

Capital Management House B.S.C. (c)

Basel II, Pillar III Disclosures

for the six months period ended

30 June 2010 (Reviewed)

Capital Management House B.S.C.(c)

Basel II, Pillar III Disclosures

At 30 June 2010 (Reviewed)

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1 Back ground

Capital Management House B.S.C.(c) ("the Bank") was incorporated in the Kingdom of Bahrain in accordance with and subject to the provisions of the Bahrain Commercial Companies Law, Decree no (21) of 2001 and its Implementation Regulations issued as per Ministerial Order No (6) of 2002 and registered with the Ministry of Industry and Commerce under Commercial Registration (CR) number 61045 on 15 May 2006. Until 7 October 2009 the Bank operated under an Investment Firm (Category I) License issued by the Central Bank of Bahrain (CBB) and from 7 October 2009 CBB has upgraded its license to a "Wholesale Islamic Bank". The Bank's registered office is at Office 81, Building B1, Road 365, Block 316, Bahrain World Trade Center, Manama, Kingdom of Bahrain. The principle activities of the Bank includes:

- Short term investments;
- Capital market: Sukuk securities, equity linked offering, initial public offering and rights
- Advisory services: Mergers and acquisitions, private placement. Divestures and real estate developments;
- Asset management; and
- Islamic deposits products and unrestricted investment

The activities of the Bank and its wholly owned subsidiaries (together the "Group") are to carry out the operations in accordance with the teachings of Islam ('Shari'a'). The Group's Shari'a Supervisory Board is entrusted to ensure the Group's adherence to Shari'a rules and principles in its transactions and activities.

The Board of Directors seeks to optimize the Bank's performance by enabling the various group business units to realize the Group's business strategies and meet agreed business performance targets by operating within the agreed capital and risk parameters and the Group's risk policy framework.

The Public Disclosures under this section have been prepared in accordance with the CBB's requirements outlined in the Public Disclosure Module (PD) Section PD - 1 Annual Disclosure requirements, CBB Rule Book Volume II for Islamic Banks.

2 Capital Adequacy

The primary objective of the Group's capital management are to ensure that the Group complies with regulatory capital requirements and that it maintains healthy capital ratios in order to support its business and to maximize shareholder value.

The Group manages its capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of its activities. In order to maintain and adjust the capital structure, the Group may adjust the amount of dividend payment to shareholders, return capital to shareholders or issue capital securities.

The Bank's capital adequacy policy is to maintain a strong capital base to support the development and growth of the business. Current and future capital requirements are determined on the basis of growth expectations of the business and future sources and uses of funds. The Bank's regulator, CBB requires the Bank to maintain a ratio of 12% of total risk weighted assets as the minimum regulatory capital. To assess the capital adequacy requirements in accordance with the CBB requirements, the Group adopts the Standardized Approach for its credit risk, Basic Indicator Approach for its Operational Risk and the Standardized Measurement Approach for its Market Risk.

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At 30 June 2010 (Reviewed)

Table 1 - Capital Structure (PD 1.3.12, 1.3.13, 1.3.15) *

	<i>Tier 1</i> <i>USD'000</i>	<i>Tier 2</i> <i>USD'000</i>
Issued and fully paid ordinary shares	100,000	
Share premium	17,579	
General reserves	563	
Legal/ Statutory reserves	2,180	
Other reserves	1,186	
Retained earnings brought forward	629	
Unrealized gains arising from fair valuing equity through statement of income 45% only	3,168	
Less: Current Interim losses	(2,557)	
Less: Unrealized gross losses arising from fair valuing equity securities	(4,827)	
Tier 1 Capital before PCD deductions	117,921	
Unrealized gains on fair valuation of Investment property (45% only)		171
Unrealized gains arising from fair valuing equity securities (45% only)		42
Tier 2 Capital before PCD deductions		213
Regulatory deductions		
Excess amount over maximum permitted large exposure limit		(2,490)
Total Deductions		(2,490)
Net Available capital	117,921	(2,277)
Total Eligible Capital Basel III (Tier 1 & Tier 2)		115,644

* For the purposes of guidance we have cross referenced every disclosure with the relevant paragraph number of the Central Bank of Bahrain's Public Disclosure Module.

Table 2 - Capital Requirement by type of Islamic financing contracts (PD 1.3.17) *

The following table summaries the exposures subject to standardized approach of credit risk and related capital requirements by type of Islamic financing contracts:

	<i>Amount of</i> <i>exposures</i> <i>USD'000</i>	<i>Risk</i> <i>weighted</i> <i>assets</i> <i>USD'000</i>	<i>Capital</i> <i>requirement</i> <i>12%</i> <i>USD'000</i>
Claims on Sovereign	8,122	-	-
Claims on Banks	30,803	7,143	857
Equity investments	30,580	42,720	5,126
Holdings of real estate	38,348	76,696	9,204
Impaired & Past due facilities	3,314	3,314	398
Other assets and Specialized financings	53,418	99,916	11,990
	164,585	229,789	27,575

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Table 3 Capital requirement for market risk (PD 1.3.18)

The following table summaries the exposures subject to standardized approach of market risk and related capital requirements:

	<i>Self Financed</i>	<i>Capital requirement 12%</i>
	USD'000	USD'000
Market Risk - Standardized Approach		
Price risk	1501	180
Equity position risk	1180	142
Sukuk risk	2124	255
Foreign Exchange risk	1966	236
Total of Market Risk - Standardized Approach	6771	813
Multiplier	12.50	12.50
	84,638	10,157
Eligible portion for the purpose of the calculations	100%	100%
RWE to be used in CAR calculation	84,638	10,157

Table 4 - Capital requirements for operational risk (PD 1.3.19 & PD 1.3.30 (a&b))

The following table summaries the exposures subject to basic indicator approach of operational risk and related capital requirements:

	<i>Capital Charge</i>
	USD'000
Indicators of Operational risk	
Average gross income (three previous years) *	15,053
Multiplier	12.5
	188,163
Eligible portion for purposes of calculation	15%
TOTAL OPERATIONAL RISK EXPOSURE	28,224

* The gross income of CMH is based on income of CMH under "Investment Firm (Category I)" license until 7 October 2009 and thereafter under "Wholesale Islamic Bank license".

Table 5 - Capital adequacy ratios (PD 1.3.20)

The following table summarizes the Capital Adequacy Ratios for total Capital and Tier 1 Capital

	Total capital adequacy ratio	Tier 1 capital adequacy ratio
Top consolidated level	33.75%	33.75%

3 Risk Management

3.1 Group wide Risk Management Objectives

The risk management philosophy of the Group is to identify, capture, monitor and manage various dimensions of risk with the objective of protecting asset values and income streams such that the interest of Group's shareholders (and others to whom the Group owes liability) are safeguarded, while the returns are intended to optimize the Group's shareholder return, with the risk exposure maintained within the self-imposed parameters.

The Group has defined its risk appetite within the parameters of its risk strategies. The Group reviews and realigns its risk appetite as per the evolving business plan of the Group with changing economic and market scenarios. The Group also assesses its tolerance for specific risk categories and its strategies to manage these risks.

In addition to satisfying the minimum regulatory capital requirements of CBB, the Group seeks to constantly identify and quantify, to the extent possible, the various risks that are inherent in the normal course of its business and maintain appropriate internal capital levels and consequently is in the process of developing an Internal Capital Adequacy assessment Plan (ICAAP) framework. The main objective of the Group's ICAAP would be to ensure that adequate capital is retained at all times to support the risks the Group undertakes in the course of its business.

3.2. Strategies, Processes and Internal Controls

3.2.1 Group's risk strategy

The 'Capital Management Policy and Risk Charter' of the Group defines the risk strategies. These are also supported by appropriate limit structures. These policies provide an enterprise wide integrated risk management framework for the Group.

The 'Risk Charter' identifies risk objectives, policies, strategies and risk governance both at the Board and Management level. The 'Capital Management Policy' is aimed at ensuring financial stability by allocating enough capital to cover the unexpected losses.

The limit structure serves as a key component in articulating risk strategy in quantifiable risk appetite. In addition the Group is in the process of implementing various risk systems to help quantify not just the regulatory capital but also the economic capital allocated to various investment portfolios.

The Group is exposed to various types of risks, such as market, credit, profit rate, liquidity and operational, all of which require the comprehensive controls and ongoing oversight. The risk management framework summarizes the spirit behind Basel II, which includes management oversight and control, risk culture and ownership, risk recognition and assessment, control activities, segregation of duties, adequate information and communication channels, monitoring risk management activities and correcting deficiencies.

During 2010 the Group has established an independent Internal Audit Function headed by a professional accountant as the Head of Internal Audit. The Internal Audit Charter has been approved by the Board and a Risk Based Internal Audit approach is being implemented. The Internal Audit Function reports to the Audit & Risk Committee of the Board.

3.2.2 Credit risk

Credit risk is the risk that one party to a financial contract may fail to discharge an obligation and cause the other party to incur financial loss. The Group controls credit risk by monitoring credit exposures with reference to limits structure and concentration of risks for counterparties, sector and geography and by continually assessing the creditworthiness of counterparties.

3.2.3 Market risk

Market risk is the risk that the fair value or future cash flows of financial instruments may fluctuate due to changes in market variables such as profit rates, foreign exchange rates and equity prices. The Group has set limits on the risk that may be accepted.

The Group is in the process of developing techniques to carry out stress testing to assess the impact of adverse market conditions on its market risk sensitive portfolio. The Group's management believes that the Group is not exposed to material market risk sensitive assets.

3.2.4 Equity Price risk

Equity price risk is the risk that the fair values of equities decrease as a result of changes in the levels of equity indices and the value of individual stocks. The Group manages this risk through diversification of investments in terms of geographical distribution and industry concentration.

3.2.5 Profit rate risk

Profit rate risk arises from the possibility that changes in profit rates may affect future profitability or the fair values of financial instruments. The Group's management believes that the Group is not exposed to material profit rate risk as a result of mismatches in profit rate repricing.

3.2.6 Foreign exchange risk

Foreign exchange risk is the risk that the value of financial instruments may fluctuate due to changes in foreign exchange rates. The currency positions are monitored on daily basis to ensure positions are maintained within established limits.

3.2.7 Operational risk

Operational risk is the risk of loss arising from system failure, human error, fraud or external events. When controls fail to perform, operational risk can cause damage to reputation, have legal or regulatory implications, or lead to financial loss. The Bank can not expect to eliminate all operational risks, but through a control frame work and by monitoring and responding to potential risks, the Group is able to manage the operational risks. Controls include effective segregation of duties, access, authorization and reconciliation procedures. Maker checker concept and dual eye principles are applied across the Group, where possible.

3.2.8 Prepayment risk

Prepayment risk is the risk that the Group will incur a financial loss because its counterparties may repay or request repayment earlier or later than expected maturity. The Group is not exposed to any significant prepayment risk.

3.2.9 Displaced commercial risk

Displaced commercial risk (DCR) refers to the market pressure to pay returns that exceeds the rate that has been earned on the assets financed by liabilities, when the return on assets is underperforming as compared to Competitor's rates.. The Group is not exposed to any significant displaced commercial risk.

3.3 Structure and organization of Risk Management Function

Risk Management Structure includes all levels of authorities, organizational structure, people and systems required for smooth functioning of risk management processes in the Group. The responsibilities associated with each level of risk management structure and authority include the

The Board retains ultimate responsibility and authority for all risk matters, including:

- a) Establishing overall policies and procedures; and
- b) Delegating authority to Investment Committee, Audit & Risk Committee and to the management to review and approve any risk related issues.
- c) Risk Management & Compliance Committee (comprising of senior officers of the Group) is responsible to review new products & facilities from risk perspective and review on an ongoing basis all risk related issues pertaining to all assets of the Group and submit its risk assessment and recommendations to the Management Committee (comprising of executive management and senior officers of the Group) in all risk related issues.

3.4 Risk Measurement and Reporting Systems

Based on the risk appetite of the Group, the Group has put in place various exposure limits (both global limits for consolidated exposure to currency, industry and geography and specific investment limits for individual assets). These limits are approved by the Board of Directors. Any limit breaches are reported to the respective senior management committees and to the Board of Directors. The limits are reviewed and revised at least on an annual basis or when it is deemed necessary.

The Group has developed a risk measurement and reporting mechanism that translates various system generated reports into a risk assessment report to monitor all limits and exposure on various types of risk.

3.5 Credit risk

3.5.1 Types of credit risk

Contracts entered into by the Group comprise of Murabaha receivables, Mudaraba investments and

Murabaha receivables

These are basically sales on deferred terms.

The Bank arranges a Murabaha transaction by buying a commodity (which represents the object of the Murabaha) and then sells this commodity to the Murabeh (beneficiary) after adding a margin of profit over the cost. The sale price (cost plus profit margin) is repaid by the Murabeh over the agreed period.

Mudaraba investments

Mudaraba investments is a partnership where the Bank ("rabbalmaal") gives money to another ("Mudarib") for investing in a commercial enterprise for a definite period of time.

Wakala

Wakala is an investment product similar to Mudaraba investments. However under an wakala agreement the investor ("Wakil") receives only an agreed ratio of profit derived from the investment and all excess are for the benefit of "Muwakkil".

3.5.2 Past Due and impaired islamic facilities

The Group defines facility (including investments) as non-performing facility when it is overdue for a period of 90 days or more. Non-performing facilities are placed on non-accrual basis and any income on such facilities are recognized on a receipts basis. It is the Group's policy that when an exposure is overdue for a period of 90 days or more, the whole of the facility extended or investment made is considered as past due and impaired and not only the overdue installments / payments.

3.5.3 Definition of Geographical area

The geographical distribution of the exposures is monitored on an ongoing basis by the Group's Financial Control Department and reported to the Management committee on an ongoing basis and to the Audit & Risk Committee of the Board on a quarterly basis. The Group's classification of geographical area is according to its business needs and the distribution of its portfolio.

3.5.4 Concentration Risk

Concentration risk is the credit risk stemming from not having a well diversified credit portfolio, i.e. being overexposed to a single customer, industry or geographic region. As per CBB's single obligor regulations, banks incorporated in Kingdom of Bahrain and licensed by CBB are required to obtain the CBB's prior approval for any planned exposure to a single counterparty, or a group of connected counterparties, exceeding 15% of the regulatory capital base.

The Group's policy and procedures include specific guidelines to focus on maintaining a diversified portfolio and all identified concentration of risks are controlled and managed accordingly.

3.5.5 Large Exposure

Large exposure is any exposure whether direct, indirect to a counterparty or a group of closely related counterparties which is greater than or equal to 10% of the Group's regulatory capital base.

Prior written approval from the CBB is required in the following cases:

- a) If any counterparty (single/group) exposure exceeds 15% of Group's regulatory capital base; and
- b) If any facility (new/extended) to an employee is equal to or above BD 100,000 (or equivalent)

3.5.6 Related party transactions

The disclosure relating to related party transactions has been made in the interim condensed financial statements for the period ended 30 June 2010. These statements are included in the website of the Group. All related party transactions have been made on arm's length basis only.

It is the policy of the Group to request and obtain Board representation in the Investment SPVs and the Board representation is primarily to monitor and manage the investments to the best interest of the shareholders of the Group. (These investments are also included in the above disclosure in the interim condensed financial statements for the period ended 30 June 2010.)

3.5.7 Credit Risk Mitigation

Credit risk mitigation refers to use of a number of techniques, such as collaterals, guarantees, credit derivatives (shari'a compliant protection) to mitigate the credit risks that the Group is exposed to. Credit risk mitigants reduce the credit risk by allowing the Group to protect against counterparty non-performance of credit contracts through collateral, netting agreements, guarantees and credit derivatives (Shari'a compliant protection).

The Group generally extends Islamic facilities or initiates equity investments only where supported by adequate underlying collateral assets and / or audited financial statements. Investments and facilities without adequate tangible collateral assets is considered only when audited financial statements reveal satisfactory financial position/ repayment ability and the facility are properly structured supported by cash flow projections, fair value projections, assignments, guarantees, etc. as appropriate. Additionally significant equity investments in new ventures are supported by Board representations to monitor the investment through its holding period. Facilities to non corporate entities without audited financial statements is discouraged and is approved only on an exceptional basis after careful analysis of the quality of the customer, market reputation etc.

Generally the Group ensures the following with respect to an acceptable collateral or underlying asset for facilities granted by the Group.

- a. The assets must be maintaining their value during the holding period of the investment,
- b. Such assets should be easily convertible into cash, if required (liquidity),
- c. There should be reasonable market for the assets (marketability), and
- d. The group should be able to enforce its rights over the asset if necessary (enforceability),

The Legal department ensures the satisfactory evidence of legal and physical ownership of the underlying assets supporting the investment or the facility.

The Financial Control Department with the assistance of Investment department ensures periodic valuation of the underlying assets (including real estate) and obtain external valuations where applicable and submit periodic reports on the adequacy or otherwise of the underlying assets to the Management Committee.

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Table 6 - Credit risk exposure (PD 1.3.23)

The following table summarizes the amount of gross funded credit exposure as at 30 June 2010 and average gross exposure over the six month period ended on 30 June 2010 and funded by own capital. The average gross funded exposure is calculated on the month end balances:

	Total gross credit exposure USD '000	Average gross exposure over the period USD '000
Funded		
Cash and bank balances	2,246	2,190
Due from financial institutions	28,567	21,053
Investments	128,513	127,172
Other assets	796	914
Sub total	<u>160,122</u>	<u>151,329</u>
Unfunded / commitments		
Investment commitments	564	1,407
Foreign Exchange commitments	451	2,416
Other commitments	1,251	1,326
Sub total	<u>2,266</u>	<u>5,149</u>
Total credit risk exposure	<u>162,388</u>	<u>156,478</u>

Table 7 - Credit risk - geographic breakdown (PD 1.3.23 (b))

The following table summarizes the geographic distribution of exposures, broken down into significant areas by major types of credit exposures:

	Bahrain USD '000	GCC USD '000	Africa USD '000	USA / Europe USD '000	Total USD '000
Funded					
Cash and bank balances	414	27	-	1,805	2,246
Due from financial institutions	16,561	12,006	-	-	28,567
Investments	69,003	30,863	18,884	9,764	128,513
Other assets	440	301	54	-	796
Total	<u>86,418</u>	<u>43,197</u>	<u>18,938</u>	<u>11,569</u>	<u>160,122</u>
Unfunded / commitments					
Investment commitments	-	-	564	-	564
Foreign Exchange commitments	-	-	-	451	451
Other commitments	1,251	-	-	-	1,251
	<u>1,251</u>	<u>-</u>	<u>564</u>	<u>451</u>	<u>2,266</u>

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Table 8 - Credit risk - industry breakdown (PD 1.3.23 (c))

The following table summarizes the distribution of exposures by industry, broken down by major types of credit exposures:

Industry sector	Real Estate USD '000	Financial services USD '000	Sovereign USD '000	& Utilities USD '000	Others USD '000	Total USD '000
Cash and bank balance	-	2,246	-	-	-	2,246
Due from financial institutions	-	28,567	-	-	-	28,567
Investments	38,347	29,222	8,122	39,803	13,019	128,513
Other assets	1	42	-	56	697	796
Total	38,348	60,077	8,122	39,859	13,716	160,122
Investment commitments	-	-	-	564	-	564
Foreign Exchange commitments	-	451	-	-	-	451
Other Commitments	-	-	-	-	1,252	1,252
	-	451	-	564	1,252	2,267

Table 9 - Credit risk - Intra group transactions (PD 1.3.23 (d))

The transactions with the 100% subsidiary Tamkeen Investment Co. B.S.C. (c) are as follows:

	USD '000
Paid up capital	3
Bank balance with the subsidiary	9
Inter company facility to subsidiary	65
Total	77

On 27 March 2008, the Bank has formulated a Management Incentive Program ("MIP") and has incorporated a wholly owned subsidiary 'Tamkeen Investment Company B.S.C. (c)', to administer MIP. The shareholders have authorized the issue of 15 million shares (maximum) under MIP. Under this program, the employees of the Bank are entitled to incentives comprising of cash and equity awards for each financial year based on achievement of performance parameters. The equity awards vest to the benefit of employees subject to the satisfaction of additional service conditions.

For the financial year 2008, the Company granted 1,066,241 share award to the employees with the vesting period of five years (2008-2012). Of the above, 475,383 shares have vested on 31 December 2009. The Company is currently in the process of completing the statutory formalities associated with the transfer of the shares.

During the six-month period ended 30 June 2010, the Bank has incorporated another wholly owned subsidiary "Suffun Investments I". The subsidiary is not operational as at 30 June 2010. The subsidiary will hold a private equity investment which will be held jointly by the Bank along with its portfolio clients. As at 30 June 2010, there are no balances due from or due to this subsidiary.

Table 10 - Credit Risk - concentration of risk (PD 1.3.23(f))

The following table summarizes the disclosure for concentration of risk to individual counterparties or group of connected counterparties in excess of 15% of regulatory capital:

	<i>USD '000</i>	<i>% of total eligible capital</i>
Counterparty 1	19,448	16.46%
Counterparty 2	18,482	15.64%

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Table 11 Credit risk - Residual contractual maturity (own capital(PD 1.3.23 g))

The following table summarizes the residual contractual maturity of the Bank's own capital breakdown of the whole credit portfolio, broken down by major type of credit exposure:

	<i>Up to 1 month USD'000</i>	<i>1 to 3 months USD'000</i>	<i>3 to 6 months USD'000</i>	<i>6 months to 1 year USD'000</i>	<i>1 to 3 years USD'000</i>	<i>Over 3 years USD'000</i>	<i>No fixed Maturity USD'000</i>	<i>Total USD'000</i>
ASSETS								
Cash and bank balances	2,246	-	-	-	-	-	-	2,246
Due from financial institutions**	22,006	5,000	-	-	-	-	1,561	28,567
Investments	99	7,576	305	736	11,554	14,780	93,463	128,513
Other assets	-	104	692	-	-	-	-	796
Total assets	24,351	12,680	997	736	11,554	14,780	95,024	160,122
LIABILITIES								
Due to financial institutions	26,000	12,525	-	-	-	-	-	38,525
Due to non financial customers	1,165	-	-	-	-	-	-	1,165
Other liabilities	217	-	-	-	-	-	99	316
Total liabilities and equity	27,382	12,525	-	-	-	-	99	40,006

* Impaired facility and balances held under escrow accounts are classified as "no fixed maturity".

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Table 12 - Credit Risk - Impaired facilities and allowances (own capital by industry and geographic sector (PD 1.3.23 (h&i)))

	Own Capital									
	Ageing Past Due					Specific allowances				
	Impaired facilities USD'000	Less than 90 days USD'000	3 to 12 months USD'000	1 to 3 years USD'000	Over 3 years USD'000	Balance at the beginning of the period USD'000	Charges during the period USD'000	Charge off during the period USD'000	Balance at the end of the period USD'000	Collective provisions (note below) USD'000
Due from financial institutions (Bahrain)	2,000	-	-	2,000	-	1,500	-	-	1,500	-
Unquoted equity shares (USA) (note below)	4,346	-	-	-	4,346	2,608	-	-	2,608	-
Quoted equity Securities (UK)	1,065	-	1,065	-	-	770	-	-	770	-
Quoted equity securities (Bahrain)	1,835	1,835	-	-	-	-	1,096	-	1,096	-
Others (not specific to a geographic area)	-	-	-	-	-	-	-	-	-	600
	9,246	1,835	1,065	2,000	4,346	4,878	1,096	-	5,974	600

Notes:

Collective provisions represent collective impairment provisions against exposures which, although not specifically identified, have a greater risk of default than when originally granted. These provision were recorded during the year ended 31 December 2009. As per management assessment there is no change in the amount of collective provision as at 30 June 2010.

During the six-month period ended 30 June 2010, one of the Bank's investment in an unquoted sukuk investment was surrendered and under the terms of conversion agreement was converted to the unquoted shares of an SPV formed to acquire the assets and liabilities of sukuk. The Group has transferred the cost and impairment provisions relating to the sukuk to the shares acquired under conversion agreement.

Industry exposures of impaired facilities are: Financial institutions = USD 4,900 thousands and Oil & gas = USD 4,346 thousands,

Table 13 Credit Risk - Restructured islamic financing contracts (PD 1.3.23(j))

During April 2010, one of the Bank's investment in an unquoted sukuk investment was surrendered and under the terms of conversion agreement was converted to the unquoted shares of an SPV formed to acquire the assets and liabilities of sukuk. The Group has transferred the cost and impairment provisions relating to the sukuk to the shares acquired under conversion agreement. Thus the gross exposure under sukuk (USD 4,346 thousands) has been considered as the cost of new equity shares and the impairment provision of USD 2,608 thousands relating to sukuk was recognised against the new shares resulting in net book value of USD1,738 thousand. The sukuk was held on a non accrual basis and therefore the future impact on the income is considered as 'Nil' due to this restructuring.

3.6 MARKET RISK

3.6.1 Introduction

The Group has adopted the definition of market risk as defined by CBB as "the risk of losses in on- and off- balance-sheet positions arising from movements in market prices".

3.6.2. Sources of market risk

For the Group, market risk may arise from movements in profit rates, foreign exchange markets or equity markets. A single transaction or financial product may be subject to any number of these risks.

Profit rate risk

Profit rate risk arises from the possibility that changes in profit rates will affect future profitability or the fair values of the financial instruments.

Foreign exchange risk

Foreign exchange risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. The currency positions are monitored on daily basis to ensure positions are maintained within established limits.

Equity price risk

Equity price risk is the risk that the fair values of equities may decrease as a result of changes in the levels of equity indices and the value of individual equities.

3.6.3. Market risk strategy

The Group's Board is responsible for approving and reviewing the risk strategy and significant amendments to the risk policies and the senior management is responsible for implementing the risk strategy approved by the Board.

Inline with the Group's risk management objectives and risk tolerance levels, the specific strategies for market risk management include:

1. The Group manages its market risk exposure by evaluating each new product/ activity with respect to the market risk associated with it;
2. The Group proactively measure and continually monitor the market risk in its portfolio;
3. The Group at all time hold sufficient capital in line with CBB Pillar 1 regulatory capital requirement;
4. The Group has established a market risk appetite which is quantified and established as market risk limit structure;
5. The Group has established a limit structure to monitor and control the market risk in its portfolio. These limits will include position limits, maximum/ stop loss limits, factor sensitivity limits, VaR limits and maturity limits;
6. The Group clearly identifies the foreign currencies in which it wishes to deal in and actively manage its market risk in all foreign currencies in which it has significant exposure.

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Table 14 Market Risk capital requirements (PD 1.3.27 (b))

The following table summarizes the capital requirement for foreign exchange risk as of 30 June 2010:

	<i>exchange risk USD'000</i>
Foreign exchange capital requirements	24,569
Maximum value	25,020
Minimum value	24,569

3.7 Operational Risk

3.7.1 Introduction

Operational risk is the risk of loss arising from system failure, human error, fraud or external events. When controls fail to perform, operational risk can cause damage to reputation, have legal or regulatory implications, or lead to financial loss. The Group can not expect to eliminate all operational risks, but through a control frame work and by monitoring and responding to potential risks, the Group is able to manage these risks. Controls include effective segregation of duties, access, authorization and reconciliation procedures. Maker checker function and dual eye principles are applied across the Group, where applicable.

Table 15 Equity position risk in banking book (PD 1.3.31 (b), (c) & (d))

	<i>Total Gross exposure USD'000</i>	<i>Average Gross exposure * USD'000</i>	<i>Publically traded USD'000</i>	<i>Risk weighted assets USD'000</i>	<i>Capital requirement 12% on RWA USD'000</i>
Equity investments	100,449	100,490	7,377	184,156	22,099
Sukuks **	23,441	22,902	18,441	22,810	2,737
Total	123,890	123,392	25,818	206,966	24,836

* Average balances are computed on month end balances

** Sukuks are considered as tradeable based on bid offer quotes in Bloomberg

Table 16 Equity gains or losses in banking book (PD 1.3.31 (d) and (e))

	USD'000
Cumulative realized loss arising from sales or liquidations in the reporting period	(834)
Cumulative realized gain arising from sales or liquidations in the reporting period	175
Total unrealized losses recognized in the balance sheet but not through statement of income	4,827
Total unrealized gains recognized in the balance sheet but not through statement of income	94
Total unrealized losses included in Tier 1 capital	4,827
Total unrealized gains included in Tier 1 capital	3,168
Unrealized gains included in Tier 2 capital	42

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3.8 Liquidity risk

Liquidity risk is the risk that an institution will be unable to meet its funding requirements. Liquidity risk can be caused by market disruptions or credit downgrades which may cause certain sources of funding to cease immediately. To guard against this risk, the Group is targeting to build a large customer base and assets are managed with liquidity in mind, maintaining a healthy balance of cash, cash equivalents, and commodity murabaha. Liquidity position is monitored on an ongoing basis by the Groups's Asset Liability Committee (ALCO) and is also compared to the limits set by the Group's Board. All exceptions are reported for adequate corrective actions.

Table 17 Liquidity ratios (PD 1.3.37)

The following table summarizes the liquidity ratios:

	30-Jun-10	31-Dec-09	31-Dec-08	31-Dec-07	31-Dec-06
Short term assets less than 1 Year / Short term Liability less than 1 Year	1.39	2.00	5.88	1.00	0.09
Commodities Murabaha / Total assets	6.81%	2.71%	23.60%	23.09%	0.00%
Liquid Assets / Total Assets	18.40%	8.72%	36.36%	31.14%	0.92%
Liquid Assets / Total Assets *	34.36%	28.18%	38.73%	31.74%	2.32%

* The Management evidenced that certain sukuk and shares are tradable or liquid and the ratio is calculated after including the tradeable sukuks and shares as liquid assets.

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Table 18 Maturity analysis of assets and liabilities and equity (PD 1.3.38)

The table below shows an analysis of assets, liabilities and equity analyzed according to when they are expected to be recovered or settled:

	<i>Up to 1 month</i>	<i>1 to 3 months</i>	<i>3 to 6 months</i>	<i>6 months to 1 year</i>	<i>1 to 3 years</i>	<i>Over 3 years</i>	<i>Total</i>
ASSETS							
Cash and bank balances	2,246	-	-	-	-	-	2,246
Due from financial institutions	22,006	5,000	-	-	-	1,561	28,567
Investments	99	3,982	2,305	16,020	57,236	48,871	128,513
Fixed assets	-	-	-	-	-	1,597	1,597
Other assets	-	104	692	-	-	-	796
Total assets	24,351	9,086	2,997	16,020	57,236	52,029	161,719
LIABILITIES AND EQUITY							
Due to financial institutions	26,000	12,525	-	-	-	-	38,525
Due to non financial customers	1,165	-	-	-	-	-	1,165
Other liabilities	217	-	-	-	-	99	316
Equity	-	-	-	-	-	121,713	121,713
Total liabilities and equity	27,382	12,525	-	-	-	121,812	161,719
Liquidity gap	(3,031)	(3,439)	2,997	16,020	57,236	(69,783)	-
Cumulative liquidity gap	(3,031)	(6,470)	(3,473)	12,547	69,783	-	-

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3.9 Profit rate risk

Profit rate risk is the potential impact of the mismatch between the rate of return on assets and the expected rate of funding due to the sources of finance (e.g. deposits etc,)

Senior management identifies the source of profit rate risk exposures based upon the current as well as forecasted balance sheet structure of the Group. The profit rate risk may arise due to Murabaha transactions, mudaraba transactions, wakala transactions and investment in sukuks.

The management believe that the Group is not exposed to any significant profit rate risk as a result of mismatches of profit rate repricing of assets and liabilities as the repricing of assets and liabilities occur at similar intervals.

Table 19 Profit rate risk in Banking book (PD 1.3.40 (b))

The following table summarizes the effect on the value of assets, liabilities and economic capital for a benchmark change of 200 basis point in profit rates:

	<i>Balances as at 30 June 2010</i>	<i>Effect on value of asset & income</i>	<i>Effect on value of liability & expense</i>	<i>Effect on value of economic capital & net income</i>
Rate sensitive assets				
1. Due from financial institutions (interbank profit rates)	28,567	571	-	
2. Investment - sukuks (floating rates on nominal)	24,000	480	-	
Rate sensitive liabilities				
3. Due to financial institutions (interbank profit rates)	(38,525)	-	(771)	
Net upward rate shocks on Rate sensitive assets & liabilities	14,042	1,051	(771)	281
Net downward rate shocks on Rate sensitive assets & liabilities	14,042	(1,051)	771	(281)

The others assets and liabilities are not rate sensitive

Table 20 quantitative indicators of Financial Performance and position (PD 1.3.9)

	30-Jun-10 **	2009	2008	2007	2006 *
Return on average equity	-5.11%	1.08%	27.71%	11.81%	2.44%
Return on average assets	-3.31%	0.75%	12.26%	7.20%	1.09%
Cost to Income ratio	210.35%	57.97%	31.01%	44.56%	66.45%

* The Group commenced its operations in 2006 and income ratio are annualized on the basis of 7 months operation for the year 2006.

** 30 June 2010 Return on equity and Return on average assets percentage are annualised on the basis of half year results

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4 Unrestricted Investment Accounts (PD 1.3.32 & PD 1.3.33)

The CBB upgraded the Bank's license from 'Investment Firm - Category 1 license' to 'Wholesale Islamic Investment Bank License' on 7 October 2009. Under its previous license, The Bank did not offer any Unrestricted Investment account product in accordance with the Investment Firm license and intends to structure Unrestricted Investment products during 2010 under its new license.

CBB requires the Group to maintain capital to cover the price risk arising from 30% of the assets funded by Unrestricted Investment Accounts (URIA) on a pro-rata basis. The Bank has no exposure under this requirement.

The Group is currently in the process of developing written policies and procedures applicable to Unrestricted Investment Accounts. URIA funds are intended to be invested and managed in accordance with Shari'a requirements.

5 Restricted Investment accounts (PD 1.3.34)

The Bank holds Investments of portfolio customers under fiduciary relationship and these are held Off-Balance sheet and separate portfolio accounts are maintained for each client. The Bank currently holds only custody accounts and performs only custodian duties.

Although the underlying investments are held in the name of the Bank, these assets are not consolidated in the Group's financial statements and the aggregated exposures as at 30 June 2010 are given below:

Table 21 Fiduciary Assets Held by the Group (PD 1.3.4)

	<i>Total Gross exposure USD'000</i>
Claims on Banks	1,165
Listed equities	3,490
Unlisted equities	26,993
Sukuks	1,998
Investment in funds	14,916
Holdings of real estate (SPVs, Musharaka and unlisted equities)	49,643
SPVs - Specialized financings	6,269
Total Exposure	104,474