



# Financial Review

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## FINANCIAL PERFORMANCE

### Overview

The Bank had a challenging year as the financial markets worldwide was in turmoil for much of the year and events climaxed in September/October 2008 with several major investment/commercial bank failures that also resulted in some forced mergers/acquisitions particularly in United States, Europe and United Kingdom. While the Bank generated increased earnings from continued growth in core banking businesses it recorded mark to market losses on managed funds and 100 per cent provision for investment in debt securities of institutions adversely impacted by the global financial crisis, where full recovery is in doubt. As a result, the Bank achieved a Net Income of BD 34.74 million for 2008, compared to a Net Income of BD 41.56 million for 2007.

At year-end 2008, the Bank's Total Assets stood at BD 2,034.10 million, compared to BD 1,903.71 million at year-end 2007. The growth in Total Assets was attributable mainly to a strong growth of 15.8 percent in Loans and Advances portfolio. Deposits also showed an impressive growth of 15.1 percent from higher mobilisation of retail and corporate deposits.

Key performance indicators remained strong with Return on Average Assets at 1.76 per cent and Return on Average Equity at 14.88 per cent for the year 2008. The Bank continues to have a strong capital adequacy ratio of 19.30 percent calculated in accordance with Basel 2 and Central Bank of Bahrain guidelines. Liquidity continues to be comfortable with liquid assets (Cash and balances with central banks, Treasury bills and Placement with financial institutions) representing 25 percent of total assets.

### Net Interest Income

Net Interest Income at BD 46.06 million for the year reflects an increase of 9.2 per cent over 2007. The main drivers for the

increase in Net Interest Income are strong growth in Loans and Advances and Customer Deposits despite lower yield on surplus liquidity deployed in money market and investments in a falling interest rate environment.

The net interest margin, on average total assets, was 2.34 per cent for 2008 compared to 2.36 per cent for 2007, reflecting a marginal decline in interest spread in spite of a steep fall in the interest rates during the year as a result of tactical gapping strategies initiated by the Bank's Treasury and Investment Group. The primary focus has been to maintain adequate liquidity, especially after the liquidity problem spiralled into a full-grown solvency crisis by the end of third quarter.

### Other Income

Other Income for the year from core banking activities witnessed strong growth on account of increase in business volumes and profit from foreign exchange activities but was overall impacted by the mark to market losses on managed funds. As a result, total Other Income for the year was BD 16.60 million compared to BD 22.86 million for 2007.

Income stream of fees and commissions showed an impressive growth of 32.5 percent to BD 13.70 million for 2008. This is in line with the expansion in business banking, retail lending and cards business activities. During the year, the Bank increased its participation in syndicated facilities and lead managed certain syndications that translated into increased commission income. Increased volume of foreign exchange business due to improved regional economic growth and strong oil prices in the first half of the year and our emphasis on offering structured solutions to fulfil special needs of our clients resulted in exchange income increasing by 35.3 percent to BD 3.86 million for 2008.

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 24.01 million showed a marginal increase of BD 0.54 million or 2.3 per cent over the previous year. Staff Expenses increased marginally from BD 17.64 million in 2007 to BD 17.86 million in 2008 arising mainly from annual salary reviews, performance related rewards and accretion to the Bank's human resources in line with the business expansion needs. Other Operating Expenses increased marginally to BD 6.15 million from BD 5.83 million in 2007 associated with system upgrades to improve operational efficiency and enhance customer service. The operating efficiency ratio was 38.32 per cent for 2008 compared to 36.09 per cent for 2007, due to the negative impact of mark to market losses on managed funds on Total Income despite the Bank's continuous efforts to improve efficiency and enhance productivity.

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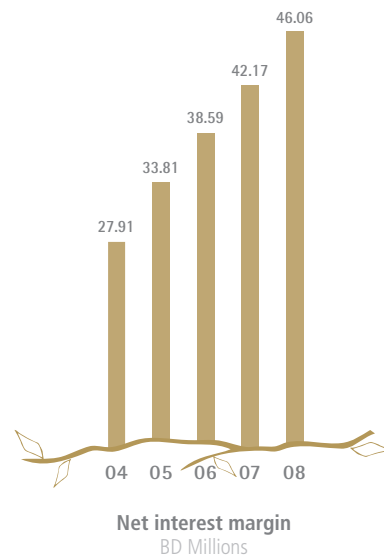
Non-performing loans decreased to BD 8.65 million, at the end of 2008 compared to BD 8.89 million at the end of 2007. The low levels of non-performing loans compared to the loan portfolio, is the result of the Bank's conservative credit risk policies, the effectiveness of credit risk management processes 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 7 to the Financial Statements

### 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. As a result of the improvement in asset quality and concerted efforts on recovering non-performing loans, an amount of BD 1.3 million was reversed during the year 2008. The Bank has also made 100 percent provision amounting to BD 5.21 million for investments in debt securities of institutions adversely impacted by the global financial crisis, where full recovery is in doubt.





The Bank's Loans and Advances portfolio is concentrated principally in Bahrain and other GCC countries.

### Assets

Total Assets at BD 2034.10 million, reflecting an increase of 6.8 per cent over 2007, is attributable mainly to a growth of BD 149.74 million in the Loans and Advances portfolio. At year-end 2008, Loans and Advances as a percentage of Total Assets was 53.9 per cent as compared to 49.7 per cent at the end of year 2007. The proportion of Placements with Banks & Financial Institutions and Investment securities to Total Assets were 20.2 and 19.6 per cent respectively.

The increase in the loan book was mainly due to enhanced participation in domestic and regional deals, syndicated facilities and club deals, strengthening and broadening of business relationships in Bahrain and GCC countries and the attractiveness of our consumer credit products. The Bank's Loans and Advances portfolio is concentrated principally in Bahrain and other GCC countries. Based on contractual maturity terms, 31.0 per cent of

the current portfolio matures within one year and 59.1 per cent is due to mature within 3 years of the balance sheet date.

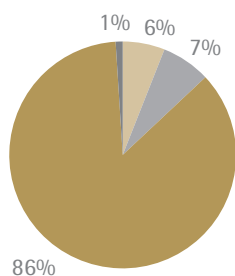
At the year-end, the Bank's Investments portfolio of BD 399.18 million (2007: BD 347.94 million) consisted of Available-for-Sale securities that comprised debt and equity securities while the Fair Value Through Profit or Loss investments comprised mutual funds and capital protected notes. A substantial portion i.e. 94.2 per cent of the total debt portfolio is in investment grade securities.

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

### Liabilities

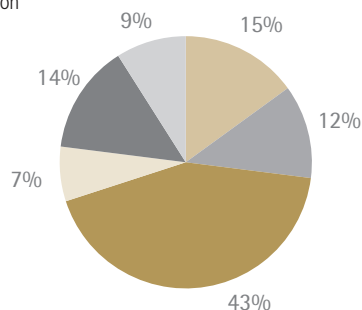
Customers' Deposits grew by BD 199.3 million or 15.1 per cent to BD 1,519.25 million as at year-end 2008, from BD 1,319.95 million at the end of 2007 with all segments of business showing growth with emphasis on generating core low cost deposits.

- Europe
- USA
- Middle East
- Others



Geographical Distribution of Assets

- Government
- Manufacturing / Trading
- Banks / Financial Inst.
- Construction
- Personal
- Others



Sector wise distribution of Assets

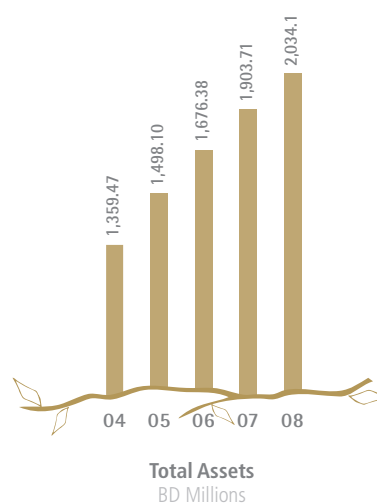
Borrowings under Repurchase Agreements and Deposits from Banks and Financial Institutions stood at BD 285.78 million at year-end 2008, BD 34.69 million lower than year-end 2007 levels of BD 320.47 million. At year-end 2008, the ratio of Customers' Deposits to Total Liabilities stood at 83.6 per cent compared to 79.8 per cent at the end of the previous year.

#### Capital Strength

Equity, inclusive of Proposed Appropriations, reflected a balance of BD 217.39 million. At the year-end, Equity as a percentage of Total Assets was 10.7 per cent.

The Bank's capital adequacy ratio at the balance sheet date was 19.3 per cent with Tier 1 ratio at 17.4 per cent. The ratios have been calculated in accordance with the Basel 2 and Central Bank of Bahrain guidelines.

The Bank's capital adequacy ratio, encompassing credit, operational 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 and Basel 2 – Pillar 3 disclosures provide further details on capital adequacy. The main factors that contribute to the Bank's strong capital adequacy ratio are high 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.





### NBB has over the years, developed risk management into a core competence and remains well positioned to meet challenges.



**Raveendra Krishnan**  
Executive Assistant General Manager  
Credit Policy & Risk Management

#### Risk Management

In a world characterised by high integration of global financial markets, innovation in financial products, extensive use of derivatives, market volatility 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 remains well positioned 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. The Trade Finance and Financial Institutions unit is involved in identifying and financing trade flows between the GCC region and the rest of the world. Commercial Banking's responsibilities cover the borrowing requirements of the small to medium-sized companies based in Bahrain. Retail Banking controls the lending portfolio to individuals in Bahrain and other retail services. Treasury and Investment is responsible for all the treasury and investment related activities of the Bank and the Abu Dhabi and Riyadh Branches serve the UAE and Saudi Arabian markets respectively.

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 from 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.

Risk management at NBB has always been conservative and proactive with the objective of achieving a balanced relation between risk appetite and expected returns.

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.

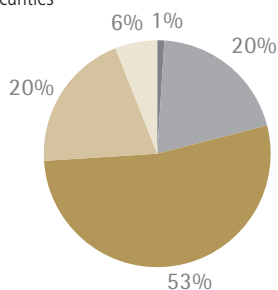
In addition to rigorous credit analysis, the terms and conditions of all credit facilities are strictly implemented by the Credit Administration Department. An internal grading system and review process ensures prompt identification of any deterioration in credit risk and consequent implementation of 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 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

identify accounts which witness a deterioration in risk profile.

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.

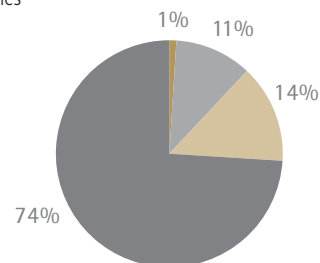
The Bank enters into derivative contracts in the normal course of business to meet customer requirements and to manage its own exposure to fluctuations in interest and exchange rates. The credit risk arising from a derivative contract is calculated by taking the cost of replacing the contract, where 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 16 to the Financial Statements.

- Treasury bills
- Placements
- Loans and advances
- Investment securities
- Other assets



Composition of total assets  
Per cent

- Equity
- Due to banks & Repos
- Customers' deposits
- Other liabilities



Composition of total liabilities and equity  
Per cent



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 2008, the Bank's provisions exceeded the entire non-performing portfolio.

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.

**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.

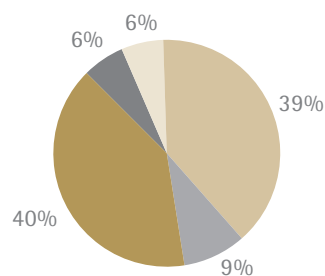
In-house expertise together with firms of international repute retained by the Bank ensures that the facility documentation encompasses eventualities that might affect the implementation of stipulated terms and conditions.

**Liquidity Risk**

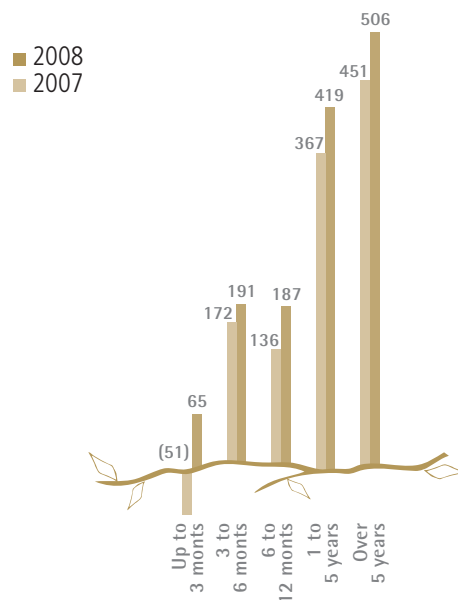
Liquidity Risk is classified as the potential inability of a bank to meet its financial obligations on account of a maturity mismatch between assets and liabilities. Liquidity risk management ensures that funds are available at all times to meet the funding requirements of the Bank. The asset/liability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

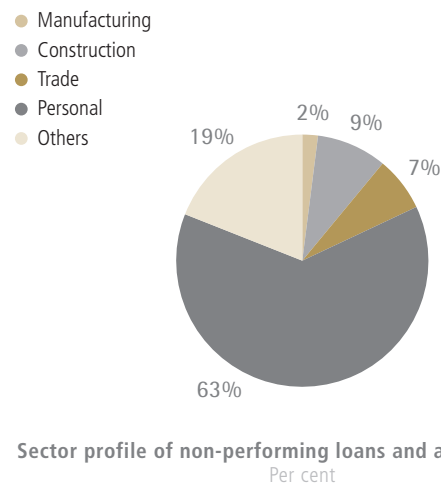
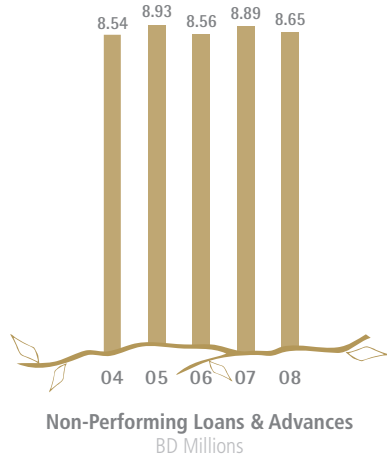
- AAA
- AA
- A
- BBB
- Non-Rated



Investment Securities by rating  
Per cent



Cumulative interest rate sensitivity gap  
BD Millions



to provide for secondary sources of liquidity. The ratio of liquid assets to total assets as at 31 December 2008 was 25 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 times. The asset and liability maturity profile by individual asset and liability category based on contractual repayment arrangements is detailed in Note 34 to the Financial Statements. As at 31 December 2008, 35.2 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 Chief Executive Officer, reviews the Liquidity Gap Profile and the Liquidity scenario and addresses strategic issues concerning liquidity.

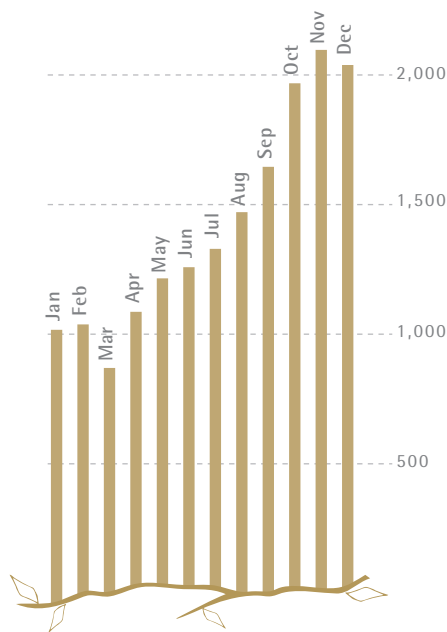
#### Interest Rate Risk

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 2008. A negative gap denotes liability sensitivity and a positive gap denotes asset sensitivity. Note 31 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 0.92 per cent on 31, December 2008 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 2.29 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.



Value-at-risk at month end - 2008  
BD (thousands)

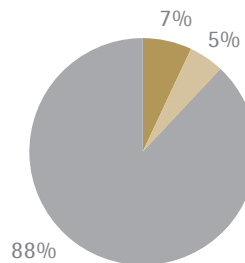
## Market Risk

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 BD 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.

- Interest Rate
- Foreign Exchange
- Others



2008 Average VaR by Risk category  
Per cent

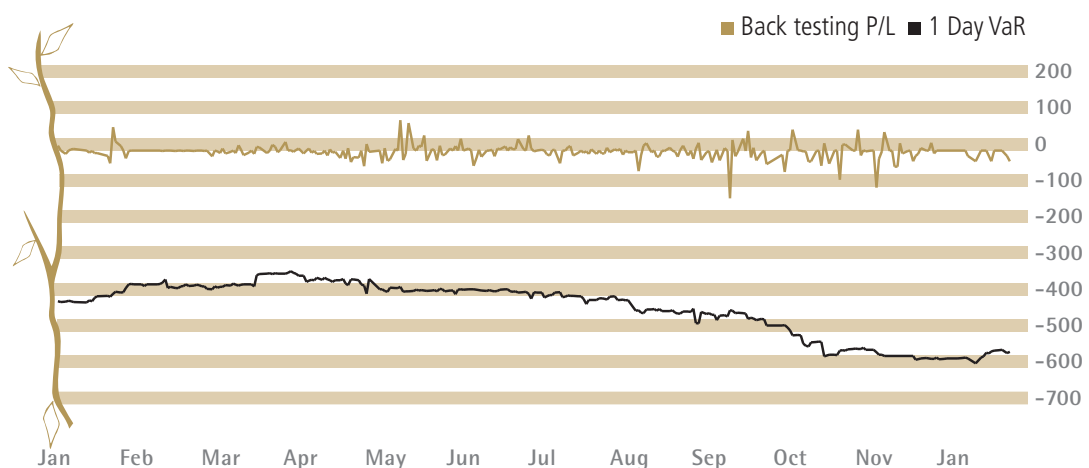
The Bank's trading activities are governed by prudent policies, by adherence to limits set annually and by regular reviews. Quality and rating are the main criteria in selecting a trading asset. The Bank uses the Value-at-Risk (VaR) measure to estimate the exposure of the trading portfolio and total currency book to market risk.

The 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 2008 was BD 2.01 Million for a 99 per cent confidence level and a 10 day time horizon. The average VaR for the last 60 days of 2008 was BD 2.02 Million.

The Value-at-Risk at month end chart shows a monthly trend of VaR from January to December 2008. During this period, the maximum VaR was BD 2.11 Million on 18 December 2008 while the minimum VaR was BD 1.07 Million on 31 March 2008.

The Value-at-Risk back-testing chart shows the Bank's 1-day VaR compared to its daily trading profit and loss from January to December 2008. The Bank uses back-testing to validate the VaR model. VaR is compared with 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.



Value-at-risk backtesting January-December 2008  
BD (thousands)



## Financial Review

Back-testing results confirm that the internal model adequately captures risk within the Bank's trading portfolio

### 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.

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

All the aspects of risks 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.

