

**Liquidity Management Centre B.S.C. (c)**  
**SHARI'A SUPERVISORY BOARD REPORT,**  
**REPORT OF THE BOARD OF DIRECTORS AND**  
**CONSOLIDATED FINANCIAL STATEMENTS**

**31 DECEMBER 2008**

**INDEPENDENT AUDITORS' REPORT TO THE SHAREHOLDERS OF  
LIQUIDITY MANAGEMENT CENTRE B.S.C. (c)**

We have audited the accompanying consolidated balance sheet of Liquidity Management Centre B.S.C. (c) [the "Bank"] and its subsidiary [together the "Group"] as of 31 December 2008, and the related consolidated statements of income, cash flows and changes in equity for the year then ended. These consolidated financial statements and the Group's undertaking to operate in accordance with Islamic Shari'a rules and principles are the responsibility of the Group's Board of Directors. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the Auditing Standards for Islamic Financial Institutions. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statements presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Group as of 31 December 2008, the results of its operations, its cash flows and changes in equity for the year then ended in accordance with the Financial Accounting Standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions and the Shari'a Rules and Principles as determined by the Shari'a Supervisory Board of the Group.

We confirm that, in our opinion, proper accounting records have been kept by the Bank and the consolidated financial statements, and the contents of the Report of the Board of Directors relating to these consolidated financial statements, are in agreement therewith. We further report, to the best of our knowledge and belief, that no violations of the Bahrain Commercial Companies Law, nor of the Central Bank of Bahrain and Financial Institutions Law, nor of the memorandum and articles of association of the Bank, have occurred during the year ended 31 December 2008 that might have had a material adverse effect on the business of the Bank or on its consolidated financial position and that the Bank has complied with the terms of its banking licence.

Liquidity Management Centre B.S.C. (c)

CONSOLIDATED BALANCE SHEET

31 December 2008

	<i>Note</i>	<b>2008</b> <b>US\$ 000</b>	<i>2007</i> <i>US\$ 000</i>
<b>ASSETS</b>			
Cash and balances with banks		<b>1,149</b>	413
Murabaha receivables	3	<b>13,807</b>	13,197
Due from bank		<b>15,000</b>	-
Investments	4	<b>242,598</b>	271,044
Other assets	5	<b>3,868</b>	10,653
Equipment		<b>369</b>	261
<b>TOTAL ASSETS</b>		<b>276,791</b>	295,568
<b>LIABILITIES AND EQUITY</b>			
<b>LIABILITIES</b>			
Due to Short Term Sukuk - investors	6	<b>161,748</b>	208,581
Due to banks		<b>42,997</b>	1,988
Due to non bank		<b>13,604</b>	17,000
Other liabilities	7	<b>2,132</b>	2,665
<b>TOTAL LIABILITIES</b>		<b>220,481</b>	230,234
<b>EQUITY</b>			
Share capital	8	<b>51,000</b>	51,000
Reserves	8	<b>5,555</b>	4,308
(Accumulated deficit) retained earnings		<b>(245)</b>	10,026
<b>TOTAL EQUITY</b>		<b>56,310</b>	65,334
<b>TOTAL LIABILITIES AND EQUITY</b>		<b>276,791</b>	295,568

\_\_\_\_\_  
Mohammed Tariq  
Chairman

\_\_\_\_\_  
Emad Al Monayea  
Deputy Chairman

\_\_\_\_\_  
Ahmed Abbas  
Chief Executive Officer

The attached notes 1 to 22 form part of these consolidated financial statements.

Liquidity Management Centre B.S.C. (c)  
**CONSOLIDATED STATEMENT OF INCOME**  
Year ended 31 December 2008

	<i>Note</i>	<b>2008</b> <b>US\$ 000</b>	<b>2007</b> <b>US\$ 000</b>
Income from investments		<b>13,528</b>	14,584
Income from Murabaha and due from bank		<b>896</b>	996
Income from Mudaraba		<b>116</b>	-
Less: Return to Short Term Sukuk - investors		<b>(7,714)</b>	(9,139)
Less: Return to banks		<b>(761)</b>	(129)
Less: Return to non banks		<b>(469)</b>	(714)
		<b>5,596</b>	5,598
Investment banking fees	9	<b>921</b>	9,696
Fair value changes	10	<b>5,891</b>	-
Loss on sale of available-for-sale investments		-	(39)
Gain on sale of investment properties		-	243
Foreign exchange gain		<b>534</b>	-
<b>OPERATING INCOME</b>		<b>12,942</b>	15,498
Staff costs		<b>4,303</b>	2,529
Depreciation		<b>89</b>	70
General and administrative expenses	11	<b>1,181</b>	1,779
<b>OPERATING EXPENSES</b>		<b>5,573</b>	4,378
<b>NET PROFIT FOR THE YEAR BEFORE IMPAIRMENT PROVISION</b>		<b>7,369</b>	11,120
Specific impairment provision	12	<b>5,627</b>	-
Collective impairment provision		<b>700</b>	-
<b>NET PROFIT FOR THE YEAR</b>		<b>1,042</b>	11,120

The attached notes 1 to 22 form part of these consolidated financial statements.

Liquidity Management Centre B.S.C. (c)  
**CONSOLIDATED STATEMENT OF CASH FLOWS**  
Year ended 31 December 2008

	<b>2008</b> <b>US\$ 000</b>	<b>2007</b> <b>US\$ 000</b>
<b>OPERATING ACTIVITIES</b>		
Net profit for the year	<b>1,042</b>	11,120
Adjustments for:		
Depreciation	<b>89</b>	70
Amortisation of premium on investments	<b>(286)</b>	(326)
Gain on sale of investment properties	-	(243)
Loss on sale of available-for-sale investments	-	39
Fair value changes	<b>(5,891)</b>	-
Specific impairment provision	<b>5,627</b>	-
Collective impairment provision	<b>700</b>	-
Directors' remuneration	-	313
Operating profit before changes in operating assets and liabilities:	<b>1,281</b>	10,973
Changes in:		
Purchase of investments held to maturity	<b>(13,069)</b>	(100,456)
Sale/redemption proceeds from investments held to maturity	<b>38,969</b>	30,334
Purchase of available-for-sale investments	<b>(7,382)</b>	(28,945)
Sale/redemption proceeds of available for sale investments	<b>6,013</b>	9,537
Sale proceeds of investment properties	-	5,149
Sale of trading investment	<b>121</b>	-
Purchase of investment available-for-sale through statement of income	<b>(862)</b>	-
Murabaha receivables	-	7,313
Other assets	<b>6,325</b>	(7,512)
Due to Short Term Sukuk - investors	<b>(46,833)</b>	50,229
Due to banks	<b>41,009</b>	1,988
Due to non bank	<b>(3,396)</b>	17,000
Other liabilities	<b>(177)</b>	(1,084)
Net cash from (used in) operating activities	<b>21,999</b>	(5,474)
<b>INVESTING ACTIVITY</b>		
Purchase of equipment	<b>(197)</b>	(190)
Net cash used in investing activity	<b>(197)</b>	(190)
<b>FINANCING ACTIVITIES</b>		
Dividend paid	<b>(5,100)</b>	(3,825)
Directors' remuneration paid	<b>(356)</b>	(313)
Net cash used in financing activities	<b>(5,456)</b>	(4,138)
<b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>16,346</b>	(9,802)
Cash and cash equivalents at 1 January	<b>13,610</b>	23,412
<b>CASH AND CASH EQUIVALENTS AT 31 DECEMBER</b>	<b>29,956</b>	13,610
Cash and cash equivalents at year end comprise of:		
Cash and balances with banks	<b>1,149</b>	413
Murabaha receivables with original maturity of ninety days or less	<b>13,807</b>	13,197
Due from bank with original maturity of ninety days or less	<b>15,000</b>	-
	<b>29,956</b>	13,610

The attached notes 1 to 22 form part of these consolidated financial statements.

Liquidity Management Centre B.S.C. (c)

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

Year ended 31 December 2008

	Reserves					Total Reserves US\$ 000	(Accumulated deficit) Retained earnings US\$ 000	Total equity US\$ 000
	Share capital US\$ 000	Statutory reserve US\$ 000	General reserve US\$ 000	Investment fair value reserve US\$ 000	Foreign exchange translations US\$ 000			
Balance at 1 January 2008	51,000	1,930	1,930	448	-	4,308	10,026	65,334
Cumulative changes in fair value	-	-	-	(4,429)	-	(4,429)	-	(4,429)
Foreign currency translation	-	-	-	-	(504)	(504)	-	(504)
Realised gain on sale of available-for-sale investments transferred to consolidated statement of income	-	-	-	(33)	-	(33)	-	(33)
<b>Total income and expenses recognised directly in equity</b>	-	-	-	<b>(4,462)</b>	<b>(504)</b>	<b>(4,966)</b>	-	<b>(4,966)</b>
Transfer of fair value gain to reserve, net	-	-	-	6,213	-	6,213	(6,213)	-
Net profit for the year	-	-	-	-	-	-	1,042	1,042
<b>Total income and expenses recognised during the year</b>	-	-	-	<b>1,751</b>	<b>(504)</b>	<b>1,247</b>	<b>(5,171)</b>	<b>(3,924)</b>
Dividend paid	-	-	-	-	-	-	(5,100)	(5,100)
<b>Balance at 31 December 2008</b>	<b>51,000</b>	<b>1,930</b>	<b>1,930</b>	<b>2,199</b>	<b>(504)</b>	<b>5,555</b>	<b>(245)</b>	<b>56,310</b>
Balance at 1 January 2007	51,000	818	818	419	-	2,055	4,955	58,010
Cumulative changes in fair value	-	-	-	29	-	29	-	29
<b>Total income and expenses recognised directly in equity</b>	-	-	-	<b>29</b>	-	<b>29</b>	-	<b>29</b>
Net profit for the year	-	-	-	-	-	-	11,120	11,120
<b>Total income and expenses recognised during the year</b>	-	-	-	<b>29</b>	-	<b>29</b>	<b>11,120</b>	<b>11,149</b>
Transfer to statutory reserve	-	1,112	-	-	-	1,112	(1,112)	-
Transfer to general reserve	-	-	1,112	-	-	1,112	(1,112)	-
Dividend paid	-	-	-	-	-	-	(3,825)	(3,825)
Balance at 31 December 2007	51,000	1,930	1,930	448	-	4,308	10,026	65,334

The attached notes 1 to 22 form part of these consolidated financial statements.

31 December 2008

## 1 INCORPORATION AND ACTIVITIES

Liquidity Management Centre B.S.C. (c) (the "Bank") is a closed joint stock company incorporated in the Kingdom of Bahrain on 31 July 2002 and registered with Ministry of Industry and Commerce under commercial registration (CR) number 49092. The Bank operates in the Kingdom of Bahrain (Bahrain) under wholesale banking license issued by the Central Bank of Bahrain (CBB). The Bank is engaged in the following activities:

- Facilitate creation of an Islamic inter-bank money market that will allow Islamic Financial Services Institutions ("IFSI") to effectively manage their assets and liabilities.
- Provide short-term liquid, tradable asset backed treasury instruments (Sukuk) based on Islamic Shari'a principles where IFSI can invest their surplus liquidity.
- Provide short-term investment opportunities based on Islamic Shari'a principles.

The activities of the Bank and its wholly owned subsidiary (together the "Group") are to carry out 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 address of the Bank's registered office is Building 722, Road 1708, Block 317, Manama, Bahrain.

The Bank operates only in Bahrain. As of 31 December 2008, the total number of employees employed by the Group was 33 (2007: 25).

The financial statements were approved by the Board of Directors on 2 March 2009.

## 2 SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies adopted in the preparation of the financial statements are set out below:

### a. Basis of preparation

The consolidated financial statements have been prepared on a historical cost basis, except for certain available-for-sale investments and trading investments that have been measured at fair value. The consolidated financial statements have been presented in United States Dollars (US Dollar), being the principal currency of the Group's operations. All the values are rounded to the nearest US Dollar thousands unless otherwise stated.

### b. Statement of compliance

The consolidated financial statements are prepared in accordance with the Financial Accounting Standards and interpretations issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), the Shari'a Rules and Principles as determined by the Shari'a Supervisory Board of the Bank, the Bahrain Commercial Companies Law, the Central Bank of Bahrain and Financial Institutions Law. For matters which are not covered by AAOIFI standards, the Group uses the relevant International Financial Reporting Standards (the "IFRS").

### c. Basis of consolidation

The consolidated financial statements comprise the financial statements of the Bank and its wholly owned subsidiary "The Short Term Sukuk Centre B.S.C. (closed)" (STSC). The financial statements of the subsidiary are prepared for the same reporting year as the Bank, using consistent accounting policies.

All intra- group balances, transactions, income and expenses and profit and losses resulting from intra-group transactions are eliminated in full.

31 December 2008

**2 SIGNIFICANT ACCOUNTING POLICIES (continued)****c. Basis of consolidation (continued)**

Subsidiary is fully consolidated from the date of formation or acquisition, being the date on which the Group obtains control, and continue to be consolidated until the date that control ceases. Control is achieved where the Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

	<i>Ownership for 2008</i>	<i>Ownership for 2007</i>	<i>Year of incorporation</i>	<i>Country of incorporation</i>
<b><i>Held directly by the Bank</i></b>				
The Short Term Sukuk Centre B.S.C. (c)	100%	100%	2003	Bahrain

**d. Cash and cash equivalents**

Cash and cash equivalents as referred to in the consolidated statement of cash flows comprise cash on hand, balances with banks, murabaha receivables maturing with an original maturity of ninety days or less and due from bank with an original maturity of ninety days or less.

**e. Murabaha receivables**

Murabaha receivables consist mainly of murabaha and international commodities stated net of deferred profits and provisions for impairment. The Group considers the promise made in the murabaha to the purchase orderer as obligatory.

**f. Mudaraba receivable**

Mudaraba is a partnership in which the bank contributes capital. These contracts are stated at the fair value of consideration given less impairment.

**g. Investments**

The investments are classified either as trading, available-for-sale or held to maturity.

*Trading investments*

These are initially recognised at cost, being the fair value of the consideration given excluding acquisition costs. These are subsequently re-measured at fair value. All related realised and unrealised gains or losses are included in the consolidated statement of income.

All investments are initially recognised at cost, being the fair value of the consideration given including acquisition costs.

*Available-for-sale investments through equity*

Subsequent to initial recognition, these investments are re-measured at fair value with unrealised gains or loss recognised directly in equity in "investment fair value reserve", until the investment is derecognised or determined to be impaired at which time the cumulative gain or loss previously recorded in equity is recognised in the consolidated statement of income.

*Available-for-sale investments through statement of income*

Subsequent to initial recognition, those investments, which are financed by equity and classified as available-for-sale through statement of income, are re-measured at fair value and the resultant gains or losses are included in the consolidated statement of income as "Fair value changes" provided that there are no investment account holders participating in such investments or to the extent of the portion related to owners' equity participating in the investments. Unrealised gains or losses are appropriated to "Investment fair value reserve" in consolidated statement of changes in equity in accordance with interpretation letter issued by AAOIFI. Upon realisation of these gains and losses, these are transferred to retained earnings.

*Held-to-maturity investments*

Investments which have fixed or determinable payments and where the Group has both the intent and ability to hold to maturity are classified as held to maturity. After initial measurement, these investments are carried at amortised cost less provision for impairment in value. Amortised cost is calculated by taking into account any premium or discount on acquisition. Any gain or loss on such investment is recognised in the consolidated statement of income, when the investment is de-recognised or impaired.

31 December 2008

**2 SIGNIFICANT ACCOUNTING POLICIES (continued)**

**h. Equipment**

Equipment is initially recognised at cost. Depreciation is provided on the straight line method on all equipments over their estimated useful life. The estimated useful lives of the equipment for the calculation of depreciation is 3-5 years.

**i. Fair value**

Fair value is determined for each investment individually in accordance with the valuation policies set out below:

- (i) For investments that are traded in organised financial markets, fair value is determined by reference to the quoted market bid prices prevailing on the balance sheet date.
- (ii) For unquoted investments, fair value is determined by reference to recent significant buy or sell transactions with third parties that are either completed or are in progress. Where no recent significant transactions have been completed or are in progress, fair value is determined by reference to the current market value of similar investments. For others, the fair value is based on the net present value of estimated future cash flows, or other relevant valuation methods.
- (iii) For investments that have fixed or determinable cash flows, fair value is based on the net present value of estimated future cash flows determined by the Bank using current profit rates for investments with similar terms and risk characteristics.
- (iv) Investments which cannot be remeasured to fair value using any of the above techniques are carried at cost, less provision for any impairment.

**j. Offsetting**

Financial assets and financial liabilities are offset and the net amount reported in the consolidated balance sheet if, and only if, there is a currently enforceable legal right to offset the recognised amounts and there is an intention to settle on a net basis, or to realise the assets and settle the liabilities simultaneously.

**k. Derecognition of financial instruments**

*Financial assets*

A financial asset (or, where applicable a part of a financial asset or part of a group of similar financial assets) is derecognised when:

- (i) the right to receive cash flows from the asset have expired;
- (ii) the Group retains the right to receive cash flows from the asset, but has assumed an obligation to pay them in full without material delay to a third party under a 'pass through' arrangement; or
- (ii) the Group has transferred its rights to receive cash flows from the asset and either (a) has transferred substantially all the risks and rewards of the asset, or (b) has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

*Financial liabilities*

A financial liability is derecognised when the obligation under the liability is discharged or cancelled or expires.

**l. Provisions**

Provisions are recognised when there is a present obligation (legal or constructive) arising from a past event and the costs to settle the obligation are both probable and able to be reliably measured.

**m. Revenue recognition**

*Income from investments (sukuk)*

Income from investments (sukuk) is recognised on a time-apportioned basis over the period of investment. Income that is 90 days or more overdue is suspended until it is received in cash.

31 December 2008

**2 SIGNIFICANT ACCOUNTING POLICIES (continued)**

**m. Revenue recognition (continued)**

*Income from Murabaha receivables*

Profit from Murabaha receivables is recognised when the income is both contractually determinable and quantifiable at the commencement of the transaction. Such income is recognised on time-apportioned basis over the period of the transaction. Where the income from a contract is not contractually determinable or quantifiable, it is recognised when the realisation is reasonably certain or when actually realised. Income related to accounts that are 90 days overdue is suspended until it is received in cash.

*Income from Mudaraba*

Income on mudaraba financing is recognised when the right to receive payment is established or on distribution by the mudarib. Income related to accounts that are 90 days overdue is suspended until it is received in cash.

*Investment Banking Fees*

These comprise fee for structuring, arranging and underwriting deals. Structuring and arranging fee income is recognised by reference to percentage of completion method, measured by reference to the percentage of cost incurred to date to estimated total cost. Underwriting and other fees are recognised when earned.

*Return to Short Term Sukuk - investors*

Return to Short Term Sukuk - investors is recognised in accordance with the underlying contracts.

*Dividend*

Dividend is recognised when the Group's right to receive the payment is established.

**n. Foreign currencies**

Transactions in foreign currencies are recorded at the rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated into US Dollars at the rate of exchange ruling at the balance sheet date. All differences are taken to the consolidated statement of income.

Translation gains or losses on non-monetary items are included in equity as "foreign exchange translations reserve".

**o. Impairment of financial assets**

An assessment is made at each balance sheet date to determine whether there is objective evidence that a specific financial asset may be impaired. If such evidence exists, any impairment loss is recognised in the consolidated income statement. Impairment is determined as follows:

- (i) For assets carried at fair value, impairment is the difference between cost and fair value, less any impairment loss previously recognised in the income statement.
- (ii) For assets carried at cost, impairment is the difference between carrying value and the present value of future cash flows discounted at the current market rate of return for a similar financial asset.
- (iii) For assets carried at amortised cost, impairment is the difference between carrying amount and the present value of future cash flows discounted at the original effective interest rate.

**p. Significant accounting judgments, estimates and assumptions**

In the process of applying the Group's accounting policies, management has used its judgements and made estimates in determining the amounts recognised in the consolidated financial statements. The most significant use of judgements and estimates are as follows:

*Classification of investments*

Management decides on acquisition of an investment whether it should be classified as held to maturity, available-for-sale investments or trading investments.

31 December 2008

**2 SIGNIFICANT ACCOUNTING POLICIES (continued)**

**p. Significant accounting judgments, estimates and assumptions (continued)**

*Fair valuation of investments*

The determination of fair values of unquoted investments requires management to make estimates and assumptions that may affect the reported amount of assets at the date of consolidated financial statements.

*Impairment of available-for-sale investments*

The Group treats available-for-sale equity investments as impaired when there has been a significant or prolonged decline in the fair value below its cost or where other objective evidence of impairment exists. The determination of what is "significant" or "prolonged" requires considerable judgment.

*Collective impairment provision*

Impairment is assessed collectively for losses on investments that are not individually significant and for individually significant investments where there is not yet objective evidence of individual impairment. Collective impairment is evaluated on each reporting date with each portfolio receiving a separate review.

The collective assessment takes account of impairment that is likely to be present in the portfolio even though there is not yet objective evidence of the impairment in an individual assessment. Impairment losses are estimated by taking into consideration of the following information: historical losses on the portfolio, current economic conditions, the approximate delay between the time a loss is likely to have been incurred and the time it will be identified as requiring an individually assessed impairment allowance, and expected receipts and recoveries once impaired. Management is responsible for deciding the length of this period which can extend for as long as one year. The impairment allowances is then reviewed by credit management to ensure alignment with the Bank's overall policy.

**q. Zakah**

In accordance with its Articles of Association, the Group is not required to pay Zakah on behalf of its shareholders.

**r. Fiduciary assets**

Assets held in a fiduciary capacity are not treated as assets of the Group.

**s. Employees' end of service benefits**

Provision is made for leaving indemnity payable under the Bahraini Labour Law applicable to non-Bahraini employees' accumulated period of service at the balance sheet date. In addition, provision for indemnity is also made for Bahraini employees in accordance with the above guidelines.

Bahraini employees of the Bank are covered by contributions made to the General Organisation of Social Insurance Scheme (GOSI) as a percentage of the employees' salaries. The Bank's obligations are limited to these contributions, which are expensed when due.

**t. Shari'a Supervisory Board**

The Group's Shari'ah Supervisory Board consists of four members appointed by the general assembly. They review the Group's compliance with general Shari'ah principles and specific fatwas, rulings and guidelines issued. Their review includes examination of evidence relating to the documentation and procedures adopted by the Group to ensure that its activities are conducted in accordance with Islamic Shari'ah principles.

**u. Earnings prohibited by Shari'a**

The Group is committed to avoid recognising any income generated from non-Islamic source. Accordingly, all non-Islamic income is credited to a charity account where the Group uses these funds for various social welfare activities.

**v. Dividend**

Dividend to shareholders is recognised as liability when it is approved by the shareholders.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

31 December 2008

**3 MURABAHA RECEIVABLES**

	<b>2008</b> <b>US\$ 000</b>	2007 US\$ 000
International commodities Murabaha	<b>13,810</b>	13,199
Deferred profits	<b>3</b>	2
	<b>13,807</b>	13,197

The Bank considers the promise made by the purchase orderer in the Murabaha contract as obligatory. The effective profit return as of 31 December 2008 ranged between 1% to 6% per annum (2007: 4.35% to 6% per annum).

**4 INVESTMENTS**

	<b>Gross</b> <b>2008</b> <b>US\$ 000</b>	<b>Impairment</b> <b>provision</b> <b>2008</b> <b>US\$ 000</b>	<b>Total</b> <b>2008</b> <b>US\$ 000</b>
Investments held-to-maturity	<b>200,519</b>	<b>700</b>	<b>199,819</b>
Available-for-sale investments through statement of income	<b>12,275</b>	-	<b>12,275</b>
Available-for-sale investments through equity	<b>35,578</b>	<b>5,167</b>	<b>30,411</b>
Trading investments	<b>93</b>	-	<b>93</b>
<b>Total</b>	<b>248,465</b>	<b>5,867</b>	<b>242,598</b>

  

	<b>Gross</b> <b>2007</b> <b>US\$ 000</b>	<b>Impairment</b> <b>provision</b> <b>2007</b> <b>US\$ 000</b>	<b>Total</b> <b>2007</b> <b>US\$ 000</b>
Investments held-to-maturity	226,026	-	226,026
Available-for-sale investments through statement of income	5,200	-	5,200
Available-for-sale investments through equity	39,249	-	39,249
Trading investments	569	-	569
<b>Total</b>	<b>271,044</b>	<b>-</b>	<b>271,044</b>

Available-for-sale investments through equity include an amount of US\$ 11.6 million (2007: nil) which are considered to be impaired and impairment charge has been taken in accordance with AAOIFI. In total an amount of US\$ 10.3 million of investments in funds held as Available-for-sale-through-equity have not been revalued as their fair value could not be reliably estimated.

Investments include an amount of US\$ 213.5 million (2007: US\$ 256.3 million) representing the underlying assets of the secured Short Term Sukuk Program (STS Program) of The Short Term Sukuk Centre B.S.C. (c) managed by the Bank. The maturities of these investments range from 1 to 8 years and the effective profit rate on these investments ranged between 2.3% to 9.5% per annum (2007: 3.75% to 9.5% per annum).

31 December 2008

**5 OTHER ASSETS**

	<b>2008</b>	<b>2007</b>
	<b>US\$ 000</b>	<b>US\$ 000</b>
Accrued profit	<b>2,394</b>	5,336
Fee income receivable	<b>456</b>	4,610
Prepaid expenses	<b>44</b>	90
Others	<b>974</b>	617
	<b>3,868</b>	10,653

**6 DUE TO SHORT TERM SUKUK - INVESTORS**

Due to Sukukholders represent STS program Sukuk owned by the investors in the secured Short Term Sukuk Program (STS Program) of The Short Term Sukuk Centre B.S.C. (c) managed by the Bank. The investors are the legal owners of the underlying investments of US\$ 213.5 million (2007: 256.3 million) of the STS program as disclosed in note 4. Returns paid to the Sukukholders during the year ranged between 1% to 6% per annum (2007: 4.7% to 6.25% per annum).

**7 OTHER LIABILITIES**

	<b>2008</b>	<b>2007</b>
	<b>US\$ 000</b>	<b>US\$ 000</b>
Staff related payables	<b>1,466</b>	1,579
Others	<b>666</b>	1,086
	<b>2,132</b>	2,665

**8 EQUITY****(i) Share capital**

	<b>2008</b>	<b>2007</b>
	<b>US\$ 000</b>	<b>US\$ 000</b>
Authorised:		
200,000,000 ordinary shares of US\$ 1 each	<b>200,000</b>	200,000
Issued, subscribed and fully paid:		
51,000,000 ordinary shares of US\$ 1 each	<b>51,000</b>	51,000

**(ii) Statutory reserve**

In accordance with the requirements of the Bahrain Commercial Companies Law, 10% of the net profit is transferred to a statutory reserve. The Bank may resolve to discontinue such annual transfers when the reserve total 50% of the paid up share capital. The reserve is not distributable but can be utilised for the purpose of a distribution in such circumstances as stipulated in the Bahrain Commercial Companies Law and with the prior approval of the CBB.

**(iii) General reserve**

In accordance with the Bank's articles of association, the Group may transfer any amount, as approved by the directors, out of net income for the year to the general reserve after appropriating statutory reserve. The general reserve is distributable, subject to the approval of CBB.

**(iv) Investment fair value reserve**

Investment fair value reserve represents unrealised gains and losses resulting from re-measurement of available-for-sale investments. This reserve is distributable upon value realisation, which takes place at the time of actual exit or derecognition of investments.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

31 December 2008

**9 INVESTMENT BANKING FEES**

	<i>2008</i> <i>US\$ 000</i>	<i>2007</i> <i>US\$ 000</i>
Sukuk and islamic financing fees and commissions income	896	9,009
Underwriting	25	687
	<u>921</u>	<u>9,696</u>

**10 FAIR VALUE CHANGES**

	<i>2008</i> <i>US\$ 000</i>	<i>2007</i> <i>US\$ 000</i>
Gain on available-for-sale investments through statement of income	6,213	-
Loss on trading investments	(322)	-
	<u>5,891</u>	<u>-</u>

**11 GENERAL AND ADMINISTRATIVE EXPENSES**

	<i>2008</i> <i>US\$ 000</i>	<i>2007</i> <i>US\$ 000</i>
Directors' remuneration and related expenses(11.1)	20	765
Legal and professional fees	208	352
Advertising and marketing	37	57
Others	916	605
	<u>1,181</u>	<u>1,779</u>

**11.1 DIRECTORS' REMUNERATION AND RELATED EXPENSES**

	<i>2008</i> <i>US\$ 000</i>	<i>2007</i> <i>US\$ 000</i>
Board of Directors' remuneration accruals	-	400
Board of Directors' remuneration - 2006	-	313
Board of Directors' meeting related expenses	20	52
	<u>20</u>	<u>765</u>

**12 SPECIFIC IMPAIRMENT PROVISION**

	<i>2008</i> <i>US\$ 000</i>	<i>2007</i> <i>US\$ 000</i>
Available-for-sale investments through equity	5,167	-
Impairment provision on receivables	460	-
	<u>5,627</u>	<u>-</u>

31 December 2008

**13 RELATED PARTY TRANSACTIONS**

Related parties comprise shareholders, directors of the Group, close members of their families, entities owned or controlled by them and companies affiliated by virtue of common ownership or directors with that of the Group. All the financing transactions with related parties are performing and no provisions is required.

The balances of major transactions with related parties as follows:

	<b>Shareholders</b> <b>2008</b> <b>US\$ 000</b>	<i>Shareholders</i> <i>2007</i> <i>US\$ 000</i>	<i>Board of</i> <i>directors</i> <i>2007</i> <i>US\$ 000</i>
Cash and balances with banks	1,137	405	-
Murabaha receivables	13,807	13,197	-
Other assets	20	-	-
Due to Short Term Sukuk - investors	108,006	73,449	-
Due to banks	16,794	1,988	-
Other liabilities	-	-	400

The income and expenses arising from dealing with related parties included in the consolidated statement of income are as follows:

	<b>Shareholders</b> <b>2008</b> <b>US\$ 000</b>	<i>Shareholders</i> <i>2007</i> <i>US\$ 000</i>	<i>Board of</i> <i>directors</i> <i>2007</i> <i>US\$ 000</i>
Income from Murabaha and			
Due from bank	452	450	-
Return to Short Term Sukuk - investors	3,181	3,609	-
Return to banks	231	129	-
Gain on sale of investment properties	-	243	-
Foreign exchange gain	561	-	-
General and administrative expenses	238	-	713

Key management personnel are those who possess significant decision making and direction setting responsibilities and includes personnel above manager level. Compensation of these key management personnel, consisting solely of short-term benefits, is as follows:

Short term employee benefits	<b>1,595</b>	<b>1,089</b>
------------------------------	--------------	--------------

31 December 2008

**14 MATURITY ANALYSIS OF ASSETS, LIABILITIES AND EQUITY**

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

<b>31 December 2008</b>	<i>Up to 1 month US\$ 000</i>	<i>1 to 3 months US\$ 000</i>	<i>3 to 6 months US\$ 000</i>	<i>6 months to 1 year US\$ 000</i>	<i>1 to 3 years US\$ 000</i>	<i>Over 3 years US\$ 000</i>	<i>No fixed maturity US\$ 000</i>	<i>Total US\$ 000</i>
<b>ASSETS</b>								
Cash and balances with banks	1,149	-	-	-	-	-	-	1,149
Murabaha receivables	13,807	-	-	-	-	-	-	13,807
Due from bank	15,000	-	-	-	-	-	-	15,000
Investments	-	981	-	12,778	111,402	115,694	1,743	242,598
Other assets	621	1,137	655	-	-	-	1,455	3,868
Equipment	-	-	-	-	-	-	369	369
<b>Total assets</b>	<b>30,577</b>	<b>2,118</b>	<b>655</b>	<b>12,778</b>	<b>111,402</b>	<b>115,694</b>	<b>3,567</b>	<b>276,791</b>
<b>LIABILITIES AND EQUITY</b>								
Due to Short Term Sukuk - investors	154,744	7,004	-	-	-	-	-	161,748
Due to banks	31,340	11,608	49	-	-	-	-	42,997
Due to non bank	-	13,604	-	-	-	-	-	13,604
Other liabilities	657	553	-	-	-	-	922	2,132
Equity	-	-	-	-	-	-	56,310	56,310
<b>Total liabilities and equity</b>	<b>186,741</b>	<b>32,769</b>	<b>49</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>57,232</b>	<b>276,791</b>
<b>Liquidity gap</b>	<b>(156,164)</b>	<b>(30,651)</b>	<b>606</b>	<b>12,778</b>	<b>111,402</b>	<b>115,694</b>	<b>(53,665)</b>	
<b>Cumulative liquidity gap</b>	<b>(156,164)</b>	<b>(186,815)</b>	<b>(186,209)</b>	<b>(173,431)</b>	<b>(62,029)</b>	<b>53,665</b>	<b>-</b>	

31 December 2008

**14 MATURITY ANALYSIS OF ASSETS, LIABILITIES AND EQUITY (continued)**

31 December 2007	<i>Up to 1 month US\$ 000's</i>	<i>1 to 3 months US\$ 000's</i>	<i>3 to 6 months US\$ 000's</i>	<i>6 months to 1 year US\$ 000's</i>	<i>1 to 3 years US\$ 000's</i>	<i>Over 3 years US\$ 000's</i>	<i>No fixed maturity US\$ 000's</i>	<i>Total US\$ 000's</i>
<b>ASSETS</b>								
Cash and balances with banks	413	-	-	-	-	-	-	413
Murabaha receivables	13,197	-	-	-	-	-	-	13,197
Investments	12,004	1,653	6,180	2,287	95,244	153,106	570	271,044
Other assets	2,356	5,521	1,928	580	65	-	203	10,653
Equipment	-	-	-	-	-	-	261	261
<b>Total assets</b>	<b>27,970</b>	<b>7,174</b>	<b>8,108</b>	<b>2,867</b>	<b>95,309</b>	<b>153,106</b>	<b>1,034</b>	<b>295,568</b>
<b>LIABILITIES AND EQUITY</b>								
Due to Short Term Sukuk - investors	188,758	4,511	-	15,312	-	-	-	208,581
Due to banks	-	-	1,988	-	-	-	-	1,988
Due to non bank	-	-	-	17,000	-	-	-	17,000
Other liabilities	1,407	-	-	771	-	-	487	2,665
Equity	-	-	-	-	-	-	65,334	65,334
<b>Total liabilities and equity</b>	<b>190,165</b>	<b>4,511</b>	<b>1,988</b>	<b>33,083</b>	<b>-</b>	<b>-</b>	<b>65,821</b>	<b>295,568</b>
Liquidity gap	(162,195)	2,663	6,120	(30,216)	95,309	153,106	(64,787)	
Cumulative liquidity gap	(162,195)	(159,532)	(153,412)	(183,628)	(88,319)	64,787	-	

31 December 2008

## 15 RISK MANAGEMENT

### Introduction

Risk is inherent in the Group's activities but it is managed through a process of ongoing identification, measurement and monitoring, subject to risk limits and other controls. This process of risk management is critical to the Group's continuing profitability and each individual within the Group is accountable for the risk exposures relating to his or her responsibilities. The Group is exposed to credit risk, liquidity risk and market risk, the latter being divided into trading and non-trading risks. It is also subject to operating risks.

The independent risk control process does not include business risks such as changes in the environment, technology and industry. They are monitored through the Group's strategic planning process.

### Risk management structure

The Board of Directors is ultimately responsible for identifying and controlling risks; however, there are separate independent bodies responsible for managing and monitoring risks.

### Board of Directors

The Board of Directors' is responsible for the overall risk management approach and for approving the risk strategies and principles.

The Board has delegated the oversight responsibilities of risk management to the Risk Management Committee and senior management (comprising the Chief Executive Officer, Deputy Chief Executive Officer and Senior Managers). They are responsible to carry out the policies laid down by the Board by ensuring that there are adequate and effective operational procedures, internal controls and systems for measuring, monitoring and controlling risks.

### Risk Management Committee

In line with the Bank's expansion and growth plans, the Board established a Risk Management Committee (RMC) to further strengthen the Group's risk management process. The RMC has the overall responsibility for the development of the risk strategy and implementing principles, frameworks, policies and limits. It is responsible for the fundamental risk issues, managing and monitoring relevant risk decisions. All the members of this Committee are from the Board. The RMC meets quarterly with the objective of assisting the Board in carrying out its responsibilities in relation to managing the Group's range of inter-related risks in an integrated manner. The Committee is supported by the Group's risk management function which assists with the establishment of policies on credit, liquidity, market and operational risk, reviews compliance with and set risk limits approved by the Board and identifies emerging risk issues. The RMC is responsible to provide oversight and management of all risks in the Group and to ensure that there is an ongoing process to continuously manage the Group's risks proactively.

The following are management committees that support the risk management of the Group.

### Risk Management Unit

The Risk Management Unit (RMU) is responsible for implementing and maintaining risk related procedures to ensure an independent control process. The RMU is a management committee set up to centralise the management of risks and to assist senior management and the risk committees in the controlling, monitoring and reporting of risks.

31 December 2008

**15 RISK MANAGEMENT (continued)**

**Risk management structure (continued)**

*Asset/liability management committee*

The Asset/Liability Management Committee is responsible for the Group's asset and liability management, pricing and funding strategies, management of market and liquidity risks, as well as ensuring that investments are made in accordance with the policies approved by the Board of Directors.

*Credit risk committee*

The Credit Risk Committee is responsible for the management of credit risk. Overseeing the management of operational risk is the Internal Audit Department which regularly reports to the Audit Committee to provide independent assurance that risks have been identified and there are sufficient and effective controls on all aspects of the Group's operations.

**Internal Audit**

Risk management processes throughout the Group are audited annually by the internal audit function that examines both the adequacy of the procedures and the Group's compliance with the procedures. Internal Audit discusses the results of all assessments with management, and reports its findings and recommendations to the Audit Committee.

**Risk measurement and reporting systems**

Monitoring and controlling risks is primarily performed based on limits established by the Group. These limits reflect the business strategy and market environment of the Group as well as the level of risk that the Group is willing to accept, with additional emphasis on selected industries. In addition, the Group monitors and measures the overall risk bearing capacity in relation to the aggregate risk exposure across all risk types and activities.

**Credit Risk**

Credit risk is the risk that any counterparty, to a financial instrument, will fail to fulfill an obligation and cause the other party to incur a financial loss. The Group attempts to control credit risk by monitoring credit exposures, limiting transactions with specific counterparties, and assessing the creditworthiness of counterparties. In addition to monitoring credit limits, the Group manages the credit exposure by entering into collateral arrangements with counterparties in appropriate circumstances, and limiting the duration of exposure. According to the terms of the STS program, the Sukukholders bear the credit risk arising from investments on account of default. However, the Bank bears the risk of a rating downgrade of its holding in sukuk assets.

The Group has established a credit quality review process to provide early identification of possible changes in the creditworthiness of counterparties, including regular collateral reviews. Counterparty limits are established by the use of a credit risk classification system, which assigns each counterparty a perceived risk rating. Risk ratings are subject to regular revision. The credit quality review process allows the Group to assess the potential loss as a result of the risks to which it is exposed and take corrective action.

31 December 2008

**15 RISK MANAGEMENT (continued)****Credit Risk (continued)****Maximum exposure to credit risk without taking account of any collateral and other credit enhancements**

The table below shows the maximum exposure to credit risk for the components of the balance sheet. The maximum exposure is shown gross, before the effect of migration through the use of master netting and collateral agreements.

	<b>Gross maximum exposure 2008 US\$ '000</b>	<b>Gross maximum exposure 2007 US\$ '000</b>
Cash and balances with banks	1,149	413
Murabaha receivables	13,807	13,197
Due from bank	15,000	-
Investments	220,990	256,299
Other assets	3,744	10,523
Total	<b>254,690</b>	<b>280,432</b>

Concentrations of credit risk arise when a number of counterparties are engaged in similar business activities, or activities in the same geographic region, or have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions. Concentrations of credit risk indicate the relative sensitivity of the Group's performance to developments affecting a particular industry or geographic location.

The concentrations of assets and liabilities analyzed by geographic regions and industry sectors are as below:

	<b>2008</b>		<b>2007</b>	
	<b>Assets US\$ '000</b>	<b>Liabilities US\$ '000</b>	<b>Assets US\$ '000</b>	<b>Liabilities US\$ '000</b>
<b>Geographic region:</b>				
Bahrain	83,265	115,176	91,111	122,979
GCC countries	152,041	93,154	172,403	105,304
Others	16,644	10,038	16,918	-
	<b>251,950</b>	<b>218,368</b>	280,432	228,283
<b>Industry sector:</b>				
Banks and financial institutions	57,511	201,378	50,320	207,177
Government	4,913	-	6,240	-
Real estate	144,777	3,351	155,814	3,358
Construction and building materials	26,557	-	26,926	-
Others	18,192	13,639	41,132	17,748
	<b>251,950</b>	<b>218,368</b>	280,432	228,283

Exposures to banks and non banks which exceed 15% of the Group's consolidated capital base amount to US\$ 183 million as at 31 December 2008 (2007: US\$ 223 million). CBB approval has been obtained on these exposures.

31 December 2008

**15 RISK MANAGEMENT (continued)****Credit Risk (continued)**

The Group's risk are well mitigated due to the nature of its financial assets which are asset backed and/or asset based. It is the Group's policy to maintain consistent perceived risk ratings across the investment portfolio. This facilitates management focus on the applicable risks and the comparison of investment exposures across all lines of business, geographic regions and products. The rating system is supported by a variety of financial analytics, combined with processed market information to provide the main inputs for the measurement of counterparty risk. All internal risk ratings are tailored to the various categories and are derived in accordance with the Group's rating policy. The attributable risk ratings are assessed and updated regularly. The Group's holdings are perceived to be rated investment grade or better.

These risk ratings used by the Group are defined as follows:

High investment grade: These borrowers are internally rated between AAA and A-. These are of high credit quality and considered as low risk.

Investment grade: These borrowers are rated internally between BBB+ and BBB-. These are of good credit quality and considered higher risk than the high grade borrowers.

Unrated: These borrowers are not rated internally. They are higher risk than investment grade but full repayments are expected.

Past due or individually impaired: These borrowers are expected to be total loss.

The table below shows the credit quality by class of financial asset, based on the Group's credit rating system.

	<i>Neither past due nor impaired</i>			
	<i>High</i>			
	<i>Investment</i>	<i>Investment</i>	<i>Unrated</i>	<i>Total</i>
	<i>grade</i>	<i>grade</i>		
	<i>2008</i>	<i>2008</i>	<i>2008</i>	<i>2008</i>
	<i>US\$ '000</i>	<i>US\$ '000</i>	<i>US\$ '000</i>	<i>US\$ '000</i>
Investments	<b>128,147</b>	<b>65,561</b>	<b>12,998</b>	<b>206,706</b>
	<b>128,147</b>	<b>65,561</b>	<b>12,998</b>	<b>206,706</b>

	<i>Neither past due nor impaired</i>			
	<i>High</i>			
	<i>Investment</i>	<i>Investment</i>	<i>Unrated</i>	<i>Total</i>
	<i>grade</i>	<i>grade</i>		
	<i>2007</i>	<i>2007</i>	<i>2007</i>	<i>2007</i>
	<i>US\$ '000</i>	<i>US\$ '000</i>	<i>US\$ '000</i>	<i>US\$ '000</i>
Investments	138,886	99,716	17,697	256,299
	138,886	99,716	17,697	256,299

The Bank does not maintain any credit rating for its Murabaha receivables as the borrowers are highly reputable financial institutions in the region, and the facilities are short-term in nature.

The above ratings are predominantly in consistent with ratings of external agencies.

31 December 2008

**15 RISK MANAGEMENT (continued)****Credit Risk (continued)****Past due but not impaired financial assets**

The following is aging analysis of past due but not impaired assets per class of financial assets:

	<i>Less than 30 days US\$ 000</i>	<i>31 to 60 days US\$ 000</i>	<i>61 to 90 days US\$ 000</i>	<i>More than 91 days US\$ 000</i>	<i>Total US\$ 000</i>
<b>31 December 2008</b>					
Held to maturity	1,650	-	-	-	1,650
Other assets	313	73	-	-	386
<b>Total</b>	<b>1,963</b>	<b>73</b>	<b>-</b>	<b>-</b>	<b>2,036</b>
<b>31 December 2007</b>					
Held to maturity	-	-	-	-	-
Other assets	-	-	-	-	-
<b>Total</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>

**Financial assets whose terms have been renegotiated**

There were no financial assets whose terms were renegotiated during the year (2007: nil).

**Collateral and other credit enhancements**

The amount and type of collateral depends on an assessment of the credit risk of the counterparty. The types of collateral mainly include charges over real estate properties.

Management monitors the market value of collateral during its review of the adequacy of the allowance for impairment losses.

Liquidity risk is the risk that an institution will be unable to meet its net funding requirements. Liquidity risk can be caused by market disruptions or credit downgrades which may cause certain sources of funding to cease immediately. For STS Program the Bank manages liquidity risk by entering into liquidity support agreements with the shareholders.

The table below summarises the maturity profile of the Group's financial liabilities based on contractual undiscounted repayment obligations.

	<i>On demand US\$ 000</i>	<i>Less than 3 months US\$ 000</i>	<i>3 to 12 months US\$ 000</i>	<i>1 to 5 years US\$ 000</i>	<i>Over 5 years US\$ 000</i>	<i>Total US\$ 000</i>
<b>31 December 2008</b>						
Due to Short Term						
Sukuk - investors	-	162,047	-	-	-	162,047
Due to banks	-	41,601	1,507	-	-	43,108
Due to non bank	-	13,691	-	-	-	13,691
Investment related commitment	1,080	-	-	-	-	1,080
Ijara commitment	-	-	1,892	31,565	6,313	39,770
<b>Total undiscounted financial liabilities</b>	<b>1,080</b>	<b>217,339</b>	<b>3,399</b>	<b>31,565</b>	<b>6,313</b>	<b>259,696</b>

31 December 2008

**15 RISK MANAGEMENT (continued)****Credit Risk (continued)**

The net funding requirement with respect to cumulative liquidity gap is managed through liquidity lines, amounting to US\$ 115 million as at 31 December 2008, provided by the shareholders (US\$7 million is unutilised). Additionally, the shareholders have committed to provide financial support to the Group for a minimum period of twelve months from 31 December 2008.

	<i>On demand</i> US\$ 000	<i>Less than 3</i> <i>months</i> US\$ 000	<i>3 to 12</i> <i>months</i> US\$ 000	<i>1 to 5 years</i> US\$ 000	<i>Over</i> <i>5 years</i> US\$ 000	<i>Total</i> US\$ 000's
<i>31 December 2007</i>						
Due to Short Term						
Sukuk - investors	-	193,677	15,865	-	-	209,542
Due to banks	-	-	2,053	-	-	2,053
Due to non bank	-	-	18,020	-	-	18,020
Investment related commitment	1,686	-	15,000	-	-	16,686
Total undiscounted financial liabilities	<u>1,686</u>	<u>193,677</u>	<u>50,938</u>	<u>-</u>	<u>-</u>	<u>246,301</u>

The net funding requirement with respect to cumulative liquidity gap is managed through a committed liquidity lines, amounting to US\$ 95 million, provided by the shareholders (fully utilised).

31 December 2008

**15 RISK MANAGEMENT (continued)****Market risk**

Market risk is the risk of loss arising from the adverse movement in the level of market prices or rates. The market risk components are foreign exchange risk, profit rate risk and equity risk. The Group's policy guidelines for market risk have been vetted by the Board of Directors in compliance with the rules and guidelines provided by the Central Bank of Bahrain.

The Group's principal investments activity focuses on the GCC countries, a region whose dynamics the Group comprehends well and where the Group has a better understanding of the inherent risks. Investments are made after rigorous qualitative and quantitative analysis, and where the desired risk-return objectives are met. A healthy diversification across industry sectors is maintained within the investments.

**i. Foreign exchange risk**

This risk refers to the adverse exchange rate movements on foreign currency positions taken by the Group. Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. The Group considers United States Dollar as its functional currency. At the balance sheet date, the Group does not have any material assets / liabilities in foreign currencies.

**ii. Profit rate risk**

Profit rate risk refers to the potential impact on the Group's net income or net income margin of equity caused by unexpected changes in rate of returns. Profit rate risk is mitigated by adopting the floating-profit rate approach through close monitoring of the secondary market trading of bonds and prevailing market expectations on profit rates and yields. The Group's policy is to measure and manage its profit rate sensitivity positions to ensure that the Group's profit rates are optimised and its long-run earning power sustained. The Group reviews the volatility of its assets and liabilities portfolio using appropriate tools and techniques.

The effect on income solely due to reasonably possible immediate and sustained changes in profit return rates, affecting both floating rate assets and liabilities and fixed rate assets and liabilities are as follows:

	<i>2008</i>	<i>2007</i>
	<i>US\$ '000</i>	<i>US\$ '000</i>
<i>Change in rate</i>	<i>Effect on net profit</i>	<i>Effect on net profit</i>
1%	<b>359</b>	419

**iii. Equity risk**

Equity risk refers to the adverse movements in the price of equities on equity positions. Equity position is marked to the market prices and monitored by the Risk Management Unit and reported to the Risk Management Committee. Risks arising from dealing and investment activities are managed by the establishment of limits that include trading limits, counterparty limits, as well as product and sub-product limits, i.e. permissible acquisition of BBB rated sukuk and above.

Equity price risk arises from the change in fair values of equity investments. The Bank has investments of US\$ 1.7 million (2007: US\$ 0.57 million) whose fair values are determined through

31 December 2008

**15 RISK MANAGEMENT (continued)****Market risk (continued)**

The effect on net income/loss and equity (as a result of a change in the fair value of equity instruments held for trading at 31 December 2008 and 31 December 2007) due to a reasonably possible change in equity indices, with all other variables held constant, is as follows:

Market indices	<i>Effect on</i>		<i>Effect on</i>	
	<i>Change in equity price</i>	<i>income/loss and equity</i>	<i>Change in equity price</i>	<i>income/loss and equity</i>
	<i>%</i>	<i>US \$ '000</i>	<i>%</i>	<i>US \$ '000</i>
	<i>2008</i>	<i>2008</i>	<i>2007</i>	<i>2007</i>
Dubai International Financial Exchange	(20)	(235)	(10)	(48)
Saudi Stock Exchange (TADAWUL)	(20)	(114)	-	-
Bahrain Stock Exchange	(20)	-	(10)	(9)

The Bank also has unquoted investments amounting to US\$ 10.3 million (2007: US\$ 39.3 million). The impact of valuation changes will only be reflected when the investment is sold or deemed to be impaired, or when a third party transaction in the investment gives a reliable indication of fair value which will be reflected in equity.

**Operational Risk**

This risk is defined as the risk of loss arising from inadequate or failed internal processes, people and systems and external events. In managing this risk, a dedicated team has been established within the Bank to undertake the identification, assessment and measurement, establishing a control framework, monitoring and reporting of operational risks.

31 December 2008

**16 SEGMENTAL INFORMATION**

The activities of the Group are performed on an integrated basis. Therefore, any segmentation of operating income, expenses, assets and liabilities is not relevant. As such, operating income, expenses, assets and liabilities are not segmented.

The Group operates solely in the Kingdom of Bahrain and, as such, no geographical segment information is presented.

**17 FAIR VALUE OF FINANCIAL INSTRUMENTS***Financial instruments*

Financial assets and financial liabilities carried on the consolidated balance sheet include cash and bank balances, murabaha receivables, due from bank, investments, other assets, due to short term sukuk - investors, due to banks, due to non banks and other liabilities.

Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable and willing parties in an arm's length transaction. Consequently, differences can arise between carrying values and fair value estimates.

Available-for-sale investments amounting to US\$ 10.3 million (2007: US\$ 39.3 million) are carried at cost due to lack of suitable methods for arriving at a reliable fair value for these investments.

**18 CAPITAL ADEQUACY**

The primary objectives of the Group's capital management are to ensure that the Group complies with externally imposed capital requirements and that the Group maintains strong credit ratings and healthy capital ratios in order to support its business and to maximise shareholders' 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 or adjust the capital structure, the Group may adjust the amount of dividend payment to shareholders, return capital to shareholders or issue capital securities. No changes were made in the objectives, policies and processes from the previous years.

The classification of the Group's capital in accordance to the regulatory requirements is as follows:

	<b>2008</b>	2007
	<b>US\$ '000</b>	US\$ '000
<b>Tier 1 Capital</b>	<b>53,070</b>	64,886
<b>Tier 2 Capital</b>	-	202
<b>Total Deductions</b>	-	-
<b>Total Eligible Capital</b>	<b>53,070</b>	65,088

To assess its capital adequacy requirements in accordance to the CBB requirements, the Group adopts the standardized approach for its Credit Risk, Basic Indicator Approach for its Operational Risk and Standardized Measurement Approach for its Market Risk.

Total Credit Risk Weighted Assets	<b>216,266</b>	229,072
Total Market Risk Weighted Assets	<b>88</b>	63
Total Operational Risk Weighted Assets	<b>18,026</b>	9,841
<b>Total Regulatory Risk Weighted Assets</b>	<b>234,380</b>	238,976
<b>Capital Adequacy Ratio</b>	<b>22.64%</b>	27.24%

31 December 2008

**19 EARNINGS AND EXPENSES PROHIBITED BY SHARI'A**

During the year there were no earnings realised by the Group from transactions which were not permitted by Shari'a.

**20 COMMITMENTS**

The Bank has the following commitments:

	<i>2008</i> <i>US\$ '000</i>	<i>2007</i> <i>US\$ '000</i>
Investment related commitment	<b>1,080</b>	16,686
Ijara commitment	<b>26,525</b>	-

The Ijara commitment represents Ijara agreement entered with certain financial institutions for the Group's Headquarters.

**21 SOCIAL RESPONSIBILITY**

The Group discharges its social responsibilities through donations to charitable causes and organisations.

**22 COMPARATIVE FIGURES**

Certain of the prior year's figures have been reclassified to conform to the presentation adopted in the current year. Such reclassifications did not affect previously reported net profit or equity.