

Name of the Bank: Al Rajhi Bank  
Period: 31-12-2009

Frequency: Annually

Table 1

**SCOPE OF APPLICATION**

- a) **This applies to Al Rajhi Banking and Investment Corporation, Saudi Arabia.**
- b) **The financial results of all subsidiaries are fully consolidated in publishing the results of Al Rajhi Banking and Investment Corporation, Saudi Arabia. Brief descriptions of the entities in the group are as follows:**
- 1) **Al Rajhi Capital Company:**  
The company was incorporated in 2007 in KSA, as a wholly owned subsidiary of Al Rajhi Bank. The subsidiary engages in Mutual Fund Management, Brokerage and Corporate Finance.
  - 2) **Al Rajhi Company for Development, Riyadh**  
The company was incorporated in 2000, for investment in Land, Building and Real estate. It is 99% owned by Al Rajhi bank.
  - 3) **Al Rajhi Banking and Investment Corporation BHD Malaysia**  
The company was incorporated in 2006 providing Islamic banking services in Malaysia and is 100% owned by Al Rajhi Bank.
- c) **There are no restrictions, or other major impediments, on transfer of funds or regulatory capital within the group. However, this is subject to the satisfaction of all internal and external approval by relevant authorities.**

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**Table 2**

**CAPITAL STRUCTURE**

**Capital of Al Rajhi Bank consists of:**

- 1. 1,500,000,000 Fully paid up ordinary shares of SAR 10 each.**

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**Table 3**

**CAPITAL ADEQUACY**

Capital adequacy indicates the ability of the Bank in meeting any contingency without compromising the interest of the depositors and to provide credit across the business cycles. Sufficient capital in relation to the risk profile of the Bank's assets helps promote financial stability and the confidence of the shareholders.

The Bank aims to maximize shareholder's value through an optimal capital structure that protects the stakeholder's interests even under most extreme stress situations, provides sufficient room for growth while meeting the regulatory requirements and at the same time gives reasonable return to shareholders.

The ultimate objectives of capital management are threefold:

1. Ensure stability of the Bank by holding sufficient capital to cover unexpected losses.
2. Promote the efficient use of capital by optimizing risk adjusted return.
3. Prudent decision making and pro-active risk management through an efficient and effective allocation of capital across the businesses.

The Bank measures various types of capital:

1. **Regulatory Capital:** Measure of capital needed to protect banks against insolvency. The regulator provides guidelines on how banks should measure regulatory capital and typically sets minimum standards for banks (e.g., 8% is set by SAMA). This approach is used for regulatory reporting and is in compliance with SAMA's rules.
2. **Accounting Capital:** This measures the equity capital as defined by accounting rules. Accordingly, this measurement is essentially the sum of paid-up capital, eligible reserves, interim profits and revaluation reserve.
3. **Statutory/Legal Capital:** This measures the required capital for the bank to be able to legally operate. The minimum statutory capital is set by the regulator and usually incorporates share capital as well as retained earnings.

Al Rajhi Bank currently uses the standardized method for calculation of the capital adequacy ratio and this methodology will be used until such time the Bank moves towards Economic Capital.

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## GENERAL QUALITATIVE DISCLOSURE REQUIREMENTS

### Structure & Organization of the Relevant Risk Management Function

a) Corporate Governance (Policies, Procedures & Governance Structure)

The risk management framework is integral to the operations and culture of Al Rajhi Bank. Risks are proactively managed within the Bank, while the framework is flexible to incorporate new businesses the Bank undertakes. The framework is comprehensive and has been communicated from the Board of Directors down to the individual business lines. Al Rajhi Bank's business strategy is to achieve the objective of being a strong financial partner with insight and transparency in risk-taking. The Risk Governance framework supports this objective.

The Risk Governance structure is comprised of the following Committees: Board of Directors, Executive Committee of the Board, Audit Committee of the Board, High Management Committee, Asset and Liability Management Committee (ALCO), Credit Committee, Remedial Management Committee, Risk Management Committee, IT Steering Committee, Purchasing Committee, Human Resources Committee, Compliance Committee, Nomination & Bonus Committee and High Sharia Committee.

The following guiding principles apply to all Credit Risk Management activities:

1. Independence: A clear separation exists between Credit Risk Management and the business divisions. All activities which commit the Bank either legally or morally to a position of risk require prior approval by authorized individuals or committees at the appropriate level from both Credit Risk Management and the Business.
2. Transparency: Credit Risk Management structures, policies and procedures are transparent, based on consistent principles which are well communicated at all levels.
3. Approval Authority: Committee and Individual approval authorities are delegated by the Board of Directors.
4. Dual Signature: Risk taking commitments require the approval of at least two authorized individuals.
5. Accountability: Risk and reward from a transaction are borne by the same business unit and which form an integral part of the key performance objectives of the business.

The functional management of risk across the Bank is undertaken by the Credit Risk Management Group headed by the Chief Risk Officer who reports to the CEO. The Credit Risk Management Group comprises of: Corporate Credit Management, Risk Management, Credit Policy & IT Projects and Credit Administration Monitoring & Control.

The Credit Risk Management Group activities comprise the following:

Evaluation and Approval of risk limits/exposures within delegated authorities (or recommendation to higher approval authorities in case of large exposures), independent of the business.

Development, communication, guidance and monitoring of adherence to comprehensive risk policies.

Recommendation, jointly with the Business Units of the Bank's risk appetite across all types and categories of risks, to the Board of Directors.

Daily management of all other risk functions, including the control, monitoring and reporting of risk limits and exposures for internal control and regulatory compliance purposes.

## 1) Credit Risk

Credit Risk is the potential risk of loss of revenue, principal and capital as a result of default or the inability of a borrower or counterparty to meet the terms of a contract through financing, dealing and investment activities.

The Bank addresses Credit Risk, which is the largest risk faced by the Bank, through the following process:

All Credit Processes – approval, disbursements, administration, classification, recoveries, write offs are governed by the Banks Credit Policy which is reviewed by Credit Risk Management and approved by the Board.

All Lending Proposals – all credit proposals are independently reviewed by Credit Risk Management who either approves within delegated limits or recommends for approval to a higher approval authority.

All Corporate Lending Accounts – are reviewed at a minimum on an annual basis.

Concentration of exposures to counterparties, geographies and sectors are governed and monitored by regulatory guidelines and limits prescribed by the Credit Policy.

Corporate Borrowers are risk rated using an internal risk rating methodology to provide support for credit decisions.

## 2) Market Risk

Market Risk is the risk of loss resulting from on and off balance sheet positions as a result of adverse movements in market prices. The management of market risk is achieved by the analysis, identification, monitoring, control and reporting of all activity that results from transactional exposures. Market Risk components are profit rate risk, foreign exchange risk, equity price risk and commodity price risk.

### a) Profit Rate Risk

Profit Rate risk refers to the potential impact on the Bank's net income margin caused by the changes in market rates of return.

The Bank manages the profit rate risk by incorporating ALCO values pertaining to pricing risk by evaluating the potential impact of a 200 bps movement in market rates.

### b) Foreign Exchange Risk

Foreign Exchange Risk refers to the impact of adverse exchange rate movements on foreign currency exposures arising out of customer transactions undertaken by the Bank. Foreign currency positions are marked to market on a daily basis and are monitored against predetermined position limits.

FX customer transactions are driven primarily by remittances. Total exposures are small relative to market volumes.

### c) Equity Price Risk/Commodity Price Risk

Equity Price Risk is the impact of adverse price movements in the price of equities on equity positions. Equity open positions are marked to market against prevailing market prices on a regular basis.

The Bank has equity exposure in the form of mutual funds and limited direct share investments. The mutual fund exposure arises when the Bank issues new funds that are administered by an asset manager. External asset managers typically require the Bank to commit that it will gather a certain number of mutual funds. While the Bank is selling the funds to a customer, it holds the difference between the committed amount and the amount sold to the customer on its books. These equities are considered long term investments are Shariah compliant. The Bank is exposed to volatility in the price of the mutual funds it has on its books. The values of the investments are updated regularly by Finance and are not considered material.

The Bank has limited direct share investments that it holds for an unspecified period of time, which may be sold in response to needs for liquidity or changes in profit rates or equity prices. The bank does not actively trade these investments and the value of the investments is updated by Finance and is not considered material.

Commodity Risk refers to the risk of loss arising from movements in commodity prices. The commodity portfolio will be revalued on a regular basis to capture the changes in market value due to changing economic conditions.

As an Islamic bank, the Bank buys and sells commodities to facilitate customer transactions to ensure compliance with Sharia. The Bank does not conduct proprietary trading in commodities for its own profit. The Bank's exposure to a commodity pricing volatility is usually limited to 1-2 hours which is considered to be not significant.

### 3) Liquidity Risk

Liquidity risk refers to the Bank's potential inability to pay its debts and obligations (funding requirements) when due because of failure to convert assets into cash, or its inability to procure enough funds or if it can, that the funds comes with an exceptionally high cost that may affect the institutions incomes and capital (cash flow mismatches at a reasonable cost). In addition, liquidity risk may result in the Bank's inability to unwind or offset underlying risks from assets it currently holds, which may force the Bank to sell its assets at a loss as the assets are illiquid or the market is suffering liquidity crunch.

Under Liquidity Risk, the Bank considers the following the three main risk types:

- a) **Term Liquidity and Call Risk:** Term liquidity risk arises when there is a mismatch between incoming and outgoing payments. There may be unexpected delays in repayments (term liquidity risk) or unexpectedly high payment outflows (call risk).
- b) **Structural Liquidity Risk:** This type of liquidity risk refers to the fact that the cost of liquidity for the purpose of closing liquidity gaps can change if refinancing becomes more expensive due to a decline in the Bank's creditworthiness.
- c) **Market Liquidity Risk:** Market liquidity risks arise when a position cannot be sold within a desired time period or only at a discount. This is especially the case with securities in illiquid markets.

### 4) Operational Risk

Operational Risk is the risk of loss resulting from inadequate or failed internal processes, people, systems, and external events. An Operational Risk Management Unit (ORMU) has been established within the Credit and Risk Management Group which facilitates the management of Operational Risk within the Bank. ORMU facilitates the management of Operational Risk by setting policies, developing systems, tools and methodologies, overseeing their implementation and use within the business units and providing ongoing monitoring and guidance across the Bank. A Group Operational Risk Committee has been established which reports through the Risk Management Committee.

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## CREDIT RISK

Credit Risk:-

a) Default/Counter Party Risk

The Bank has quantified its default risk as part of Pillar I using the Standardized Approach. This approach will continue to be used to determine the amount of capital the Bank will hold for default/counterparty risk.

In this method, risk weights are defined for certain types of credit exposures primarily on the basis of external rating provided by rating agencies for obligors with no internal rating. The default risk is then equated to the resulting capital requirements.

While calculating capital requirements, various credit risk mitigation techniques are used in order to limit credit risk. These include financial collateral such as cash and shares, certain forms of physical collateral such as real estate, as well as guarantees.

Overall, the Bank uses the Standardized Approach to calculate the associated capital however, any additional capital required under Pillar 2 is calculated using proprietary developed internal models.

### Capital Treatment of Exposures

Under the guidelines of SAMA of the Standardized Approach the bank categorizes as follows:

1. Sovereigns: SAMA requires that the Bank operating in Saudi Arabia with exposures to other sovereigns (meeting the guidance criteria prescribed by Basel II) use the preferential risk weight assigned to the sovereign by the relevant national supervisory authority.
2. Claims on Banks and Securities Firm are to use Option 2 under the Basel II Guidelines.
3. MDB's, Claims on Corporates, Claims included in the regulatory non-mortgage retail portfolios, Claims secured by residential mortgages, claims secured by commercial real estate, past due loans, off balance sheet items all follow SAMA guidelines on Basel II.

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Table 4

**CREDIT RISK: GENERAL DISCLOSURES FOR ALL BANKS**

**1. Definitions of past due and impaired:**

**For Accounting Purposes:**

A financed asset is considered past due where a repayment is overdue for 90 days or less, however, if the repayment is overdue for more than 90 days the financed asset is considered as impaired.

**For Basel II Purposes:**

(i) The bank considers that the obligor is unlikely to pay its credit obligations to the bank in full, without recourse by the bank to actions such as realizing collateral (if held); or

(ii) The obligor is past due more than 90 days on any material credit obligation to the bank.

**2. Description of approaches followed for specific and general allowances and statistical methods.**

a. Portfolios that are considered individually significant, i.e. Corporate Bank assets, are reviewed individually for impairment, and any asset with specific impairment is afforded a specific reserve taking into account potential future cash flow recoveries net of collateral.

b. Unimpaired individually significant assets are grouped together and a provision afforded, based on a study undertaken on the historical performance of the portfolio.

c. Portfolios that are not considered individually significant, i.e. Retail Bank assets, are provisioned based on a behavioral analysis of the underlying portfolio.

**3. Discussion of the bank's credit risk management policy.**

Credit Risk is considered to be the most significant and pervasive risk for the Bank. The Bank takes on exposure to credit risk, which is the risk that the counter-party to a financial transaction will fail to discharge an obligation when due causing the Bank to incur a financial loss. Credit risk arises principally from financing (credit facilities provided to customers) and from investments held with financial institutions. Further, there is credit risk in certain off-balance sheet financial instruments, including guarantees, letters of credit, acceptances and commitments to extend credit. Credit risk monitoring and control is performed by the Credit Risk Management Group which sets parameters and thresholds around the Bank's financing activities.

**a. Credit risk measurement**

**Financing**

The Bank has structured a number of financial products which are structured in accordance with Shariah Law in order to meet customer demand. These products are all classified as financing assets in the Bank's consolidated balance sheet. In measuring credit risk of financed assets at a counterparty level, the Bank considers the overall credit worthiness of the customer based on a proprietary risk methodology. For corporate customers, this risk rating methodology utilizes a 22 point scale based on quantitative and qualitative factors with 19 performing categories. The risk rating process is intended to reflect counterparty credit quality and assist in determining suitable pricing commensurate with the associated risks.

The risk rating process enables the Bank to detect any weakness in the portfolio quality and make appropriate adjustments to credit risk allowances, where credit quality has deteriorated and where losses are likely to arise. The Bank evaluates individual corporate customer balances, which are past due to make appropriate allowances against financed assets. For the remaining corporate loan portfolio, the Bank applies a loss rate to determine an appropriate collective

allowance. The loss rate is determined based on historical experience of credit losses.

For retail customers, the Bank has recently rolled out and implemented its retail credit scoring models. Credit risk is determined using an Application or Behavioral Score within a detailed credit program with well defined parameters. In order to monitor credit risk in the retail portfolio, the Bank has formulated guidelines for each retail product. These guidelines provide for various quantitative and qualitative factors for critically scrutinizing, sanctioning and monitoring credit risks.

## b. Risk Limit Control and Mitigation Policies

The responsibility for Credit Risk Management is enterprise wide in scope. Strong risk management is integrated into daily processes, decision making and strategy setting, thereby, making the understanding and management of credit risk the responsibility of every business segment.

In order to ensure objectivity, accountability and to reinforce ownership, the following Units within the Bank assist in the credit control process:

- Corporate Credit Unit (Credit Evaluation and Assessment).
- Credit Administration Monitoring and Control Unit.
- Remedial Unit.
- Credit Policy Unit.
- Retail Credit Unit (Credit Evaluation and Assessment).

The monitoring and management of credit risk associated with financing are made by setting approved credit limits. The Bank manages limits and controls concentrations of credit risk wherever they are identified – in particular, to individual customers and groups, and to industries and countries.

Concentrations of credit risks arise when a number of customers are engaged in similar business activities, 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 risks indicate the relative sensitivity of the Bank's performance to developments affecting a particular industry or geographical location.

The Bank seeks to manage its credit risk exposure through diversification of its financing to ensure there is no undue concentration of risks with individuals or groups of customers in specific geographical locations or economic sectors.

The Bank manages credit risk by placing limits on the amount of risk accepted in relation to individual customers and groups, and to geographic and economic segments. Such risks are monitored on a regular basis and are subject to an annual or more frequent review, when considered necessary. Limits on the level of credit risk by product, economic sector and by country are reviewed at least annually.

Exposure to credit risk is also managed through regular analysis of the ability of customers and potential customers to meet financial and contractual repayment obligations and by revising credit limits where appropriate.

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**Table 5**

**STANDARDIZED APPROACH AND SUPERVISORY RISK WEIGHTS IN THE IRB APPROACHES**

The Bank uses the following ECAIs

- S&P
- Moody's
- Fitch

The types of exposures for which each agency is used are for Corporate, Banks, Public Sector Entities (PSE's) & Sovereign

Per The Basel II guidelines we map the ECAIs rating to the standardized risk weight outlined by Basel II

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**Table 6**

**CREDIT RISK: DISCLOSURES FOR PORTFOLIOS SUBJECT TO IRB  
APPROACHES**

NOT APPLICABLE

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**Table 7**

**CREDIT RISK MITIGATION: DISCLOSURES FOR STANDARDIZED AND IRB APPROACHES**

The general qualitative disclosure requirement with respect to credit risk mitigation includes:

- policies and processes for, and an indication of the extent to which the bank makes use of, on- and off-balance sheet netting;
- policies and processes for collateral valuation and management;
- a description of the main types of collateral taken by the bank;
- the main types of guarantor and their creditworthiness; and
- Information about (market or credit) risk concentrations within the mitigation taken.

Risk Management and Mitigation:-

1. Management and mitigation of credit risk is core to the way the Bank operates and the way it does business. Listed below are some of the ways the Bank manages and mitigates credit risk:

2. Limit setting: The Bank has set different limits to protect itself. These include limits on how credit facilities granted to companies are based on their capital and reserves, the maximum total loan granted is based on the Bank's capital as well as the rating of the customer, restrictions on allowable loan tenure for different customer rating and limits on sector concentration.

3. Tangible Collateral and guarantees: Different requirements have been set depending on the type of loan product for the type of acceptable collateral (e.g., cash, shares, real-estate, other pledges, third party guarantees, etc.). In addition, rules have been developed on how various types of tangible collateral should be valued and how often the value of the tangible collateral should be revalued and when the Bank would need to ask for additional collateral.

4. Credit Approval Authorities: Different authorities and limits have been defined for individuals or approval committees across the Bank and are dependent on rating and size of limit recommended.

5. Credit Evaluation Process: A clear credit evaluation process has been designed for the Bank to ensure that a consistent and robust method is followed.

6. Measuring the quality of credit: There are various models for both the retail and corporate portfolio which ascertains a risk rating on the client. These models take into consideration both quantitative and qualitative factors to ascertain a risk rating. These rating models have been developed using Al Rajhi specific data where applicable.

7. Legal Documentation: Appropriate legal documentation is executed to ensure that the Bank has recourse to protect itself in case of default on a loan. There are different variations depending on the product, type, and credit quality of the customer.

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**Table 8**

**GENERAL DISCLOSURE FOR EXPOSURE RELATED TO COUNTERPARTY CREDIT RISK**

NOT APPLICABLE

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**Table 9**

**SECURITIZATION: DISCLOSURE FOR STANDARDIZED AND IRB APPROACHES**

NOT APPLICABLE

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**Table 10**

**MARKET RISK: DISCLOSURE FOR BANKS USING THE STANDARDIZED APPROACHES**

Market Risk :

The Bank is exposed to market risks, which is the risk that the fair value of future cash flows of a financial instrument will fluctuate due to changes in market prices. Market risks arise on profit rate products, foreign currency and mutual fund products, all of which are exposed to general and specific market movements and changes in the level of volatility of market rates or prices such as profit rates, foreign exchange rates and quoted market prices. The Bank uses the standardized Model to calculate the capital for Market Risk.

Foreign Currency Risk:

The Bank is exposed to the effects of fluctuations in foreign currency exchange rates on its financial position, results of operations and cash flows. The Bank's management sets limits on the level of exposure by currency and in total, which are monitored daily.

A substantial portion of the net foreign currency exposure to the Bank is in US Dollars, where Saudi Riyal is pegged to the US Dollar. The other currency exposures are not considered significant to the Bank's foreign currency risks and as a result the Bank is not exposed to major foreign currency risks.

Market Risk components are profit rate risk, foreign exchange risk, equity risk and commodity risk.

a) Profit Rate Risk

Profit rate risk arises more in the Bank's assets than its liabilities in the current structure of its balance sheet. If the Bank increases the profit bearing liabilities especially to the corporate clients, the risk structure would change.

Profit Rate risk refers to the potential impact on the Bank's net income margin or market value of equity caused by the unexpected changes in rate of returns.

The Bank manages the profit rate risk by incorporating ALCO values and forecasted asset and liability run off rates into the Profit Rate Risk Model.

There is a core assumption for the Profit Rate Risk Model that a 200 basis point shift in profit rates is the largest shock that can be experienced in the near term. Whilst recent market activity has resulted in increasingly higher one off shifts in profit rates, however, none have come close to 200 bps.

b) Equity/Asset Risk

Equity Risk is the impact of adverse price movements in the price of equities on equity positions. Equity open positions are marked to market against prevailing market prices on a regular basis.

The Bank has exposure to equities in the form of mutual funds (~ SAR 244 million) and direct share investments (~ SAR 974 million). The mutual fund exposure arises when the Bank issues new funds that are administered by an external asset manager. External asset managers typically require the Bank to commit that it will gather a certain number of mutual funds (e.g., SAR 100 million). While the Bank is selling the funds to a customer, it holds the difference between the committed amount and the amount sold to customer on its book. These equities are considered long term investments and are Sharia compliant. The Bank is exposed to volatility in the price of the mutual funds it has on its books. The value of the investments is updated daily by Finance and is not considered material.

The direct share investments are held for an unspecified period of time, which may be sold in response to needs for liquidity or changes in profit rates or equity prices. The bank does not actively trade these investments and the value of the investments is

updated by Finance and is not considered material.

c) Commodity Risk

Commodity Risk refers to the risk of loss arising from movements in commodity prices. The commodity portfolio will be revalued on a regular basis to capture the changes in market value due to changing economic conditions.

As an Islamic bank, the Bank buys and sells commodities to facilitate customer transactions to ensure compliance with Sharia. The Bank does not conduct proprietary trading in commodities for its own profit. The Bank's exposure to a commodity pricing volatility is usually limited to 1-2 hours.

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**Table 11**

**MARKET RISK: DISCLOSURES FOR BANKS USING THE INTERNAL MODELS  
APPROACH (IMA) FOR TRADING PORTFOLIOS**

NOT APPLICABLE

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**Table 12**

**OPERATIONAL RISK**

Operational Risk Overview

Al Rajhi Bank has adopted the Standardized Approach for calculating capital adequacy covering operational risk and defines 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.”

Sources of Risk

Operational Risk for the Bank arises from various different areas including:

- Internal fraud: An act of a type intended to defraud, misappropriate property or circumvent regulations, the law or company policy, excluding diversity/discrimination events, which involves at least one internal party.
- External fraud: An act of a type intended to defraud, misappropriate property or circumvent the law by a third party.
- Employment practices and workplace safety: An act inconsistent with employment, health or safety laws and agreements (e.g., payment of personal injury claims, or from diversity/discrimination events)
- Clients, products, and business practices: A failure to meet a professional obligation to specific clients (including fiduciary and suitability requirements) either unintentionally or through negligence, or from the nature or design of a product.
- Damage to physical assets: The loss or damage to physical assets from a natural disaster or other events.
- Business disruption and system failures: Disruption of business or system failures.
- Execution, delivery, and process management: Failed transaction processing or process management, from relations with trade counterparties and vendors

The Bank currently uses the Standardized Approach to calculate the minimum regulatory capital for Operational Risk.

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**Table 13**

**EQUITIES: DISCLOSURES FOR BANKING BOOK POSITIONS**

Al Rajhi Bank has adopted the Standardized Approach for calculating capital adequacy covering the Bank's equity investment position.

Equity investments whose fair value cannot be reliably measured are carried at cost.

An investment in mutual funds arises when the Bank issues new funds that are administered by an external asset manager. External asset managers typically require the Bank to commit that it will gather a certain number of mutual funds (e.g., SAR 100 million). While the Bank is selling the funds to a customer, it holds the difference between the committed amount and the amount sold to customer on its book. These equities are considered long term investments and are Sharia compliant. The Bank is exposed to volatility in the price of the mutual funds it has on its books. The value of the investments is updated daily by Finance and is not considered material.

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**Table 14**

### **PROFIT RATE RISK IN THE BANKING BOOK**

Profit rate risk arises more in the Bank's assets than its liabilities in the current structure of its balance sheet. If the Bank increases the profit bearing liabilities especially to the corporate clients, the risk structure would change.

**Liabilities:** The majority of the Bank's customer deposits are in non-profit bearing current accounts. Changes to the profit rate have no bearing on these accounts. However, the Bank has a smaller number of corporate deposits and retail term deposits that are rate sensitive.

**Assets:** The Bank charges different profit rates according to the maturity of loans (longer term loans usually require a higher profit rate). To determine the profit rate, the Bank uses a current market rate (e.g., SAIBOR) as a proxy to determine what to charge given market conditions.

Find below a description of each of the sources for each subtype of profit rate risk:

**Re-pricing risk:** Most of the risk that the Bank experiences are in lost earnings when profit rates decrease. This is due to the composition of the book which is made up of mostly non-profit bearing current account liabilities and fixed rate assets. In other words, the Bank is an asset-sensitive bank that benefits from a rise in rates and is disadvantaged by a fall in rates because the amount of re-pricing assets is larger than the re-pricing liabilities. A profit rate decrease has an inverse effect on the equity value of the Bank's fixed rate assets (increase) versus earnings (decrease) since the assets still hold a higher profit rate compared to the decreased market rate.

**Assets:** There are different profit rates and re-pricing terms for the Bank's assets. Since the market rate (SAIBOR for SAR, LIBOR for US\$) is used as a benchmark for the profit rate, a drop in profit rate can result in lost earnings.

**Basis risk:** Because most of the Bank's assets and liabilities are dependent on the SAIBOR rate and not on other rates, the risk is low. For US\$ assets and liabilities, the rate is based on LIBOR, and any loans are squared off with liabilities that closely match both the amount and tenure. This minimizes any basis risk.

**Profit Rate Risk –** This is a risk that exists in two areas – profit re-pricing and yield curve shifts. Re-pricing risk lies in the fluctuations in profit rates that have differing impact on bank assets while yield curve risk is posed by the change in portfolio values caused by unanticipated shifts in the slope and shape curves. They include:

- a) Displaced commercial risk-- when the Bank is required to pay a return greater than the income it generates on any underlying asset. This is captured when the Bank experiences a change in profit rates (profit rate re-pricing) which drives the difference in the variable and fixed payments. The Bank currently has a minimal number of variably priced assets and liabilities.
- b) Rate of return risk occurs when profit rates change (profit re-pricing) and there is a mismatch between the return of assets and liabilities.

**Approach:**

For measuring overall sensitivity in the banking book, the Bank measures the Profit at Risk, also referred to as Earnings-at-Risk (EAR) approach. The EAR perspective considers how changes in profit rate will affect a bank's reported earnings. This methodology focuses on the risk to earnings in the near term, typically the next one or two years. Fluctuations in profit rates generally have the greatest impact on reported earnings through changes in a bank's net financing income (that is, financing income less income paid on time investments and murabaha financing expense). It uses 200 basis point change as a stress test. The approach of measurement is as follows (but not limited to):

- Estimate expected run-off rate of assets at different tenors (i.e., determine tenor versus maturity matrix);
- Assess expected change in yield curve given short term change of 200 basis points;