken. Stress tests have been carried out, and new methods for measuring and controlling liquidity risk have been developed in the light of the results of those tests. During 2010 the Group expects to have a dialogue with the FSA regarding the proportionality of the application of their new requirements to a smaller institution. The Group will also need to test their conclusions concerning liquidity risk tolerance against those of the FSA.

#### Quantitative requirements

As noted above, the Group has undertaken liquidity stress tests at 31 December 2009. These tests envisage both a market wide and idiosyncratic (specific to the Group) stress. The stress tests comprise an initial 14 days extreme stress event, followed by a further 2½ months recovery period. Based on these tests, the Board has determined the minimum level of liquid

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assets which need to be held in order to assure the Group's ability to continue to meet its obligations throughout the three month stress period. At 31 December 2009 holdings of liquid assets exceeded the minimum assessed requirement.

The Board has also agreed limits for longer dated maturity transformation (with which the Group is currently in compliance), and other measurement metrics designed to give early warning for possible future deteriorations in the Group's liquidity position.

Overall liquidity risk declined during the year as term lending balances were reduced, thus reducing the extent of maturity transformation in the Group's balance sheet. At 31 December 2008 loans and advances to customers and banks with a residual maturity of over one year amounted to £573,878,000. By 31 December 2009 this total had fallen by £133,728,000 to £440,150,000.

### Reporting requirements

The Group is confident that it will be able to comply with the new reporting requirements which will be introduced during 2010. Investment made by the Group in data warehouse and financial reporting systems in previous years has meant that access to detailed data on a timely basis can be relatively easily accommodated.

### 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.

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 & Risk Committee. Where control weaknesses are identified as a result, changes to procedures are made.

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Operational losses<sup>4</sup> and near misses are closely monitored and reported to the Group's ALCO. Operational losses in 2009 amounted to £32,000 (2008: £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.

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<sup>4</sup> 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 based on reports provided by the fund managers.

At 31 December 2009 the carrying value of those investments in the Group's balance sheet (which is the same as estimated fair value) was as follows:-

	<b>2009</b>	<b>2008</b>
	<b>Fair value of investments</b>	<b>Fair value of investments</b>
	<b>£'000</b>	<b>£'000</b>
Equity shares	2,369	2,375
Equity investment funds	4,653	2,630
	<u>7,022</u>	<u>5,005</u>

There were no sales or liquidations of investments during the year. At 31 December 2009 £1,285,000 (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 3k of the 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 (I recall our having stated elsewhere that we don't have any of these?) 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). There were no collective impairments as at 31 December 2009 (2008: £2,293,000).

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 2009

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.

At 31 December 2009 seven facilities comprising amounts due to the Group from counterparties in the Middle East and African region of £38,275,000 were determined to be impaired (*2008: two facilities comprising £3,456,000 due to the group*). No collateral was held in respect of these facilities, but £2,900,000 (*2008: £3,456,000*) was covered by personal guarantees issued by the owners of both of the borrowing companies.

The Group holds financial assets due from one borrower that would have been past due or impaired had terms not been renegotiated. The amount of that asset was £6,694,000, and the amount which would have been due had terms not been renegotiated was £558,000. (*31 December 2008: Nil*).

At 31 December 2009, £18,000 was past due which was in respect of unimpaired financial assets (*31 December 2008: £Nil*).

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## Pillar 3 disclosures

The movement in impairments during the year was as follows:

£'000	2009			2008		
	Individual	Collective	Total	Individual	Collective	Total
Balance at 1 January	3,456	2,293	5,749	2,748	1,534	4,282
Exchange translation and other movements	237	(222)	15	1,487	576	2,063
Effect of discounting	(119)	0	(119)	(33)	0	(33)
Provisions written off	0	0	0	(1,388)	0	(1,388)
Profit and loss account						
New allowances	31,767	0	31,767	767	183	950
Reversal of allowances no longer required	(240)	(2,071)	(2,311)	0	0	0
Recoveries of amounts written off in previous periods	0	0	0	(125)	0	(125)
	31,527	(2,071)	29,456	642	183	825
Balance at 31 December	35,101	0	35,101	3,456	2,293	5,749

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Pillar 3 disclosures for the year ended 31 December 2009

Appendix 1

## Organisation Chart

