BASEL- III PILLAR III
QUALITATIVE DISCLOSURES

31 DECEMBER 2013

Table of contents

Contents	Page

1. GENERAL

Under the directives of Saudi Arabian Monetary Agency (SAMA), banks operating in the Kingdom of Saudi Arabia, implemented Basel Capital Adequacy framework commonly known as Basel II Accord, with effect from 1 January 2008. In this regard, SAMA's aim is to encourage market discipline through disclosures, which will provide the reader more valuable information about the banks' risks and exposures. In this context, below are the necessary disclosures required under Basel Accord's Pillar 3 framework.

2. SUBSIDIARIES & SIGNIFICANT INVESTMENTS

SAMA disclosure requirements apply to Arab National Bank (ANB), as well as to its subsidiaries. A brief description of the bank's subsidiary is as follows:

Arab National Bank Investment Company (ANBI):
A wholly owned Saudi limited liability company, registered in the Kingdom of Saudi Arabia under commercial registration No. 1010239908 issued on 26th Shawal 1428 (corresponding to 7th November 2007). The main activities are to provide investment services and asset management activities related to dealing, managing, arranging, advising and custody of securities regulated by the Capital Market Authority. The subsidiary commenced its operations effective 3rd Muharram 1429 (corresponding to 12th January 2008). Accordingly, ANB started consolidating the financial statements of ANBI, effective 12th January 2008.

Arabian Heavy Equipment Leasing Company:
A 62.5 % owned subsidiary incorporated in the Kingdom of Saudi Arabia, as a Saudi closed joint stock company, under commercial registration no. 1010267489 issued in Riyadh dated 15th Jumada 1, 1430 (10th May 2009). The company is engaged in leasing of heavy equipments and operating in compliance with Shariah principles. The Bank started consolidating the subsidiary's financial statements effective 10th May 2009, when the subsidiary started its operation. AHEL's other shareholders are Ejar cranes and Equipments LLC and Olayan Group.

Apart from this, ANB has made more than 10% equity investments in the following entities :-

Saudi Home Loan Company (SHL):
SHL is a Saudi limited liability company owned 40% by ANB and the remaining 60% is mainly owned by Dar Al Arkan Real Estate Development Company (DAAR), International Finance Corporation (IFC) and Kingdom Installment Company.

SHL was established as a specialized Islamic home finance company within the Kingdom of Saudi Arabia. Products and services are fully Shari'ah compliant. The company's authorized capital is SAR 2 billion, out of which a total amount of SAR 800 million (ANB's Share 320 million) was paid by the shareholders as of 31st December 2013.

Ejar Cranes & Equipment LLC (Ejar):
ANB has 16.67% ownership interest in the Company. Ejar is a dedicated crane leasing company, which was founded in Dubai at the end of 2006. The company is a joint venture between a number of regional companies involved in

providing plant machinery, and specifically cranes. As of 31st December 2013, ANB's paid capital in Ejar reached SAR 59.8 million. ANB has initiated the process to divest its investment in Ejar Cranes & Equip. LLC and will in turn increase its share in AHEL after Ejar has divested its stake in AHEL.

ANB-AIG Cooperative Insurance Co. (JV) :
ANB has established a Joint Venture (JV) with Chartis-AIG subsidiary - (10% share) and MetLife ALICO (30% share) to form a cooperative insurance company in Saudi Arabia, which is owned 30% by ANB and its nominees, and balance of 30% has been offered to the public. The company's Initial Public Offering (IPO)was completed during second quarter of 2013.The company is currently being licensed by SAMA and is expected to commence operations shortly. It will offer general as well as individual insurance policies.

ANB Insurance Agency
A Saudi limited liability company, established during 2013 as a wholly owned subsidiary, registered in the Kingdom of Saudi Arabia under the commercial registration no. 1010396423 issued in Riyadh dated 28 Muharram, 1435 (corresponding to December 1, 2013). The agency is licensed by the Saudi Arabian Monetary Agency under the license no. 341000077525 to perform insurance agent activities. The agency is not yet operating and will start its operation after obtaining the approvals of the concerned regulatory parties.

i) Restrictions and impediments on transfer of funds.
There are no restrictions or major impediments on transfer of funds or regulatory capital between the Bank and its fully owned subsidiary, apart from obtaining SAMA approval, when required.

3. BANK'S CAPITAL STRUCTURE

The Bank's capital comprises of:

Tier I capital which is the core measure of a bank's financial strength from a regulator's point of view. It comprises paid up capital, eligible reserves, retained earnings and adjustments due to changes in the unrealized mark-to-market (MTM) for available-for-sale (AFS) securities.

Tier II capital, comprises subordinated loan capital, qualifying general provisions. During 2006, ANB issued USD 500 million 10 year subordinated floating rate notes under its USD 850 million Euro Medium Term Note program. The notes initially carried a special commission rate of Libor plus 83 bps. The notes are non-convertible, subordinated and listed on the London stock exchange. These notes are callable on a quarterly basis starting from the 5th years from issuance. Effective October 31, 2011 and based on the step-up condition the commission rate has been adjusted to Libor plus 133 bps. During 2009, USD 50 Million was purchased from the secondary market & retired. The maturity of notes is now less than 5-years, and only 40% of the value is considered as Tier II capital.

4. BANK'S CAPITAL ADEQUACY

ANB has established Internal Capital Adequacy Assessment Committee (ICAAC) with the mandate to monitor and ensure that the Bank has adequate capital to support all the risks inherent in its current and future business plans.

ANB's capital adequacy process *inter-alia* includes identification and assessment of all types of material risks and ensures that besides having enough capital to cover these risks, adequate policies, processes and internal controls are in place to manage these risks in a timely manner. While ANB has adhered to the Pillar-I capital calculation methodologies under the Standardized Approaches, as per the guidelines issued by SAMA, it has developed its own methodologies for assessing and allocating capital for Pillar-II risks. At the same time, stress-testing scenarios are applied to arrive at the stressed capital ratios, with a view to ensure that ANB remains adequately capitalized under stressed conditions during economic down-turns.
ANB’s capital adequacy targets are set for the ratios based on Pillar-I and II risks, calculated on both Tier 1 & 2 capital. ANB intends to operate at least 4% over and above Basel’s minimum capital adequacy requirements of 8% (corresponds to 12%) or the capital adequacy ratio (CAR) target advised by SAMA, whichever is higher. However, a management action trigger is set at 0.5% over and above the minimum target CAR, wherein the Bank’s Internal Capital Adequacy Assessment Committee (ICAAC) will review the capital adequacy position and recommend corrective action, if required.

5. BANK’S RISK MANAGEMENT

ANB has an independent Risk Management Group responsible for overall enhancement of the risk culture within the Bank by encouraging open communication with other business/supporting units and developing techniques in alignment with best practices for risk management as well as in compliance with local regulatory requirements. Risk Management Group has the following five major Departments:

i. Credit Risk
ii. Market Risk
iii. Operational Risk
iv. Business Continuity Management (BCM)
v. Credit Administration & Control (CAC)

5.1 Credit Risk

Credit Risk Department manages the credit exposures arising principally from lending activities. Such lending activities may include loans, advances as well as exposures arising from off-balance sheet financing instruments such as commitments, guarantees and letters of credit.

5.1.1 Strategies and Processes

Credit Risk policies and procedures are established to provide control on credit risk portfolios through periodic assessment of the credit worthiness of obligors, quantifying maximum permissible exposure to specific obligor and continuous monitoring of individual exposures and portfolios.

The Credit Risk policy of the Bank is designed to ensure clear recognition of credit risk management strategies and objectives, which include:

- Strengthening and enhancing Bank's ability to measure and mitigate credit risks on pre-emptive basis to minimize credit losses.

- Strengthening and enhancing Bank's systems and procedures for early problem recognition.
- Strengthening and enhancing credit portfolio management process.
- Compliance with local regulatory requirement and industry's best practices for credit risk management.

The Bank's Credit Risk policy addresses all functions and activities related to the credit lending process, starting from defining the minimum required information for assessing obligor credit worthiness and ending with clear risk-based approval authority mechanism.

5.1.2 **Structure & Organization**

An independent Credit Risk Department, part of Risk Management Group, is responsible for Policy formulation and Portfolio management for all type of credit risks undertaken by the Bank. Furthermore, Credit Review Department has specialized teams for Corporate, Commercial and Retail business units, and are responsible for conducting independent financial analysis and appraisals of Credit proposals, submitted by the respective business units.

ANB has a centralized credit approval process and follows the philosophy of joint approval authority, which is directly linked to the borrower's Probability of Default (PD) and its facility characteristics measured by Loss Given Default (LGD) estimates. Based on afore-mentioned factors, there are three main layers of approval authorities. The highest credit authority is vested in the Executive committee, having five Board members, including MD, as its members. The second level of credit approval authority is vested in the Senior Credit Committee, which comprises of MD, Head of Credit Review Division and three or more senior managers of the Bank. The third layer consists of the four levels of approval authorities, which draws its members from the business units and the Credit Review Division.

5.1.3 **Risk Measurement & Reporting System**

The Bank's loan portfolio can be broadly divided into the following two categories:

A) <u>**Corporate and Commercial Loans Portfolio**</u>:

Credit Risk tracks trends and identifies weaknesses in the quality of corporate and commercial loans portfolio by employing:

- Obligor & facility risk rating system to assess the quality of obligor and riskiness of facilities.
- Periodic reviews and reporting of aggregate statistics on asset diversification and credit quality for key segments of the portfolio.

Rating system is established with the objective to:

- place the responsibility on business units to regularly evaluate credit risk on exposures and identify problems within their portfolios;

- establish early warning signals for detecting deterioration in credit quality;
- set standard for business units to submit their inputs on problematic exposures;
- provide guidelines to respond and take remedial actions as soon as deterioration in credit quality is detected.

The Bank classifies its exposures into 13 risk categories, of which 10 are for performing obligors and 3 are for non-performing obligors.

Periodic reviews & reporting standards are established to monitor Corporate and Commercial credit portfolio quality and diversification. Regular monthly and quarterly reports are sent to Senior Management/Board, covering the following:

- Total potential exposure and actual outstanding amount;
- Amount and percentage of exposure outstanding in each risk rating grade;
- Obligors' exposure migration across risk grades from one period to another;
- Overall portfolio risk grade by Region/Business units.

B) **Consumer Assets Loans Portfolio**:
The major part of Bank's consumer loans and credit card exposures are against salary assignments, and borrowers are employees of selective list of acceptable employers. The consumer loans' portfolio is driven by strict lending criteria in the form of minimum salary requirements, length of service and pre-specified Debt Service Ratio (DSR).

Periodic reviews & reporting mechanism is in place to monitor the Consumer assets loans portfolio quality and diversification, covering the following:

- Consumer Assets loans portfolio growth from one period to another.
- Consumer Assets loans portfolio distribution by employer.
- Consumer Assets loans portfolio distribution by delinquencies (days past due bucket wise).
- Amount of losses charged-off.

5.1.4 Hedging and Mitigants

Collaterals and securities are always desirable, being an effective means of reducing risk and enhancing credit quality. However, Bank's credit risk policy does not encourage granting credit exposures solely based on collaterals. Collaterals are viewed as a secondary source of repayment or way-out in the event that the customer is facing difficulty in repaying the granted credit from cash flows. The Bank's policy is that credit facilities should always be able to stand on their own (successful repayment from operational cash flows) without relying on the collateral as the primary source of repayment.

As per Bank's policy credit exposure is considered secured, if it is fully supported by tangible collateral/security and in accordance with minimum requirement in terms of coverage ratios as detailed under:

Type of tangible Collateral Security	Minimum collateral required
Cash Margin	100% of the facility limit
Bank Guarantees	100% of the facility limit
Pledged shares: Corporate/Commercial	150% of the facility limit
Pledged shares: Margin Trading customers	200% of the facility limit
Transfer of Title Deeds	200% of the facility limit

All collaterals and securities are evaluated periodically to ensure that the market value of collateral/security against credit exposures is in line with the stipulated coverage ratios. ANB has identified a selective list of companies based on strict criteria, whose shares are accepted as collateral. For Real Estate properties offered to the bank as collateral, the security must be appraised by accredited real estate offices appointed by the Bank prior to giving any acceptance/commitment to the borrower.

Bank Guarantees, held as collateral, should meet strict criteria for acceptance, which includes being unconditional & irrevocable, issued by banks, acceptable to ANB.

As a matter of policy all collaterals should be in the same currency as the underlying credit exposure. Exceptions are made on case-by-case basis with appropriate justification.

5.2 MARKET RISK

The primary objective of ANB's market risk management function is to provide a coherent policy and operating framework for a strong Bank-wide management of market risk and liquidity risk.

5.2.1 Strategies and Processes

The Board approves the market risk appetite, in terms of limits, for all types of market risks including foreign currency risk, interest rate risk and equity risk. These limits are based on notional amount, sensitivity, stop-loss and/or VaR (Value at Risk). The Board has also approved Market Risk Policy that provides guidance to identify, measure and monitor the Bank's exposure to market risk.

Liquidity management policy and limits ensure that liquidity is maintained at sufficient levels to support operations and meet payment demands even under stressed conditions that might arise with a sudden change in the market environment. The Bank has also in place a comprehensive stress testing policy and liquidity contingency funding plan.

5.2.2. Structure & Organization

Market risk and Liquidity risk are overseen by two management committees – Asset Liability Committee (ALCO) and Market Risk Policy Committee (MRPC). ALCO deals with Bank-wide market risk issues as opposed to MRPC, which deals with Treasury specific issues. ALCO meets on a regular basis to discuss the risk exposures vis-à-vis the prevailing market conditions and sets guidelines to manage these risks within the risk appetite set by the Board. MRPC acts as a sub-committee of ALCO with authority to monitor and control Treasury-related (as opposed to bank-wide) activities. MRPC has the authority to restrict utilization of the ALCO-approved limits. Market Risk Department, which is independent of the business function, monitors all limits and provides periodic market risk reports to ALCO and MRPC members.

Treasury Middle Office is an independent unit reporting to MRD and is responsible for ensuring that all Treasury related internal controls are functioning effectively and all non-adherence are brought to management's attention on a timely basis.

5.2.3. Scope and Nature of Reporting System

Daily Risk Report is provided to Senior Management that covers the trading activity and liquidity ratios. Stress testing for interest rate risk, foreign exchange risk and liquidity risk is conducted on a regular basis and results are presented to ALCO for review. Detailed market risk reviews are submitted to the Board and its committees, including Risk Committee and Audit Committee, on a quarterly or semi-annual basis. The reviews highlight major changes in the Bank's market and liquidity risk profiles as well as compositions of the investments portfolio.

5.2.4 Hedging and Mitigants

Bank has implemented a dynamic interest rate hedging policy in accordance with the International Accounting Standards. Interest rate derivatives, mainly interest rate swaps and futures are used to hedge specific exposures with an aim to keep the interest rate risks within limits. The Bank also uses currency swap to hedge specific positions in foreign currencies, when necessary. Effectiveness of all hedges is regularly monitored throughout their term.

5.3 Operational Risk Management [OR]

Operational Risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Operational risk includes legal and regulatory risk, but excludes strategic and reputational risk.

5.3.1 Objectives

Objective of Operational Risk Management is to support ANB's vision through efficient and effective operational processes. Operational risk management aims to:

- Develop common understanding of Operational Risk across the Bank in order to assess exposure of businesses to operational risk and take appropriate actions.
- Ensure that there is clear accountability, responsibility and adherence to best practices for management and mitigation of operational risk.
- Provide robust tools that help Business Units manage operational risks towards successful achievement of business objectives.
- Minimize reoccurrence of similar type of losses.

5.3.2 Governance

ANB monitors its operational risks through an Operational Risk Framework supported by its policy and procedures that define roles and responsibilities for managing and reporting operational risk.

Bank has established governance structure to support management and oversight of operational risk across business units and support functions. The governance framework includes oversight by Board's Risk Committee, Senior Management supervision through Operational Risk Committee (ORC), and independent monitoring and reporting of operational risks by Operational Risk Management (ORM) department. To ensure that highest level of governance is maintained, Internal Audit Division conducts independent assessment of the activities carried out and reports directly to Audit Committee of the Bank.

5.3.3 Measurement and Management

ANB has established Control and Risk Self-Assessment (CRSA) framework to identify operational risks arising from products, procedures & activities and evaluate the effectiveness of controls over those risks. These risks and controls are self-assessed and monitored by the business/support units on a regular basis. The consolidated assessment results are benchmarked with pre-defined risk appetite/acceptable level and appropriate actions initiated to strengthen the control environment. Historical internal loss events and internal audit issues support the completeness and accuracy of the CRSA. An independent review and challenge process also assists in ensuring completeness, accuracy and consistency across the Bank.

ANB's Loss data management system allows collection and analysis of loss events (actual, potential and near-miss), identifies new risks or control weaknesses that caused the operational loss, escalating them to appropriate levels of management and to ORC. The mechanism aims at minimizing any financial consequences of the events and addressing the root causes for refining the control mechanism to reduce re-occurrence of similar losses in future.

5.3.4 Monitoring and Reporting

The goal of operational risk monitoring and reporting is mainly to initiate corrective actions as early as possible to strengthen control environment. ORM monitors self-assessment results on monthly basis and follows-up with business/support units on key weaknesses in their respective areas. ORM regularly updates Operational Risk Committee on the overall operational risk environment of the Bank and key operational loss events during the period. Operational Risk Dashboard which covers operational loss trends, details of major events and risk profiles status are reported to the Managing Director and Senior Management on a monthly basis. A quarterly Risk review report is submitted to Board/ExCom summarizing impact of operational risk events during the quarter and progress on key operational risk initiatives. Regular reporting to ORC and senior management facilitates oversight and provides necessary executive support for operational risk activities in the Bank.

5.4 Business Continuity Management

The mission of Business Continuity Management (BCM) is to plan for the Bank continuing to function as a viable business entity, during a disaster or serious business disruption, and providing for the orderly restoration of essential business services, at the earliest possible time.

BCM achieves its objective by conducting business impact analysis, working with all essential business and support units within the Head Office to identify the impact of disruptions and to prioritize the critical business processes. BCM has developed recovery plans for all critical business processes, defining the level of recovery and resumption service to be offered during a crisis, which has already been tested. A Crisis Management plan has also been developed to define crisis invocation procedures and the roles/responsibilities of crisis management teams.

5.5 Credit Administration & Control

Credit Admin & Control (CAC) is responsible for ongoing administration of the credit portfolio, which *inter-alia* includes Limit monitoring, Disbursement authorization, Collateral coverage & monitoring; Compliance with terms of approval, Preparation, maintenance and custody of collateral security documentation, Credit checking and Follow-up on credit irregularities.

6. BANK'S CREDIT EXPOSURES

6.1 Definition of Past Due

Exposures that are not settled on their due date are classified as "Past Due" and reflected as such on the Bank's books the following day. The appearance of a loan as past due, does not imply that there is a problematic credit, as the business units often successfully prompt the customers to settle the amounts within a few days.

6.2 Definition of Impaired Assets:

In determining whether a corporate exposure has become impaired, Bank makes judgments as to whether there is any observable data indicating decrease in the estimated future cash flows. This evidence may include an indication that there has been an adverse change in the payment status of borrowers. Management uses estimates based on historical loss experience for loans with similar credit risk characteristics, when estimating the cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

6.3 Definition of Non Performing Assets:

Exposures are classified as non-performing and are placed on the non-accrual status in the following cases:

- The principal of loan or interest payment remains past due more than 90 days after its due date.
- The balance of an overdraft account remains in-active for more than 180 days.

The non-performing exposures migrate across the non-performing risk grades (Substandard, Doubtful, and Loss) according to their days past due and/or deterioration in credit quality.

6.4 Approaches for Specific & General Provisions:

As per Bank's provisioning policy, provisions are estimated depending on risk rating, type of collateral held and expected future recovery.

I. Provisions for Corporate & Commercial portfolio:

Specific provisions are booked against the impaired exposures by comparing the present value of expected cash-flows with its current carrying amount based on the criteria prescribed by International Accounting Standards– IAS 39.

II. Provisions for Consumer Loans & Credit Cards loans portfolio:

Specific provisions are booked against the impaired exposures based on the criteria of Days Past Due (DPD), as per the following table:

Buckets	Days Past Due (DPD)	Provisioning (% of total bucket)
1*	1 – 29 days	0%
2	30 – 59 days	15%
3	60 – 89 days	25%
4	90 – 119 days	50%
5	120 – 149 days	75%
6	150 – 179 days	100%
7	180+ days	Write – Off

*Due to high instance of customers becoming bucket 1 delinquent and their self-curing nature, no specific provisions are to be raised against these accounts.

III. General Provisions:

In addition to specific allowances against individual borrowers, ANB also makes a collective impairment allowance against exposures which, although not specifically identified as requiring a specific allowance, have a higher risk of default than when it was originally granted. This takes into consideration factors such as any deterioration in country risk, industry, technological obsolescence, as well as identified structural weaknesses or deterioration in cash flows.

7. EXTERNAL CREDIT ASSESMENT INSTITUTIONS (ECAIs) USED

As per the guidelines provided by SAMA, ANB is using i) Moody's, ii) Standard & Poor's, and iii) Fitch for assigning Risk Weight and calculating Risk Weighted Assets (RWAs) under the Standardized Approach. Obligors, which are not rated by any of these three ECAIs are considered as "un-rated". Only the solicited ratings from the eligible ECAIs are being used for capital adequacy calculations.

8. CREDIT RISK MITIGATION: DISCLOSURES FOR STANDARDIZED AND IRB APPROACHES

ANB is using standardized approach to calculate capital charge for credit risk, and has adopted simple approach for calculating Credit Risk Mitigation, The calculation methodologies are based on the guidelines specified by SAMA. ANB has been using following types of collateral for Credit Risk Mitigation (CRM) purposes under the Standardized Approach, as per SAMA guidelines:

- **Financial Collateral:**
  The Bank takes only cash as financial collateral for mitigation purpose as per Simple Credit Risk Mitigation Approach.

- **Guarantees as collateral**:
  The Bank takes guarantees issued by other banks as a credit risk mitigant for its exposures. In such cases, a simple substitution of the risk weight is applied as per Simple Credit Risk Mitigation Approach. The Bank has limit structure in place for managing exposure to each bank, which mitigates the concentration risk while using bank-guarantees as eligible collateral.

9. COUNTERPARTY CREDIT RISK

9.1 Objective and Policies

The primary objective of counterparty credit risk management function is to effectively identify, measure and manage all derivatives related counterparty exposures through regular review of counterparty limits and daily monitoring of exposures vs. limits.

9.2 Strategies and Process

Limits for all banking counterparties are approved by Senior Credit Committee based on guidelines approved by the Executive Committee of the Board. With regard to corporate customers, derivative products are offered only to selective large corporate customers with a demonstrated need to employ these products to manage the financial risks in their businesses.

9.3 Structure and Organization

Treasury Group manages day-to-day counterparty exposures for derivatives within the limits set by the Senior Credit Committee. Credit Control Department monitors and controls the exposures independently so that the exposures remain within the approved limits.

9.4 Scope and Nature of Risk Measurement and Reporting Systems

Capital charge for Over the Counter (OTC) derivative products is calculated using the current exposure method. Under this method potential future exposure is calculated, applying SAMA recommended add-on factors and positive mark-to-market of the transactions.

10. MARKET RISK CAPITAL CALCULATION

ANB maintains a low risk appetite for proprietary trading activity; as a result, trading activity is limited to FX Spots, FX Forwards, Plain vanilla interest rate derivatives and FX derivative instruments. The Bank uses standardized approach to calculate the capital charge for market risk in trading book. However, Bank is also in compliance with required qualitative and quantitative standards of SAMA for the adoption of Internal Model Approach.

10.1 Strategies and Processes

Board approves the trading limits keeping in view the overall business strategy of the Treasury Group. All traded products are covered by individual product programs, which lay down product description, business strategy, target customers, risk management, back office and accounting processes. The overall trading book limits as approved by the Board includes:

- Notional limit
- Volume limit
- VaR limit
- Sensitivity limit

10.2 Structure and Organization

The Head of Treasury Group is responsible for managing all trading activities on a day-to-day basis within the established trading limits and in accordance with the direction and guidance given by Market Risk Policy Committee (MRPC). Treasury is responsible to identify and recommend to MRPC new trading strategies in specific instruments and target markets that are in accordance with the Bank's risk appetite.

Market Risk Department is responsible for monitoring and comparing trading activity exposures to the Board-approved trading risk limits. All trading instruments are regularly marked-to-market and valuation methodologies are reviewed by Market Risk Department.

11. OPERATIONAL RISK CAPITAL CALCULATION

For the purpose of its capital computation under Basel II, ANB adopted the Alternative Standardized Approach (ASA). Under ASA, the capital charge is computed by categorizing ANB's activities into 8 business lines (as defined by the Basel framework) and multiplying the business line's twelve quarters' average gross income by a pre-defined beta factor, which is same as for the Standardized Approach except for two business lines — retail banking and commercial banking. For these business lines, Loans and Advances multiplied by a fixed factor 'm' (0.035) — replaces gross income as the exposure indicator, and for both business lines using a beta of 15%.

12. EQUITIES (BANKING BOOK POSITIONS)

12.1 Strategies and Processes

The Bank's equity exposure is diversified across listed local stocks of different industry sectors and mutual funds. The portfolio is managed with a conservative approach to achieve a stable long term return with low market volatility. The Bank has also made Strategic Equity Investments in affiliates and subsidiaries to achieve diversification of revenue streams and capitalize on the opportunities available in housing finance, equipment leasing and insurance.

12.2 Structure and Organization

A senior management committee manages the Bank's local equity portfolio. Treasury group monitors the portfolio on a day to day basis and makes recommendation to the management committee for purchase or sale of existing stocks within the Board's approved limits. Board has also approved limits for international equity investments to be managed by Treasury Group, however currently there are no positions in international equity. Investments in affiliates and subsidiaries are regularly reviewed and monitored by the strategic investment unit of the Bank.

12.3 Scope and Nature of Risk Reporting and/or Measurement Systems

A detailed investment report is submitted to ALCO and MRPC on a regular basis. The report covers details of securities held, their market values, and securities sold/ bought during the period. Valuation for the equity exposures are based on quoted market price, whereas strategic equity investments are held at book value.

13. BANKING BOOK INTEREST RATE RISK

Interest rate risk in the banking book mainly arises from mismatches in re-pricing dates of interest sensitive assets and liabilities. ANB's policy is to achieve a balance between profitability from banking activities and minimizing risk to earnings and capital from changes in interest rates. The Bank's exposure to interest rate risk is managed with the objective that profits are not unduly impacted by the volatility of the interest rates.

13.1 Risk Management and Monitoring Process

The Board approves the acceptable level of interest rate risk in the banking book by setting a limit on interest rate gaps by maturity buckets together with other limits. Treasury Group is responsible for day-to-day management of interest rate risk under the guidance provided by ALCO. Treasury Group monitors the changes in financial markets leading to interest rate movements. Based on future outlook, Treasury takes appropriate interest rate exposures or hedges the existing exposures, if needed. Interest rate derivatives (mainly interest rate swaps) are used to hedge interest rate exposure of the Bank. Interest rate limits are independently monitored by Market Risk Department of Risk Management Group and reported to ALCO.

13.2 Scope and Nature of Risk Reporting and/or Measurement Systems

To manage the Bank's interest rate risk exposure, Market Risk Department uses the following reports:

- Interest rate gap Analysis
- VaR analysis
- Interest rate stress testing
- Impact of rate movements on investment portfolio

ALCO approves key assumptions underlying these reports, which are documented and reviewed on a periodic basis.