Financial Performance

Overview

The Bank recorded strong growth in Net Income of BD 41.56 million for 2007 representing an 12.75 per cent increase over 2006 net income of BD 36.86 million.

The growth in Net Income by BD 4.70 million is the net result of an increase in Net Interest Income by BD 3.58 million and increase in Other Income by BD 3.90 million offset by an increase in Operating Expenses by BD 2.78 million.

The growth in Total Income was attributable to increased earnings from continued growth in both the Bank's core commercial banking businesses and treasury activities.

At year-end 2007, the Bank's Total Assets stood at BD 1,903.71 million, an increase of 13.56 per cent over the comparative figure of BD 1,676.38 million at year-end 2006. The growth in Total Assets was attributable mainly to an increase in Loans and Advances portfolio and higher deployment in Placements with Banks and other Financial Institutions. Deposits also increased by 10.02 per cent from higher mobilisation of retail and business deposits.

Key performance indicators ratios remained strong with Return on Average Assets 2.32 per cent in 2007 compared to 2.32 per cent in 2006 while Return on Average Equity increased to 17.85 per cent in 2007 compared to 16.74 per cent in 2006.

Net Interest Income

Net Interest Income at BD 42.17 for the year reflects an increase of 9.28 per cent over 2006. The main drivers for the increase in Net Interest Income are strong growth in Loans and Advances, Customer Deposits and improved yield on surplus liquidity deployed in money market and investments.

The Bank's Treasury initiated gapping positions when interest rates were steady in the beginning of the year and provided several profitable opportunities. However following the deterioration in credit markets caused by sub prime issues and liquidity concerns the Bank has positioned its portfolio to take advantage of changes in the market environment and outlook over the short to medium term.

The net interest margin, on average total assets, was 2.36 per cent for 2007 compared to 2.43 per cent for 2006, reflecting a marginal decline in interest rate spreads generated from the Bank's core activities.

Other Income

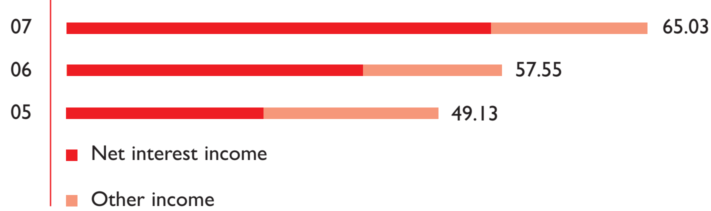
Other Income for the year increased by 20.57 per cent to BD 22.86 million in 2007, compared to BD 18.96 million in 2006, derived mainly from higher fee and commission income, profits on managed funds and profit from foreign exchange activities.

The Bank pursued a prudent investment policy during the year of investing in senior investment grade floating rate securities, fixed income securities aimed at maximising returns and asset diversification while maintaining adequate liquidity. Foreign exchange activities focused on customer driven business with increased deal flows that translated in higher FX returns.

Treasury related activities generated other income aggregating BD 11.85 million for the year; BD 2.97 million higher than 2006. The increase is mainly on account of higher commission on funds, better foreign exchange income and higher profits on managed funds portfolio.

Income stream of fees and commissions showed growth momentum in line with the expansion in our business banking lending activities, cards business and trade finance activities. During the year, the Bank increased its

Net interest and other income
BD (millions)



participation in syndicated facilities and financing arrangements in the region and in structuring major project finance deals in Bahrain and the GCC states that translated in to increased commission income.

Details of Other Income, with comparative figures for the previous year, are set out in Note 23 to the Financial Statements.

Operating Expenses

Operating Expenses at BD 23.47 million showed a modest increase of BD 2.78 million or 13.44 per cent over the previous year. The increase is attributable to an increase in Staff Expenses compensated by a decline in Other Operating expenses. Staff Expenses increased from BD 14.04 million in 2006 to BD 17.64 million in 2007 arising mainly from annual salary reviews, across the board salary adjustments, performance related rewards and accretion to the Bank's human resources in line with strategic plans and business expansion needs under way. Other Operating Expenses decreased marginally to BD 5.83 million from BD 6.65 million in 2006. The results of the Bank's continuous efforts to improve efficiency and enhance productivity are reflected in the operating efficiency ratio of 36.09 per cent for 2007 compared to 35.95 per cent for 2006.

Provisions

In accordance with International Accounting Standard 39, the Bank follows a model-based approach for assessing the adequacy of provisions for loan losses. Provisions for individually significant credit exposures are determined by discounting expected future cash flows. Impairment and uncollectability is also measured on a portfolio basis, for a homogenous group of loans and advances not individually identified as impaired, on the basis of estimates of incurred losses inherent within the loans and advances portfolio that have not been specifically identified at the balance sheet date. The estimates are based on internal risk ratings, historical default rates adjusted considering current observable data, rating migrations, loss severity, macroeconomic outlook and other relevant factors that reflect the effect of current conditions on the loan book.

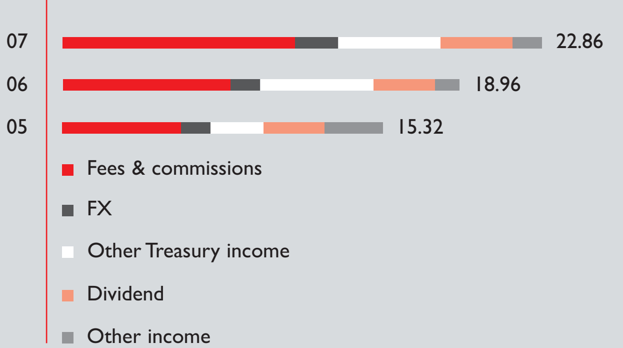
Our non-performing loans were marginally higher at BD 8.89 million, at the end of 2007 compared to BD 8.57 million at the end of 2006. The low levels of non-performing loans compared to our loan portfolio, is the result of the Bank's conservative credit risk policies, the effectiveness of credit risk management processes and the success of our recovery efforts. At year-end, the Bank held loan loss provisions adequate to cover the entire non-performing loan portfolio. Details of the Bank's non-performing loans, provisions and movements therein during the year are detailed in Note 6 to the Financial Statements.

Assets

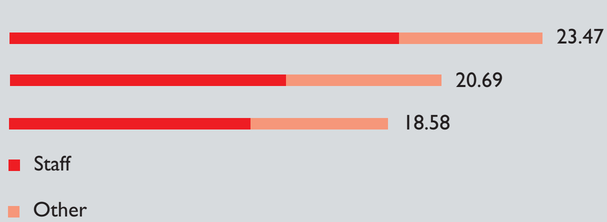
Total Assets at BD 1,903.71 million, reflecting an increase of 13.56 per cent over 2006, is attributable mainly to growth in Placements with Banks and Financial Institutions of BD 162.71 million, and a growth of BD 161.66 million in the Loans and Advances portfolio. The increase in the loan book was mainly due to enhanced participation in domestic and regional project finance deals, syndicated facilities and club deals, strengthening and broadening of business lending relationships in Bahrain and GCC countries and the attractiveness of our consumer credit products. At year-end 2007, Loans and Advances as a percentage of Total Assets were 49.7 per cent as compared to 46.8 per cent at the end of year 2006. The proportion of Placements with Banks and Financial Institutions in Total Assets increased to 26.3 per cent as compared to 20.1 per cent for the previous year.

The Bank's Loans and Advances portfolio is concentrated

Composition of other income
BD (millions)



Total operating expenses
BD (millions)



principally in Bahrain and other GCC countries. Based on contractual maturity terms, 39.3 per cent of the current portfolio matures within one year and 62.0 per cent is due to mature within 3 years of the balance sheet date.

At the year-end, the Bank's Investment portfolio of BD 348.79 million (2006: BD 392.42 million) consisted of Available-for-Sale securities that comprised debt and equity securities while the Fair Value Through Profit or Loss investments comprised mutual funds and capital protected notes. A substantial portion i.e. 93.6 per cent of the total debt portfolio is in investment grade securities.

The Treasury Bills portfolio decreased to BD 16.89 million at end of 2007 compared to BD 74.42 million at the end of the prior year.

Notes 29 and 30 to the Financial Statements provide details of the distribution of Total Assets by geographical region and industry.

Liabilities

Deposits mobilised from customers grew by BD 120.17 million or 10.02 per cent to BD 1,319.95 million as at year-end 2007, from BD 1,199.78 million at the end of 2006. The growth came from all segments with increases in retail, corporate and government deposits.

Borrowings under Repurchase Agreements and Deposits from Banks and Financial Institutions stood at BD 320.47 million at year-end 2007, BD 94.04 million higher than year-end 2006 levels of BD 226.43 million. At year-end 2007, the ratio of Customers' Deposits to Total Liabilities and Shareholders' Equity stood at 69.3 per cent compared to 71.6 per cent at the end of the previous year.

Capital Strength

Shareholders' Equity, inclusive of Proposed Appropriations, reflected a balance of BD 243.63 million. At the year-end, Shareholders' Equity as a percentage of Total Assets was 12.8 per cent as compared to 13.3 per cent at the end of the previous year.

The Bank's capital adequacy ratio at the balance sheet date was 28.3 per cent (2006: 28.7 per cent) with Tier 1 ratio at 21.4 per cent (2006: 21.5 per cent). The ratios are calculated in line with guidelines issued by the Central Bank of Bahrain for measuring credit and market risk that are based on those of the Basel Committee on Banking Supervision.

The Bank's capital adequacy ratio, encompassing both credit and market risk, is well above the Basel requirement of 8 per cent and also comfortably above the minimum level of 12 per cent set by the Central Bank of Bahrain. Note 40 to the Financial Statements provides further details on capital adequacy. The main factors that contribute to the Bank's strong capital adequacy ratio are its strong capital base, low levels of non performing assets that are fully provided for and the low risk profile of our on-balance sheet and off-balance sheet exposures which includes significant exposures to low risk weighted assets namely governments, public sector undertakings, banks and financial institutions.

Risk Management

In a world characterised by high integration of global financial markets, innovation in financial products, extensive use of derivatives, and large scale regulatory changes, the management of risk has become a key issue for every bank. NBB has over the years, developed risk management into a core competence and is well placed to meet these challenges. The Bank evaluates risk in terms of the impact on income and asset values and it reflects the Bank's assessment of the potential impact on its business on account of changes in political, economic and market conditions and in the credit worthiness of its clients. Risk

management at NBB has always been conservative and proactive with the objective of achieving a balanced relation between risk appetite and expected returns. Risk arises from the Bank's lending and investment activities as carried out by the various units. Corporate Banking is responsible for lending to large corporate entities in Bahrain. Regional Banking handles credit facilities to leading corporates in other countries of the GCC. Corporate Finance, Trade Finance and Financial Institutions are involved in identifying and developing opportunities for specialist corporate finance products and for financing trade flows between the GCC region and the rest of the world. Commercial Banking is responsible to cover the borrowing requirements of small to medium-sized companies based in Bahrain. Retail Banking controls the lending portfolio to individuals in Bahrain and other retail services. Treasury and Capital Markets is responsible for all the treasury and capital market related activities of the Bank and the Abu Dhabi Branch serves the UAE market.

The overall authority for risk management in the Bank is vested in the Board of Directors. The Board authorises appropriate credit and market risk policies as well as suitable operational guidelines based on the recommendation of Management. Approval authorities are delegated to different functionaries in the hierarchy depending on the amount, type of risk and collateral security. The Bank has established committees that decide on all risk issues and authorities are properly structured.

Integral to the Bank's risk management system is an internal audit department that plays a role in evaluating the independence and overall effectiveness of the Bank's risk management functions. A periodic review of risk assets is conducted by the department to confirm that established policies, procedures and approved terms are complied with and to review asset quality and highlight areas of concern so that corrective action can be taken in time.

The Credit Policy and Risk Management (CPRM) division of the Bank provides the necessary support to Senior Management and the business units in all areas of risk management. This division functions independently of the business units to analyse risks and put forth its recommendations prior to approval by the delegated authorities. The Bank promotes healthy debate among the business units and CPRM to achieve an optimum balance between risk and return.

The Bank's risk management process encompasses the various dimensions of risk as follows:

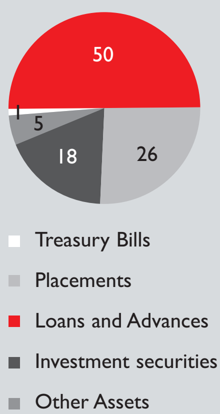
Credit Risk

Credit Risk represents the potential financial loss as a consequence of a customer's inability to honour the terms and conditions of the credit facility. Such risk is measured with respect to counterparties for both on-balance sheet assets and off-balance sheet items.

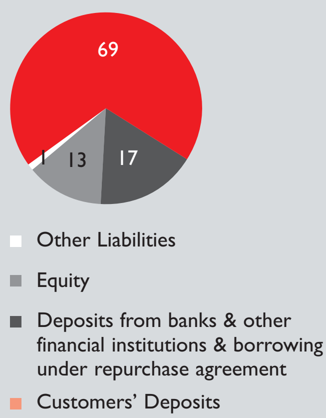
The Bank has well laid out procedures, not only to appraise but also regularly monitor credit risk. Regular reviews are carried out for each account and risks identified are mitigated in a number of ways which include obtention of collateral, counter-guarantees from shareholders and/or third parties. Adequate margins are maintained on the collateral to provide a cushion against adverse movement in the market price of collateral.

In addition to rigorous credit analysis, the terms and conditions of all credit facilities are strictly implemented by the Credit Administration Department. An internal grading system and review process ensures prompt identification of any deterioration in credit risk and consequent implementation of corrective action. The Bank's internal ratings are based on a 10-point scale which takes into account the financial strength of a borrower as well as qualitative aspects to arrive at a comprehensive snapshot of

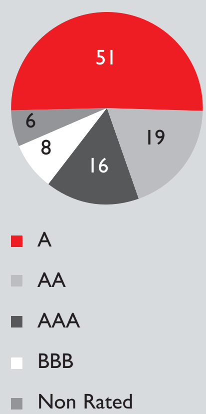
Composition of total assets
Per cent



Composition of total liabilities and equity
Per cent



Investment security by rating
Per cent



the risk of default associated with the borrower. Ratings are further sub-divided into categories which reflect estimates of the potential maximum loss in an event of default. Risk Ratings assigned to each borrower are reviewed at least on an annual basis. Regular monitoring of the portfolio enables the Bank to weed out accounts which witness a deterioration in risk profile. During the year, the Bank introduced Risk Adjusted Return on Capital (RAROC) as a measure of the economic profitability of credit facility relationships. Going forward, the Bank expects to further enhance usage of RAROC as one of the decision making tools to facilitate choice between competing business opportunities.

The Bank follows stringent criteria in setting credit limits for countries and international financial institutions. Prudent norms have also been implemented to govern the Bank's investment activities. Not only are regular appraisals conducted to judge the credit worthiness of the counterparty but day-to-day monitoring of financial developments across the globe ensures timely identification of any event affecting the risk profile.

The Bank enters into derivative contracts in the normal course of business to meet customer requirements and to manage its own exposure to fluctuations in interest and exchange rates. The credit risk arising from a derivative contract is calculated by taking the cost of replacing the contract, where its mark to market value is positive, together with an estimate for the potential future change in the value of the contract. The credit risk on contracts with a negative mark to market value is restricted to the potential future change in their market value. Details of derivative contracts are contained in Note 15 to the Financial Statements.

The Bank has systems and procedures in place to generate alerts in case of past dues in any account. A stringent classification process is followed for all accounts with past dues of over 90 days. The Bank applies rigorous standards for provisioning and monitoring of non-performing loans. Level of provisions required is determined based on the security position, repayment source, discounted values of cash flows, etc. Adequate provisions are carried to guard against inherent risks in the portfolio. At year-end 2007, the Bank's provisions exceeded the entire non-performing portfolio.

Legal Risk

Legal risk management systems supplement the above credit procedures and guard against the inability of the Bank to enforce claims against counterparties and borrowers.

In-house expertise together with firms of international repute retained by the Bank ensures that the facility documentation encompasses eventualities that might affect the implementation of stipulated terms and conditions.

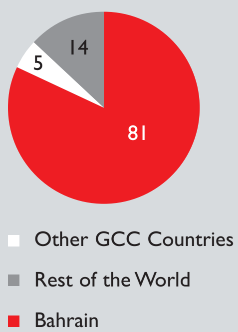
Liquidity Risk

Liquidity Risk is classified as the potential inability of a bank to meet its financial obligations on account of a maturity mismatch between assets and liabilities. Liquidity risk management ensures that funds are available at all times to meet the funding requirements of the Bank.

The asset/liabilities management policies of the Bank define the proportion of liquid assets to total assets with the aim of minimising liquidity risk.

The Bank has maintained adequate investments in liquid assets, such as inter-bank placements and treasury bills. In addition, the Bank also relies on trading assets and other marketable securities to provide for secondary sources of

Geographical profile of non-performing loans and advances
Per cent



liquidity. The ratio of liquid assets to total assets as at 31 December 2007 was 30 per cent. The high level of liquidity enables the Bank to meet fluctuating customer borrowings and drawdowns comfortably.

The Bank's ability to maintain a stable liquidity profile is primarily on account of its success in retaining and growing its customer deposit base. The marketing strategy of the Bank has ensured a balanced mix of demand and time deposits. Stability of the deposit base thus minimises the Bank's dependence on volatile short-term borrowings.

The Treasurer closely monitors the maturity profile of assets and liabilities so that adequate liquidity is maintained at all time. The asset and liability maturity profile by individual asset and liability category based on contractual repayment arrangements is detailed in Note 35 to the Financial Statements. As at 31 December 2007, 44.8 per cent of assets were scheduled to mature within three months. Substantial investment securities with contractual maturities of more than three months can also be readily liquidated. Considering the effective maturities of deposits based on retention history and in view of the ready availability of liquid investments, the Bank is able to ensure that sufficient liquidity is always available. Proper contingency plans exist and can be implemented on a timely basis to minimise the risk associated with dramatic changes in market conditions. The Asset Liability Committee (ALCO) chaired by the Managing Director, reviews the Liquidity Gap Profile and the Liquidity scenario and addresses strategic issues concerning liquidity.

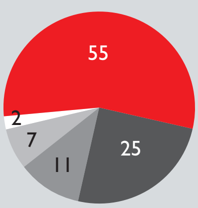
Interest Rate Risk

Interest Rate Risk is measured by the extent to which changes in the market interest rates impact margins, net interest income and the economic value of the Bank's equity. The Bank's asset and liability management process is utilised to manage interest rate risk through the structuring of on-balance sheet and off-balance sheet portfolios. Net interest income will be affected as a result of volatility in interest rates to the extent that the repricing structure of interest bearing assets differs from that of liabilities. The Bank's goal is to achieve stable earnings growth through active management of the assets and liabilities mix while, selectively, positioning itself to benefit from near-term changes in interest rate levels.

The Bank uses interest rate gap analysis to measure the interest rate sensitivity of its annual earnings due to repricing mismatches between rate sensitive assets, liabilities and derivatives' positions. The interest rate sensitivity graph illustrates the Bank's repricing gap structure as at 31 December 2007. A negative gap denotes liability sensitivity and a positive gap denotes asset sensitivity. Note 32 to the Financial Statements gives details of the Bank's exposure to interest rate risk.

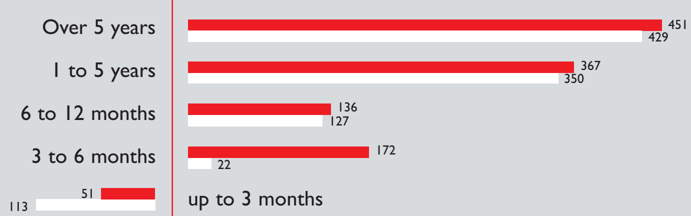
Duration analysis is used to measure the interest rate sensitivity of the fixed income portfolio. Duration of the portfolio is governed by economic forecasts, expected direction of interest rates and spreads. Modified Duration gives the percentage change in value of the portfolio following a 1% change in yield. Modified Duration of the Bank's fixed income portfolio was 0.35 on 31.12.2007, which implies that a 1% parallel upward shift in the yield curve could result in a drop in the value of the portfolio by BD 0.53 million. Interest rate swaps and forward rate agreements are used to manage the interest rate risk. The Treasurer is primarily responsible for managing the interest rate risk. Reports on overall position and risks are submitted to senior management for review and positions are adjusted if deemed necessary. In addition, ALCO regularly reviews the interest rate sensitivity profile and its impact on earnings. Strategic decisions are made with the objective of producing a strong and stable interest income over time.

Sector profile of non-performing loans and advances
Per cent



- Manufacturing
- Construction
- Trade
- Personal
- Others

Cumulative interest rate sensitivity gap
BD (millions)



2006 2007

Market Risk

Market Risk is classified as the risk to the value of the trading portfolio arising from changes in interest rates, foreign exchange, commodities and equity prices. The Bank's trading activities are governed by conservative policies, by adherence to limits set annually and by regular reviews. Quality and rating are the main criteria in selecting a trading asset. The Bank uses the Value-at-Risk (VaR) measure to estimate the exposure of the trading portfolio and total currency book to market risk.

The measure determines the dollar value of the price sensitivity of market-traded instruments to market risk factors for a certain degree of confidence over a pre-defined time horizon. Based on the approval of the Central Bank of Bahrain in 1999, the Bank has been computing its market risk using an internal model based on RiskMetrics methodology.

The value quantifies the maximum potential change in the future value of the portfolio due to the sensitivity of the positions to the volatility of and correlation between the risk factors such as interest rates, foreign exchange rates and equity prices. Daily reports in this regard are submitted to senior management for review and decision making purposes.

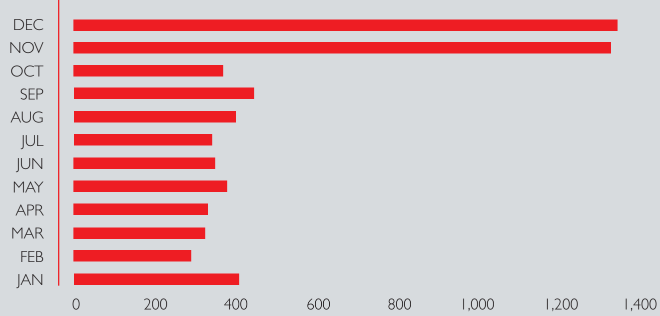
The Bank uses exponentially weighted RiskMetrics datasets on volatilities and correlations in estimating the VaR for its trading portfolio. A 99 per cent level of confidence is used to determine the maximum potential loss in the portfolio over the relevant time horizon. It implies 1 per cent likelihood of the loss exceeding the VaR limit.

The VaR for the trading portfolio calculated as at 31 December 2007 was BD 1.34 million for a 99 per cent confidence level and a 10 day time horizon. The average VaR for the last 60 days of 2007 was BD 1.51 million.

The chart on this page shows a monthly trend of VaR from January to December 2007. During this period, the maximum VaR was BD 1.66 million on 28th November 2007 while the minimum VaR was BD 0.28 million on 18th Febraury 2007.

The Bank uses back-testing to validate the VaR model. VaR is compared with actual daily profits and losses incurred on the trading portfolio. This assists in identifying any exceptions or losses that are not covered by the VaR measure. Back-testing results confirm that the internal model adequately captures risk within the Bank's trading portfolio.

Value-at-risk at month end - 2007
BD (thousands)



Operational Risk

Operational Risk is the risk of monetary loss on account of human error, fraud, systems failures or the failure to record transactions. The Bank has well laid out procedures and systems that set out the methodologies for carrying out specific tasks. These systems and procedures are constantly reviewed and revised to address potential risks.

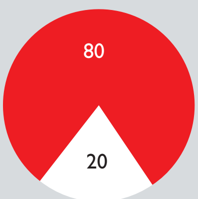
The scope of the Bank's internal audit department encompasses audits and reviews of all business units, support services and branches. The internal audit process focuses primarily on assessing risks and controls and ensuring compliance with established policies, procedures and delegated authorities. New products and services are reviewed by the internal audit department and assessed for operational risks prior to their implementation. The internal audit department is operationally independent and reports significant internal control deficiencies to the Audit Committee.

The Bank has a well-established off-site computer back-up centre that provides full system support to the Bank's operations in case of an emergency in the information technology systems. The computer back-up centre is regularly tested to ensure its readiness for a seamless switchover in case of any emergency.

The necessary precautions have been put in place to protect the Bank from money laundering activities.

All the aspects of risk mentioned above are reviewed regularly at each meeting of the Board of Directors and the Executive Committee, based on a comprehensive risk report. This integrated approach to risk management also serves the Bank in achieving its objective of protecting the interests of shareholders and customers.

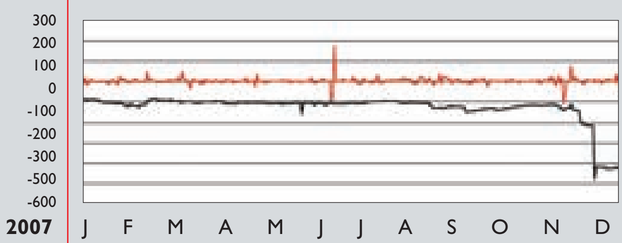
2007 Average Var by risk category
Per cent



■ Foreign Exchange

□ Interest Rate

Value-at-risk backtesting January-December 2007
BD (thousands)



■ Back testing P/L

■ 1 Day VaR