Bank Dhofar S.A.O.G

DISCLOSURE REQUIREMENTS UNDER PILLAR – III OF BASEL II.

1. Disclosure Policy:

The following detailed qualitative and quantitative public disclosures are provided in accordance with Central Bank of Oman (CBO) rules and regulations on capital adequacy standard Basel II issued through circular BM 1009 on September 13, 2006. The purpose of these requirements is to complement the capital adequacy requirements and the Pillar II – Supervisory review process. These disclosures are intended for market participants to assess key information about the Bank's exposure to various risks and to provide a consistent and understandable disclosure framework for easy comparison among banks operating in the market. The Bank has an approved disclosure policy to comply with the disclosure requirements set out by the Central Bank of Oman, other regulatory authorities, International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS) .

The major highlights of the Central Bank of Oman (CBO) regulations on capital adequacy are:

a. To maintain capital adequacy ratio (CAR) at a minimum of 12%;
b. To adopt the standardized approach for credit risk for implementing Basel II, using national discretion for:
    - Adopting the credit rating agencies as external credit assessment institutions (ECAI) for claims on sovereigns and Banks;
    - Adopting simple/comprehensive approach for Credit Risk Mitigants (CRM)
    - Treating all corporate exposures as unrated and assign 100% risk weight.
c. To adopt standardized approach for market risk and basic indicator approach for operational risk.
d. Capital Adequacy returns must be submitted to CBO on a quarterly basis; and
e. The Bank's external auditors must review capital adequacy returns.

2. Scope of Application:

The Bank has no subsidiaries or significant investments and Basel II is applied at the Bank level only.

3. Range of Disclosures:

3.1. Capital Structure:

The capital base for complying with capital standards is quite distinct from accounting capital. The regulatory capital is broadly classified into three categories – Tier I, Tier II and Tier III. Bank Dhofar's capital structure consists of Tier I capital and Tier II capital.

Tier I capital includes paid up capital, share premium, legal and general reserves and other disclosed free reserves, including subordinated loan reserves, non cumulative perpetual preferred stocks and retained earnings (available on a long term basis).

Tier II (Supplementary capital) consists of undisclosed reserves, revaluation reserves/cumulative fair gains or losses on available for sale instruments, general loan loss provision/ general loan loss reserve in capital, hybrid debt capital instruments and subordinated term debt subject to certain conditions. Tier II capital of the Bank also includes 45% of Investment revaluation reserve and general provisions to the extent of 1.25% of total risk weighted assets.

The use of Tier III (short term subordinated debt) is limited only for part of the requirements of the explicit capital charge for market risks. The Bank does not have any Tier III capital and there are no innovative or complex capital instruments in the capital structure.

The details of capital structure are provided as under:

TIER I CAPITAL :	**RO'000** Amount
Paid up capital	81,355
Legal reserve	20,479
Share premium	58,506
Subordinated loan reserve	25,667
Retained Earnings	18,458
Proposed bonus shares	10,169
Less Goodwill	(3,971)
Cumulative unrealized losses recognized directly in equity	(144)
TOTAL TIER I CAPITAL	**210,519**
TIER II CAPITAL	
Investment revaluation Reserve (45% only)	828
General Provision (Max of 1.25% of total risk weighted assets)	18,530
Subordinated Loan	7,700
TOTAL TIER II CAPITAL	**27,058**
TOTAL ELIGIBLE CAPITAL	**237,577**

3.2 Capital Adequacy:

The Bank has adopted Standardized Approach (SA) for computation of capital charge for credit risk and market risk, and Basic Indicator Approach (BIA) for operational risk. Under Standardized approach for credit risk, the Bank has adopted simple approach for recognizing collaterals in the Banking Book and for risk weighting the claims on Sovereigns and Banks, credit ratings of Moody's, S & P, or Fitch is used. Assessment of capital adequacy is carried out in conjunction with the capital adequacy reporting to the CBO.

The Bank's capital adequacy ratio is 14.02% as against the CBO requirement of 12%. The Bank's policy is to manage and maintain its capital with the objective of maintaining strong capital ratio and high rating. The Bank maintains capital levels that are sufficient to absorb all material risks the Bank is exposed to and provides market return to the shareholders. The Bank also ensures that the capital levels comply with regulatory requirements and satisfy the external rating agencies and other stakeholders including depositors and senior creditors. The whole objective of the capital management process in the Bank is to ensure that the Bank remains adequately capitalized at all times.

The Bank has in place a capital adequacy framework by which the Bank's annual budget projections and the capital required to achieve the business objectives are linked in a cohesive way. Capital requirements are assessed for credit, market and operational risks. The Bank's capital adequacy ratio is periodically assessed and reported to the Risk Management Committee (RMC) of the Board of Directors. The Bank also conducts various stress tests and observes its impact on capital, to ensure capital adequacy. The composition of capital in terms of Tier I, II and III are also analyzed to ensure capital stability and to reduce volatility in the capital structure.

i) Position of various Risk weighted Assets is presented as under:

Sl. No	Details	Gross Balances (Book Value)	Net Balances (Book Value)*	Risk Weighted Assets
		RO'000	**RO'000**	**RO'000**
1	On balance sheet items	1,759,211	1,678,569	1,305,256
2	Off balance sheet items	246,144	218,323	218,253
3	Derivatives	6,084	6,084	1,928
4	Total Credit Risk	**2,011,439**	**1,902,976**	**1,525,437**
5	Market Risk			**42,537**
6	Operational Risk			**126,210**
7	Total Risk Weighted Assets			**1,694,184**

* Net of provisions and, reserve interest

ii) Detail of Capital Adequacy:

Sl. No	Details	RO'000
1	Tier 1 Capital	210,519
2	Tier 2 Capital	27,058
3	Tier 3 Capital	-
4	**Total Regulatory Capital**	**237,577**
5	Capital Requirement for Credit Risk	183,053
6	Capital Requirement for Market Risk	5,104
7	Capital Requirement for Operational Risk	15,145
8	**Total Required Capital**	**203,302**
9	Tier 1 Capital Ratio	12.43%
10	Total Capital Ratio	14.02%

3.3 Risk Exposure and Assessment:

The risks to which banks are exposed to and the techniques that banks use to identify, measure, monitor and control those risks are important factors market participants consider in their assessment of an institution. In this section, several key banking risks are considered: credit risk, market risk, interest rate risk in the banking book and operational risk. For each separate risk area (e.g. credit, market, operational, banking book interest rate risk) the Bank describes its risk management objectives and policies, including scope and nature of risk reporting and/or measurement systems and risk mitigation strategies.

3.3.1 Credit Risk:-

Credit risk is defined as the possibility that a borrower or counterparty will fail to meet its obligations in accordance with agreed terms. Credit risk, therefore, arises from the Bank's dealings with or lending to a corporate, individual, another bank, financial institution or a country.
The objective of credit risk management is to minimize the probable losses and maintaining credit risk exposure within acceptable parameters.

The Bank has well established credit risk policy duly approved by the Board which establishes prudent standards, practices in managing credit risk and setting up prudent bench marks, limits for management of credit risks. Continuous review of the credit policy is done to adapt to the business environment and regulatory requirements at all times.

The Board of Directors delegate credit approval powers for Wholesale Banking and Consumer Banking functional areas, which are clearly defined in Authorities Matrix contained in the Manual on Delegation of Authority. All concerned executives are responsible to ensure that they exercise their delegated powers in terms of the approved Authorities Matrix and seek appropriate special approvals wherever required.

Executive Committee of the Board is the topmost credit approving authority of the Bank which is mainly responsible for approving all credit proposals beyond the authority level of the management. This committee is also the final authority for approving investments beyond the authority of the management. The senior management executives are also empowered with certain loan approving limits beyond which the credit proposals shall be considered by the Management Credit Committee (MCC) which is empowered to consider all credit related issues up to certain limits.

Credit risk is managed by the Risk Management Division (RMD) through a system of independent risk assessment of all the corporate, Mid sector and Small and Medium Enterprise credit proposals before they are considered by the appropriate approving authorities. The borrowers in the Standard Category are assigned a risk rating on a scale of 7 grades based on quantitative as well as qualitative parameters. All accounts reflecting weakness in financials or operations as defined by CBO are assigned the grade 8 (Special Mention category) for closer monitoring. RMD approves the risk grade of the borrower and also identifies the risk factors in the credit proposal and suggests suitable mitigation. This facilitates the approving authorities in making informed credit decision. In addition RMD reviews grading of obligors, and conducts regular analysis of the credit portfolio. Every corporate account is reviewed annually and in case of accounts graded as 6,7 and 8 (Special Mentioned category accounts), reviews are conducted at higher frequency.

However, the borrowers who do not publish audited financials are treated as unrated. The Bank is in the process of developing the credit risk rating models for these types of borrowers. The rating model for Real estate borrowers has been developed and development of model for SME borrowers is under process.

The Bank also has established Credit Control department which looks after Loan Review Mechanism (LRM). LRM helps in ensuring credit compliance with the post-sanction processes/ procedures laid down by the Bank from time to time. It involves taking up independent account-specific reviews of individual credit exposures as per the Board approved LRM Policy. Credit Control department also monitors various credit concentration limits. Counterparty/group exposures are limited to 15% of the Bank's capital base as stipulated by CBO and where a higher limit is required for projects of national importance prior approval of CBO is obtained. The credit control department also undertakes a pre-sanction review and monitoring of the retail loans and personal loans.

Retail lending is strictly in accordance with the CBO guidelines. The Bank is planning to introduce a scoring mechanism as a selection tool for the retail loans during the year 2011.

In addition to these, the Bank also undertakes business with other banks. The maximum exposures to these banks are defined through internally developed model and the total exposure to such counterparty banks is restricted at 200% of the net worth of the Bank. The Bank has also implemented country limits approved by the Board to ensure portfolio diversification in terms of sovereign and geographical exposure. Specific country risk limits have been set up based on the internal risk rating grades assigned to various countries and these limits are reviewed on half yearly basis.

In the absence of acceptable external credit rating agency in the Sultanate of Oman, the Bank has obtained the approval of the CBO to treat all corporate exposures as unrated and accordingly assign risk weight of 100% for computing capital requirements under Basel II.

Past dues and impaired exposures are defined in accordance with the relevant CBO regulations. Specific and general provisions are computed periodically in accordance with the CBO regulations as well as other applicable accounting standards. General loan loss provisions equivalent to 1% of the loans categorized as Standard and Special Mention for meeting the latent loan losses are provided for. However, a general loss provision of 2% of the Standard and Special Mention personal loans is created considering the heightened risk inherent in personal loans.

All lending decisions are made after giving due consideration to credit policy requirements.

i) Analysis of gross credit exposures, plus average gross exposure over the period broken down by major types of credit exposure:

Sl. No.	Type of Credit Exposure	Average Gross exposure		Total Gross exposures	
		RO'000	RO'000	RO'000	RO'000
		As at 31.12.2010	As at 31.12.2009	**As at 31.12.2010**	As at 31.12.2009
1	Overdrafts	**103,743**	105,472	**100,308**	109,402
2	Loans	**1,087,766**	976,219	**1,140,637**	1,046,641
3	Loans against trust receipts	**71,516**	72,696	**67,577**	76,641
4	Other	**10,325**	12,390	**9,749**	10,940
5	Bills purchased /discounted	**3,841**	2,932	**5,609**	3,675
6	Advance against credit cards	**10,128**	9,456	**9,556**	10,533
7	**TOTAL**	**1,287,319**	1,179,165	**1,333,436**	1,257,832

ii) Geographic distribution of exposures, broken down in significant areas by major types of credit exposure:

Sl. No	Type of Credit Exposure	Oman	Other GCC Countries	*OECD Countries	India	Pakistan	Other	Total
		RO'000	RO'000	RO'000	RO'000	RO'000	RO'000	RO'000
		1	2	3	4	5	6	7
1	Overdrafts	84,310	-	-	-	-	-	84,310
2	Personal Loans	575,090						575,090
3	Loans against trust Receipts	67,389	188	-	-	-	-	67,577
4	Other Loans	573,002	7,119	1,424	-	-	-	581,545
5	Bills Purchased / negotiated	5,609	-	-	-	-	-	5,609
6	Any other	19,305	-	-	-	-	-	19,305
7	Total	1,324,705	7,307	1,424	-	-	-	1,333,436

Overdraft and others included Personal overdraft and others

*excluding countries included in column 2

iii) Industry or counterparty type distribution of exposures broken down by major types of credit exposures:

Sl. No.	Economic Sector	Overdraft	Loans	Bills purchased	Others	Total	Off balance sheet exposures
		RO'000	RO'000	RO'000	RO'000	RO'000	RO'000
1	Import Trade	10,079	56,035	49	18,129	84,292	23,915
2	Export Trade	69	46	-	-	115	89
3	Wholesale & Retail trade	5,452	34,442	-	10,413	50,307	7,934
4	Mining & Quarrying	1,831	25,041	-	21	26,893	1,331
5	Construction	20,567	107,952	2,149	13,934	144,602	173,972
6	Manufacturing	7,661	63,478	2,901	31,007	105,047	79,186
7	Electricity, gas & water	25	43,622	37	117	43,801	6,384
8	Transport & Comm.	1,525	31,601	-	-	33,126	316
9	Fin. Institutions	2,460	72,509	-	-	74,969	8,375
10	Services	16,216	39,428	56	2,928	58,628	31,355
11	Personal	15,998	549,653	-	9,439	575,090	12,270
12	Agriculture & Allied	4,972	3,472	-	219	8,663	1,432
13	Government	-	72,656	-	1	72,657	314
14	Non Resident lending	-	8,543	-	188	8,731	234
15	All others	13,453	32,159	417	486	46,515	2,409
16	**Total (1 to 15)**	100,308	1,140,637	5,609	86,882	1,333,436	349,516

iv) Residual contractual maturity breakdown of the whole portfolio, broken down by major types of credit exposure:

Sl. No.	Time Band	Overdrafts	Loans	Bills purchased/ Discounted	Others	Total	Off-balance sheet exp.
		RO'000	RO'000	RO'000	RO'000	RO'000	RO'000
1	Upto 1 month	5,015	96,043	5,609	51,872	158,539	106,309
2	1-3 months	5,015	78,634	-	16,514	100,163	32,463
3	3-6 months	5,015	55,518	-	15,697	76,230	38,730
4	6-9 months	5,015	38,149	-	-	43,164	23,897
5	9 – 12 months	5,015	53,038	-	700	58,753	16,055
6	1-3 years	25,077	316,594	-	-	341,671	86,683
7	3 – 5 years	25,077	201,052	-	-	226,129	35,719
8	Over 5 years	25,079	301,609		2,099	328,787	9,660
9	**TOTAL**	100,308	1,140,637	5,609	86,882	1,333,436	349,516

v) Analysis of loan book by major industry or counterparty type:

Sl. No.	Economic Sector	Gross loans	Of which NPLs *	General provision held	Specific prov. Held	Reserve Interest	Prov. Made during the year	Adv. Written off during year
		RO'000	RO'000	RO'000	RO'000	RO'000	RO'000	RO'000
1	Import Trade	84,292	12,547	717	4,325	7,848	35	-
2	Export Trade	115	43	1	25	18	7	-
3	Wholesale & Retail	50,307	11,984	383	4,929	7,129	47	-
4	Mining & Quarrying	26,893	1	269	1	-	3	-
5	Construction	144,602	10,283	1,343	2,776	1,661	673	-
6	Manufacturing	105,047	1,013	1,040	472	214	211	-
7	Electricity, gas & water	43,801	-	438	-	-	-	-
8	Transport& Communications	33,126	3	331	1	2	-	-
9	Financial Institutions	74,969	-	750	1,462	2,682	-	-
10	Services	58,628	4,168	545	-	-	98	6
11	Personal	575,090	18,848	11,484	7,960	6,394	4,682	57
12	Agriculture & Allied	8,663	-	87	-	-	-	-
13	Government	72,657	-	727	-	-	-	-
14	Non-Resident lending	8,731	4,030	47	3,850	186	-	-
15	All Others	46,515	94	368	1,201	34	28	-
16	TOTAL (1 to 15)	1,333,436	63,014	18,530	27,002	26,168	5,784	63

* Represents only on balance sheet NPLs.

vi) Geographical distribution of amount of impaired loans:

Sl. No.	Countries	Gross loans	Of which NPLs	General provisions held	Specific provisions Held	Reserve Interest	Provisions Made during the year	Advances Written off during year
		RO'000	RO'000	RO'000	RO'000	RO'000	RO'000	RO'000
1	Oman	1,324,705	58,984	18,483	23,152	25,982	6,563	63
2	Other GCC countries	7,307	4,030	33	3,850	186	-	-
3	OECD countries*	1,424	-	14	-	-	-	-
4	India	-	-	-	-	-	-	-
5	Pakistan	-	-	-	-	-	-	-
6	Others	-	-	-	-	-	-	-
7	TOTAL	1,333,436	63,014	18,530	27,002	26,168	6,563	63

*excluding countries included in row 2

vii) Movement of Gross Loans :

(OR in 000's)

Movement of Gross Loans during the year							
Sl No	**Details**	**Performing Loans**		**Non-performing Loans**			
		Standard	**S.M.**	**Substandard**	**Doubtful**	**Loss**	**Total**
		RO'000	**RO'000**	**RO'000**	**RO'000**	**RO'000**	**RO'000**
1	Opening Balance	1,177,097	20,566	17,051	5,001	38,117	1,257,832
2	Migration/changes (+/-)	(26,130)	25,419	(6,645)	(2,286)	9,642	-
3	New Loans	367,853	54,876	1,947	111	4,066	428,853
4	Recovery Loans	(289,099)	(60,160)	(2,268)	(277)	(1,217)	(353,021)
5	Loans written off	-	-	(14)	-	(214)	(228)
6	**Closing Balance**	**1,229,721**	**40,701**	**10,071**	**2,549**	**50,394**	**1,333,436**
7	Provisions held*	18,530	-	3,260	1,136	22,606	45,532
8	Reserve Interest	-	-	293	263	25,612	26,168

*Indicate the general provisions held under performing loans and specific provisions under non performing loans

3.3.2 Credit Risk: Disclosures for portfolios subject to the Standardized Approach:

i) The Bank has obtained CBO approval vide its letter dated December 11, 2006 to use the ratings of Moody's, Standard & Poor (S&P) or Fitch for risk weighting claims on sovereigns and banks. However, as mentioned earlier, the Bank has obtained CBO approval to treat all corporate exposures as unrated and assign 100% risk weight on all of them.

ii) The Bank is adopting the simplified approach for collateral recognition under the standardized approach, where 0% risk weight is assigned for the exposures covered by cash collateral. The total exposure covered by cash collateral, which attracts 0% risk weight is RO 55.29 million All other credit exposures of Corporate and Retail (except mortgage loans, where valuation of the mortgaged house property is not older than 3 years, are assigned 35% risk weight) are assigned 100% risk weight.

iii) The Bank also conducts stress tests using simulation technique on portfolio basis at regular intervals to assess the impact of credit risk on its profitability and capital adequacy. The same is placed before the Risk Management Committee of Board of Directors.

3.3.3 Credit Risk Mitigation: Disclosures for Standardized approaches:

The Bank has adopted the simple approach for credit risk mitigation and no off setting of the collaterals is done to calculate the capital requirement. However, the main CRM techniques followed by the Bank are based on collaterals which the Bank endeavors to obtain for it's exposures, as far as commercially practicable. The collaterals mainly consist of real estate properties, shares listed on the Muscat Securities Market (MSM), government bonds, unlisted shares and Bank fixed deposits. However, the Bank's predominant form of eligible collateral as defined by CBO in its guidelines and for capital adequacy computation purposes is in the form of cash, acceptable Bank guarantees and shares listed on the MSM main index.

The Bank had revised the credit risk rating framework in the year 2009 and had introduced 11 risk grades for borrowers (including the Non Performing Loans) to further strengthen credit risk management. The revised credit risk rating framework includes more objectivity and granularity in the rating grades, mapping the single point score provided by the rating model to a scale of 1 to 7 for standard category assets. The rating grade indicates the default probability of the borrower's obligation. The Bank has also developed the facility rating system based on Basel II foundation approach during the year which considers the collateral support, seniority and other structural aspects of the facilities provided. The facility rating system is proposed to be introduced in the first half year of 2011.

The Bank shall also develop required systems for estimation of Probability of Default (PD), Loss Given Default (LGD) and Exposure at Default (EAD) in order to adopt the advanced approaches under Basel II gradually. A road map to put in place risk management systems to prepare the Bank to adopt advanced approaches of Basel II has been laid down. The necessary data requirement is being identified and incorporated in the new core banking system. With the availability of the data, a suitable risk based information system shall also be developed. Bank has already started conducting training programmes on risk management practices for the staff and such trainings shall be intensified further to ensure percolation of risk culture across the Bank.

The Bank expects to refine the existing risk management systems and practices on an ongoing basis and with that experience, approach the CBO with a framework and a road map to move to Foundation Internal Rating Based approach (FIRB), for it's approval at an appropriate time.

3.3.4 Market Risk:

Market Risk is the risk to the Bank's earnings and capital due to changes in the interest rates or prices of securities, foreign exchange and equities, as well as the volatilities of those changes. The Bank for International Settlements (BIS) defines market risk as "the risk that the value of 'on' or 'off' balance sheet positions will be adversely affected by movements in equity and interest rate markets, currency exchange rates and commodity prices". Market Risk has been categorized into interest rate risk, foreign exchange risk, commodity price risk and equity price risk.

Bank has comprehensive Treasury Risk Policy and Investment Management Policy which encompasses assessment, monitoring and management of all the above market risks. Bank has defined various internal limits to monitor market risk and is computing the capital requirement as per standardized approach of Basel II.

Details of various market risks faced by the Bank are set out below:

i) Interest Rate Risk (IRR): Interest rate risk is the risk where changes in market interest rates might adversely affect a Bank's financial condition. The immediate impact (up to one year) of changes in interest rates is on the Net Interest Income (NII) and a long term impact (more than one year) of changing interest rates is on the Bank's net worth.

The responsibility of interest rate risk management rests with the Bank's Asset and Liability Management Committee (ALCO). Bank periodically computes the IRR on the Banking book that arises due to re-pricing mismatches in interest rate sensitive assets and liabilities. The impact of IRR on the earnings of the Bank is computed and placed to ALCO on monthly basis. An internal

limit of 8% for the impact on projected NII has been set and is monitored. Similarly, Bank has developed a model to assess the impact of IRR on the Equity value based on duration gap analysis method and an internal limit of 20% has been fixed for the same.

Details relating to re-pricing mismatches and the interest rate risk thereon are placed to the ALCO regularly and also to the Risk Management Committee of the Board. In addition, scenario analysis assuming a 200 basis point parallel shift in interest rates in RO, USD and other currencies and their impact on the interest income and net profit of the Bank are assessed on a quarterly basis and placed to Risk Management Committee with proposals for corrective action if necessary.

Impact on earnings and economic value of equity due to adverse movement of 100 bps and 200 bps in interest rate is provided as under:

(RO in 000's)

Position as at 31.12.2010. Impact on	+ or – 1%	+ or – 2%
Earnings	**3,780**	**7,560**
Economic Value of Equity	**18,521**	**37,043**
Impact on earning as a % of NII	**6.60%**	**13.21%**
Impact as a % of Equity capital	**7.80%**	**15.60%**

ii) Foreign Exchange Risk:

Foreign Exchange Risk maybe defined as the risk that a Bank may suffer losses as a result of adverse exchange rate movements during a period in which it has an open position, either spot or forward, or a combination of the two, in an individual foreign currency.

The responsibility of management of foreign exchange risk rests with the Treasury department. The Bank has set up internal limit of 40% of Tier I capital to monitor foreign exchange open positions. Most of the foreign exchange transactions are conducted for corporate customers and mostly are on back to back basis. Bank has also defined various limits for foreign currency borrowing and lending.

The Bank also conducts stress tests to assess the impact of foreign exchange risk on its profitability and capital adequacy and the same is placed to Risk Management Committee of Board of Directors on regular basis.

iii) Commodity Risk: Commodity Risk occurs due to volatility in the prices of the commodities. Presently the Bank has no exposure to the commodity market.

iv) Equity Position Risk: Equity Position risk occurs due to change in the market value of the Bank's portfolio as a result of diminution in the market value of the equity securities. The responsibility of management of equity position risk rests with the Investment Management Department of the Bank. The Bank does not hold trading position in equities. The Bank's portfolio is marked to market on regular basis and the difference in the book value and market value are adjusted against revaluation reserve. The Bank also conducts regular stress test on equity position risk and assesses its impact on profitability and capital adequacy.

Bank has introduced the Value at Risk method for the domestic quoted equity portfolio and the same as on 31.12.2010 works out to OMR 411K at 95% confidence level, which is 5.25 % of the portfolio of OMR 7.82Mn.

v) The Capital Charges: The capital charge for the entire market risk exposure is computed under the standardized approach using the duration method and in accordance with the guidelines issued by CBO in its circular BM 1009. The Bank adopts duration method in measuring interest rate risk in respect of debt securities held in trading book. The Bank does not hold any trading position in equities and in commodities necessitating capital charge to cover the market risk. Foreign exchange risk is computed on the average of the sum of net short positions or net long positions, whichever is higher of the foreign currency positions held by the Bank.

The capital charge for various components of market risk is presented below:

Type of risk	**RO'000 Amount**
Interest Rate Risk	**-**
Equity Position Risk	**-**
Commodities Position risk	**-**
Foreign Exchange position risk	3,403
TOTAL	**3,403**

For assessing the Market risk, the Bank shall, with the approval of CBO, graduate to more advanced measurement techniques from the present Standardized method adopted by the Bank.

3.3.5 Liquidity Risk

Liquidity risk is the potential inability to meet the Bank's liabilities as they become due. It arises when the banks are unable to generate cash to cope with a decline in deposits or increase in assets.

The Bank's Liquidity Risk Management is governed by the Treasury Risk Policy document approved by the Board of Directors as well as the provisions of relevant CBO guidelines on liquidity risk management. The Treasury risk policy also incorporates contingency plans and measures, so as to be always in a position to meet all maturing liabilities as well as to fund asset growth and business operations. The contingency funding plan includes effective monitoring of the cash flows on a day to day basis, holding of tradable high quality liquid assets, which may be readily disposed off in sizeable amount etc. The Bank also has in place adequate lines of credit from both local and international banks to meet any unforeseen liquidity requirements.

The Bank monitors its liquidity risk through cash flow approach and stock approach. Under cash flow approach the Bank generates Maturity of Assets and Liabilities (MAL) report which captures all the maturing assets and liabilities into various pre-set time buckets ranging from one month to five years. The mismatches in various time buckets indicate liquidity gap and the Bank strictly adheres to the CBO set limit of 15% of cumulative liabilities (outflows) on mismatches (liquidity gaps) in time buckets up to one year. In addition, the Bank has also set up internal limit on mismatches in time buckets beyond one year. Under stock approach, the Bank monitors the liquidity risk through liquidity ratios, which portrays the liquidity stored in the balance sheet.

Treasury department of the Bank controls and monitors the liquidity risk and ensures that the Bank is not exposed to undue liquidity risk and at the same time make optimum use of its funds. Middle office in Risk Management Division also monitors the liquidity position of the Bank and provide the liquidity gap positions to Treasury Department to manage liquidity gaps.

Middle office also undertakes regular stress test using simulation technique that provides the requirement of liquidity over a given horizon at a certain confidence level.

The Bank has reconciled the statement of Maturity of Assets and Liabilities with the discussions under IFRS (Refer item no. 35 of the Notes to financial statements).

3.3.6 Operational Risk:

Basel Committee on Banking Supervision has defined operational risk as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events." This definition includes legal risk, but excludes strategic and reputational risk. Legal risk includes, but is not limited to, exposure to fines, penalties, punitive damages resulting from supervisory actions, as well as private settlements.

Bank has a well defined Operational Risk Management (ORM) policy which inter-alia includes Operational Risk Events, Operational Risk losses and ORM process. Business and Functional units are primarily responsible for taking and managing Operational Risk on a day-to-day basis. Risk Management Division provides guidance and assistance in the identification of risk and in the ongoing operational risk management process.

Bank has set up Operational Risk Management Committee to identify, manage, measure, monitor, mitigate and report operational risks. The committee is composed of members from senior management and is headed by Chief Executive Officer of the Bank. Basel II has provided three different approaches viz., Basic Indicator approach (BIA), The standardized approach (TSA) and Advanced measurement approach to compute the capital charge of Operational Risk. The Bank has adopted the BIA for computing the capital charge for Operational Risk as per CBO guidelines. The approach requires the Bank to provide 15% of the average gross income for the last three years as capital charge for operational risk.

While the Bank has adopted BIA approach for capital adequacy calculation purposes, initiatives has also been taken to move towards adopting The Standardized Approach by mapping the business activities into eight business lines and assessing the operational risk in each of them. The requirements for the same is being incorporated in the new core banking solution.

The system of collecting and collating data on operational risk events has been improved further to build a strong loss data base and to move over to the advanced measurement system for operational risk as required by the CBO guidelines.

The Bank is also in the process of strengthening the operational risk management systems further by developing framework of operational risk tools like Risk Control and Self Assessment (RCSA) and Key Risk Indicators (KRI). KRIs for various business units shall be put in place by the end of 2011.