BRANCHES

	telephone	fascimile		telephone	fascimile
Head Office	802 000	2462973	Al-Yermouk	5337769	5525945
Airport	4735295	2405830	Arraya	2997606	4735294
Al-Ahmadi	3987902	4836968	Fahed Al-Salem	2432826	5632275
Al-Dumna	5728877	5319904	Gharnata	4860357	5735680
Al-Fahaheel	3926216	5329275	Hawali	2625724	4860376
Al-Farwania	4740050	4733866	Kifan	4837556	4838264
Al-Ghazali	4848537	4555830	Ministries Complex	2494033	2997609
Al-Jabria	5329274	3981289	Sabah Al-Salem	5516357	3930961
Al-Jahra	4555820	2625726	Salwa	5615668	2494031
Al-Koot	3930960	3926215	Shamiya	4927174	2312504
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bkme.com

His Highness
Sheikh Sabah Al-Ahmad
Al-Jaber Al-Sabah

Emir of the state of Kuwait

His Highness
Sheikh Nawaf Al-Ahmad
Al-Jaber Al-Sabah

Crown Prince of the state of Kuwait

His Highness
Sheikh Naser Al-Mohammad
Al-Ahmad Al-Sabah

Prime Minister of the state of Kuwait

INTRODUCTION

making life simple

bkme has been a landmark in Kuwait's heritage and banking history for over 65 years. During this time, the Bank has grown and developed with the country, ever present during the highs and lows, true to its mission to serve its customers' needs and loyal to the country's traditions and values.

As Kuwait continues to grow economically, the demands and requirements for financial services have become more exacting and diversified. In order to best serve the people of Kuwait, bkme realizes the necessity for the Bank, to grow and evolve together with these developments. In 2007, the Bank will be integrated with the Ahli United Bank Group (AUB); a move that will open up a whole new array of opportunities and a wealth of resources enabling us to offer new and enhanced products and services only a regional presence can support and implement.

Our focus will remain the same: to 'make life simple' by offering premier customer service from a team of dedicated professionals, trained to the highest standards with the ability to deliver products and services specifically targeting the needs of our existing customers as well as attracting new customers.

During 2006, processes and procedures have been streamlined and brought into line with AUB Group protocols. In 2007, we anticipate a seamless integration and look forward to concentrating our efforts on forging ahead, thus creating excellent benefits and returns for customers and shareholders alike.

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ANNUAL HIGHLIGHTS AND FINANCIAL PERFORMANCE

Achieved a net profit in 2006 of KD 45.11 million, an increase of 13% over 2005.

Earnings per share rose by 21% to 59.3 fils.

Recommended the highest ever cash distribution in the history of bkme of 50% (50 fils per share).

Capital adequacy ratio calculated under Basel II accord stands at 18.14%.

Ahli United Bank Group awarded the 'Best Bank in The Middle East and Africa' by Global Finance and 'Global Bank of The Year in The Middle East' by The Banker.

Private Banking Division awarded by Euromoney the 'Best Local Private Bank in the Middle East'.

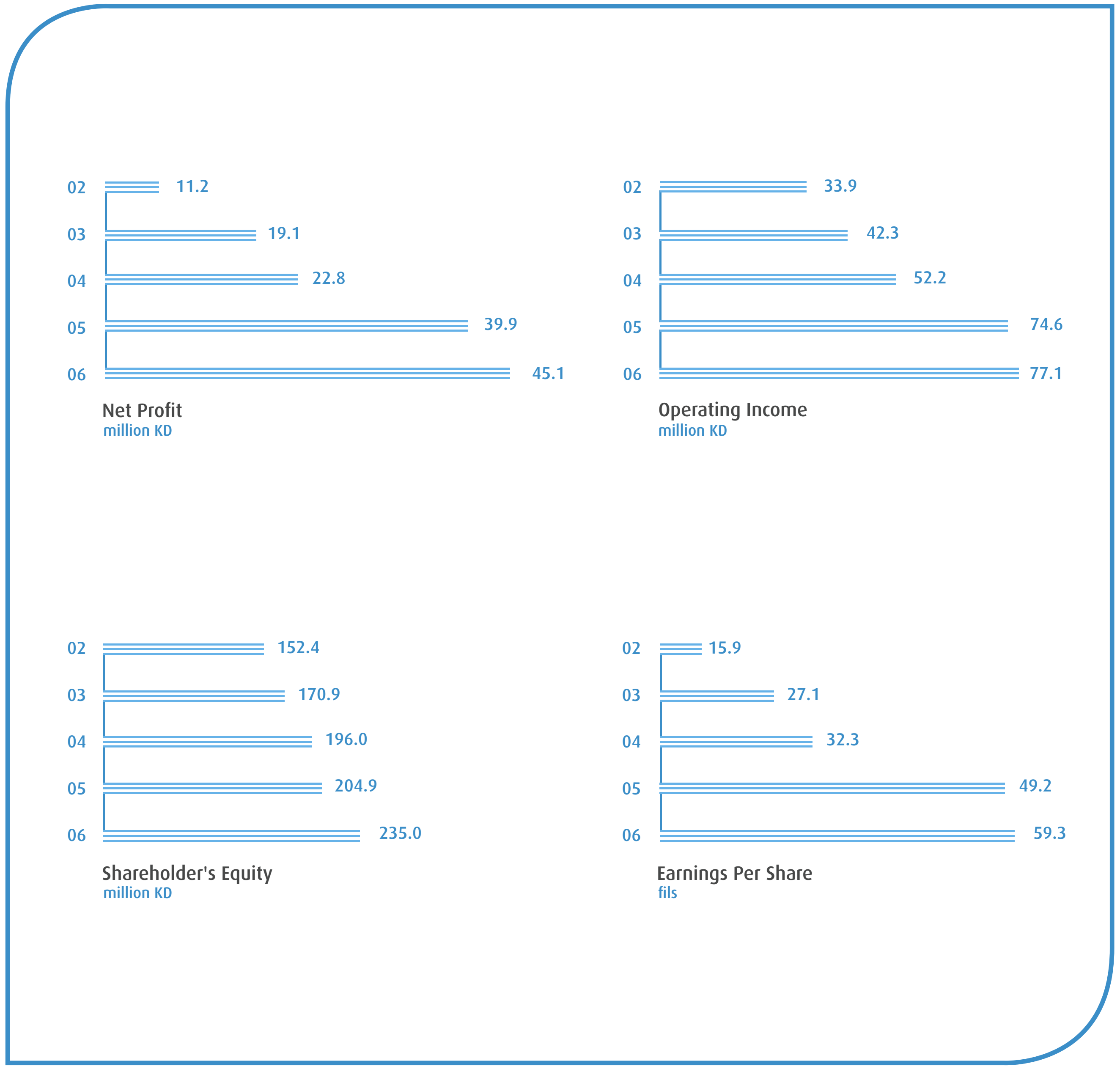
Successful implementation of 24/7 Customer Contact Center.

Introduction of the 'Service Excellence' employee assessment and coaching programme, and the 'Ideal Branch' Award.

Kuwait Stock Exchange, Dubai Financial Market, Abu Dhabi Securities Market and the US Market provided to traders via traditional and electronic channels, such as Private Diwaniyas, Branch eTrading Corners, on-premises alliances, and special training centers.

Anti-Skimming hardware and software installed on all ATMs, the first in Kuwait and the second in the Middle East.

Opening of the first branch under the new architectural concept.



CHAIRMAN'S MESSAGE

On behalf of the Board of Directors, I have great pleasure in presenting the 2006 annual report and consolidated financial statements of bkme – the Bank of Kuwait and the Middle East. This year the focus has been very much on our incorporation into Ahli United Bank Group (AUB), one of the region's premier financial groups, whilst still outperforming last year's profits and continuing to provide excellent products and outstanding services to our valued customers.

Now, with the flourishing economy and dramatic expansion and diversification Kuwait is currently enjoying, the time has come for the Bank to provide the necessary products and services to facilitate the demands of our economic growth. We see our integration with AUB Group as a major step to serve our customers in excess of their requirements by being able to offer a true regional presence with global recognition. It is indeed a proud and prestigious moment and we look forward to forging close professional and personal relationships, combining expertise and local knowledge with a regional network in order to become the Bank of choice in Kuwait.

AUB Group's reputation is well known. Awarded 'Best Bank - Middle East and Africa 2006' and 'Global Bank of the Year 2006 - Middle East' by the well-reputed magazines "Global Finance" and "The Banker" respectively, the integration with AUB Group offers an enormous motivational drive and challenge to build and innovate together for higher rewards. We see the continued success of Private Banking as a target for excellence and keenly welcome the opportunity to broaden our scope geographically as well professionally, extending our reach to attract new customers and to provide existing customers with an innovative range of products and services only a regional standing can offer.

The continued domestic economic growth and product expansion by the Bank has resulted in an agreeable net profit in 2006 of KD 45.11 million, an increase of 13% over 2005. This was derived from a total operating income of KD 77.15 million showing an increase of KD 2.55 million over the previous year. Total assets achieved substantial growth to KD 1,929 million whilst shareholders' equity grew to KD 235 million. Earnings per share rose to 59.3 fils, a significant rise of 21%.

These results have led to a considerable improvement in the Bank's key financial ratios – the Return on Average Assets to 2.7% (2.5% in 2005), and Return on Average Shareholders' Equity to 21.5% (20.5% in 2005).

In light of these rewarding results, the Board of Directors recommended the distribution of cash dividend of 50% (50 fils per share for the year ended 31st December 2006), the highest ever cash distribution in the history of bkme.

bkme's capital adequacy ratio calculated under the Basel II accord stands at a comfortable 18.14% enabling the Bank to expand its asset base.

Continuing to build on our promise to 'make life simple' there have been significant enhancements across the board to simplify and offer more directly focused products and services, therefore efficiently benefiting our customers. One of the major initiatives this year has been the successful implementation of a 24hr call center to deal with both banking and non-banking issues. The call center has the invaluable benefit of centralizing and channeling information between the Bank and customers. Once the process is enhanced during 2007, by the routing of branch calls as well, customers will be offered a single number option covering a whole range of services. This, along with additions to our extremely successful partner programme, launched last year, and considerably improved Credit Card services, has significantly increased customer satisfaction and approval of our offerings. The opening, this year of our 'concept branch' has further streamlined and enhanced services and we look forward to more branch openings in the coming year as well as convenience initiatives both in locations and services.

Restructuring within the Bank continued apace during the year. This has partly been undertaken to be in line with AUB Group's systems and procedures but also, as in the case of Corporate Banking and e-banking,

"The integration with AUB Group offers an enormous motivational drive and challenge to build and innovate together for higher rewards".

CHAIRMAN'S MESSAGE (CONTINUED)

to simplify the handling of portfolios for both the Bank and the customer. The new systems in place allow flexibility for further growth and diversity in order to cater to the specific needs of each and every customer in a coherent and comprehensive manner whilst also ensuring staffing levels remain at a satisfactory ratio.

The HR development has had a challenging year and has striven to augment cross department relationships by coordinating and cooperating closely with relevant departments on initiatives and incentives throughout the year as well as implementing required and desirable training. Their input into the motivation and well-being of the staff at all levels has been commendable and they have successfully achieved a motivated team of committed individuals working with, and for one another, at a time when it is most crucial.

Information Technology remains at the forefront of the Bank's success in making life simple. Their constant upgrading and sourcing of ground-breaking technology, up to the minute processes and accurate and professional application continues to enhance both our services and our reputation for leading edge attainment. That said, the department has been able to make the adjustments for compatibility with AUB Group and still managed to improve customer services and security. An ambitious new Treasury system is planned for 2007 as well as other sophisticated applications for systems and services focusing on security and customer satisfaction showing their dynamic approach in this important area of the Bank.

2007 will be an exciting and challenging year all round. It is the start of a new era we step into well prepared, confident in our abilities and mindful of the vast potential our cooperation with AUB Group offers. The advantages of being part of a regional group with international operations opens up a wealth of opportunities to maximize return on investment for our shareholders, increased services and products for our customers and great opportunities for career development for our existing staff whilst becoming a very attractive employer for those interested in a banking career.

I take this opportunity on behalf of the Board of Directors to wish His Highness the Emir Sheikh Sabah Al Ahmad Al-Jaber Al-Sabah continued health and prosperity in the coming year. Our best wishes also to His Highness Crown Prince Sheikh Nawaf Al-Ahmad Al-Jaber Al-Sabah.

As always, my sincere thanks to our shareholders for their unfailing support and confidence and, of course, to our loyal, valued customers for their trust in us.

The last word however, must go to the management and staff of bkme. In what has been a challenging year of restructuring and reorganization they have dedicated themselves above and beyond the call of duty to ensure a smooth transition in the spirit of true cooperation whilst upholding their promise to serve our customers to the highest standards possible. I wish them all the greatest success in the coming year and look forward to our progressing together onto greater things.

HAMAD ABDULMOHSEN AL-MARZOUQ
Chairman and Managing Director

"Continuing to build on our promise to 'make life simple' there have been significant enhancements across the board to simplify and offer more directly focused products and services, therefore efficiently benefiting our customers".

BOARD OF DIRECTORS

Mr. Hamad Abdul Mohsen Al-Marzouq
Chairman & Managing Director

Mr. Faisal Abdul Rahman Al-Medlij
Deputy Chairman of the Board

Mr. Jamal Shaker Al-Kazemi
Board Member

Mr. Abdul Hameed Al Meamari
Board Member

Mr. Adel Mohammad A. El-Labban
Board Member

Mr. Abdul Wahab Marzouq Al-Marzouq
Board Member

Mr. Mohammad Saleh Behbehani
Board Member

Mr. Sanjeev Baijal
Board Member

EXECUTIVE MANAGEMENT

Mr. Ahmed Mohammed Zulficar
Deputy CEO Risk, Finance & Operations

Mr. Medhat Fouad Tawfik
Assistant General Manager
Head of Private Banking & Wealth Management

Mr. Thunayan Mohammad Al-Ghanim
Treasurer

Mr. Sherif Saad Al-Essawi
Head of Corporate Banking

Mr. Ramy Salah El-Din Sobhy
Head of Financial Institutions

Mrs. Iman Wajeeh Al-Madani
Head of Human Resources

Mr. Rushdi Moustafa Abou Samra
Head of Legal & Board Secretary

Mrs. Jehad Saud Al-Humaidhi
Head of Information Technology

Mr. Saeed Essa Al-Nawfal
Head of Operations Group

Mr. James Eugene Galligan
Head of Retail Distribution

Mr. Tanu Geol
Head of Audit

Mr. Viswanathan Balram
Head of Finance

MANAGEMENT REVIEW

Retail Distribution

Innovative products launched during 2006 have led to considerable growth in new customers in retail banking and in 2007, we look forward to continued success and development including an increased focus on customer interactions to make their lives simple and provide unparalleled levels of customer service in the region.

Some of the new initiatives implemented in 2006 have included service excellence, mystery shopping and ideal branch staff incentives which have increased both customer satisfaction and the level of overall business. The expansion of the direct sales force has also enhanced customer service and satisfaction as their reputation for high efficiency, excellent service and energetic enthusiasm continues to grow. New products for the expatriate community have been launched successfully and are considered the best available for this market segment in Kuwait.

Customer convenience has been heightened by the opening of three new branches and an increase to four for the number of branches open from Saturday to Wednesday, thus offering a Saturday to Thursday service.

Our current plan is for a dramatic increase in the number of branches in 2007 and 2008, particularly in residential locations, including kiosk branch services where the focus is to provide convenience to customers by offering essential branch services simply and efficiently.

We look forward to building on the success of our 'concept branch', opened in 2006, which offers new and unique services including online trading facilities, a welcoming, customer friendly design and a brand new approach to customer interaction including coffee area, interactive product information and special trading rooms. This is in line with our strategic direction to provide easily accessible services within the community.

A core element of our strategy will be the continued development of our value added acquisition initiative. A key offering this year was salary cash backs; a unique offer from bkme. More directly, the launch of the Al Hassad Al Rabeh draw has been an attractive incentive to customers, offering the largest amount of prize money (up to KD 3 million), and is unique in its frequency and number of prizes awarded.

As we move into 2007, we look forward to our total integration with Ahli United Bank Group. This alliance has already allowed our customers to benefit not just from local financial but the expanded regional presence of the Group including the GCC market. This has added invaluable service benefit, which will rapidly expand during 2007. We eagerly anticipate further development of our alliance in retail banking offering customers the undoubted benefit derived from group innovation and creativity across the board.

Corporate Banking

During 2006 Corporate Banking strategy has been brought into line with Group Policy in order to facilitate a smooth transition to Ahli United Bank Group in the year 2007. We see our association as a tremendous opportunity and greatly look forward to making proactive use of the Group's excellent resources, geographic presence and capabilities.

MANAGEMENT REVIEW (CONTINUED)

Corporate Banking (continued)

We also intend to introduce a specialized unit focusing on gaining more in-depth knowledge of various industries.

Throughout the year, we have continued to reinforce the bkme brand and have, and will, continue to make life simple for our customers by building up close and trusting relationships with our clients in order to respond accurately, efficiently and comprehensively to their specific needs.

Corporate Banking is the heart of bkme, and as such, we strive to liaise and cooperate by actively cross selling the entire range of products and services the Bank offers.

Treasury

Treasury continued to operate at a fast pace and implemented its plans for the interbank market. Concentrating on customer service was a continuing priority and with the co-operation of AUB Group, customer satisfaction was increased, adding value to both banks and auguring well for our association in 2007. Treasury is proud to announce its enhancement and diversification of its products and services which have met all bkme's customers needs.

The cost of funding, had potentially the most important impact; the increase of costs in customer and interbank deposits was obvious, but the impact was lessened due to bkme activities within the Kuwaiti market, the offshore market in KD and the welcome move by the Central Bank allowing local banks to lend KD to Offshore banks, a move very much appreciated by all.

In order to maintain this high degree of efficiency, thus providing excellent customer service, staff were sent on various courses conducted in-house and at the Institute of Banking Studies. In addition, regular on-the-job training was provided within the relative departments of the Group to broaden knowledge and understanding of all aspects of the department. This is seen not only as invaluable for staff but also gives a first hand experience of problems faced in other areas, so therefore, creating a more tolerant and cohesive group.

An even greater effort was made to assist customers in all matters relating to the various products and services being offered by our Group. Close cooperation initiated by our Account Officers, between themselves, clients and members of our Group, whenever they felt it was required took customer service to a higher level. To maintain this, testing was carried out at the Disaster Recovery Site and the Business Continuity Plan of the Division was revised and updated.

In 2007 we will witness the hiring of more professional employees which constitutes one of the key initiatives along with the finalization of the new dealing system.

Trade Finance and Treasury Operations

2006 was the focal point to increase and maintain a high degree of efficiency and excellence in customer servicing. In order to achieve this goal, the staff went through selected courses conducted in-house and at the Institute of Banking Studies, besides regular on-the-job training.

The Division successfully carried out testing at the (Disaster Recovery Site) and the Business Continuity Plan of the division was revised and necessary changes were incorporated into the manual.

bkme's customers were assisted in all matters relating to the various products and services being offered by the Bank. Furthermore, highly qualified Account Officers met with customers and members of the Bank with the objective of enhancing our level of customer service.

A number of SWIFT message formats pertaining to Trade Finance underwent a series of changes as a result of which System changes were applied and extensive testing was carried out to ensure that the System would generate the messages in the appropriate format and therefore achieving Straight Through Processing.

Financial Institutions Group

During 2006, bkme's International Corporate Banking Division was reorganized and renamed as the "Financial Institutions Group". This Group reports now directly to Ahli United Bank's Financial Institutions Group. bkme's Financial Institutions Group is now fully integrated within AUB's Financial Institutions Group, and that has enabled a better management of the existing resources and at the same time capitalized on strengthening the existing relationships of each entity of AUB Group. Both Financial Institutions Groups strive to draw on the excellent business and trust that have been established over the years with the major financial institutions across the world.

In its new role, the Financial Institutions Group works very closely with all the Divisions of the various entities of the group with a view to better utilize all the resources of the existing large regional and international networks. This will support client diversification for all the business units of the Group and will provide the capability to better respond to our customers' needs and source new business opportunities and transactions such as financing large regional energy, water and power projects.

One of the major benefits of the Financial Institutions Group's reorganization is to secure increased coverage as well as to ensure optimal funding and servicing capabilities to all entities of the Group. Another added benefit is the ability to cross-sell the products and services of all the members and entities of AUB Group.

On a last point, the Financial Institutions Group has been instrumental in cooperating with the Electronic Banking Division which ultimately helped in the implementation, selling and marketing of the electronic trading products and services to regional and international financial institutions.

Marketing Communication Unit

2006 proved an exciting and a challenging year for the Division formerly known as Marketing and Business Development Division. In preparation of our integration with Ahli United Bank Group, the Division is now known as the Marketing Communication Unit - MCU. The sole purpose of MCU as of May 2006 is to coordinate marketing and product development initiatives with AUB Group. Streamlining resources and re-designing the function posed an enormous challenge met with enthusiasm and dedication by those involved.

During the course of 2006, the marketing activities have grown immensely with the launch of new products and services related to new deposit products, loans and credit cards. The new deposit products have been emphasized

MANAGEMENT REVIEW (CONTINUED)

Marketing Communication Unit (continued)

such as Al Hassad Al Rabeh, AUB Group's flagship product, introduced in Kuwait in March 2006, offering a huge amount of cash prizes worth KD 3 Million in total. Loans for locals offered salary cash back incentives and for expats, the Unique Selling Proposition loan product offered lending up to 22 times of salary. Towards the last quarter of 2006, to increase acquisition and usage of bkme's credit cards, we have successfully launched an exhilarating credit card program which Unique Selling Proposition was 0% interest on the credit cards outstandings transferred from another bank.

As part of the restructuring and enhancement of marketing operations in 2006, a dynamic new concept has been introduced to MCU: Marketing Intelligence, which is determined to create leverage for internal and external customers to ensure that they are as competitive and as well positioned in the marketplace as they can be. The Marketing Intelligence is central to the operations of bkme as it helps it to direct what information is gathered and how.

During the year, Marketing Intelligence has monitored and collected reliable information about competing products, converted information into intelligence and communicated data on newly launched products and services of bkme vs. competition, and that on a daily basis across all relevant departments. This has provided retail staff and Direct Sales Unit with an excellent insight and knowledge of competitors' products as well as being a powerful selling tool to promote our own with a directly competitive approach.

In line with the Bank's strategy, we have enhanced our Management Information System in order to better measure and scale marketing initiatives in respect to product performance, impact of advertising campaigns and market penetration.

Human Resources

During 2006 Human Resources Division has been responsible for a number of initiatives and assessments focused on personal and career developments for staff whilst enhancing services to our customers.

Training programs have included the award of an Investment Management Certificate through bkme for Group Private Banking and Wealth Management and CBBM certification to a number of Branch Managers and the Manager of Direct Sales Unit.

Human Resources Division, in coordination with Business Planning and Quality Assurance Division, initiated a sequence of "Let's Make A Difference" one day training workshop during the period from July to September 2006 attended by all branch staff and to be extended to the rest of the Bank's staff in Phase Two.

Focusing mainly on the benefits of positive attitude, positive thinking, abilities and achievements, superior customer service and customer service standards, the workshops were valuable in diverting and creating the operational culture into a solid positive sales and service culture across the Bank.

Continuing to enhance and strengthen the sales and services culture, several high-level training programs were conducted and were addressed to Managers and Senior Managers from different Business Areas. Out of those programs was the "Customer Focused and Relationship Manager" delivered by Professor Anthony Hourihan (a Professor at Harvard Business School and tutor at Insead Training Institute), which addressed the various critical success factors of competitive market and equipping the audience with tools to do so.

Over the year, one of our aims has been to attract highly caliber employees with strong potential to the Bank and structure a Sales Team, who collectively and individually, will penetrate the market in an aggressive yet professional approach to attract and widen the customer base and eventually increase bkme's market shares. In order to achieve this, a total of one hundred fifty nine new employees joined the Bank, out of which twenty-three were Direct Sales Officers and fifty-seven in retail and branches. The newly formed Customer Contact Center boasts fourteen agents, and we have welcomed others to almost every department within the Bank.

Other staff initiatives during the year have included a Retail Ceremony celebrating the great success of the "Retail Loans Campaign". Sales Champions were awarded Appreciation Certificates, as were many other Star Performers in the Retail area.

To introduce a competitive spirit between the Branches, the Ideal Branch Program was activated. This proved a great success with Fahad Al Salem Branch winning for the first two quarters and awarded "The Ideal Branch Of The Year" of 2006, while Gharnata and Ministries Complex Branches won for the third and for the fourth quarters respectively.

As we look forward to and in anticipation of joining the AUB Group in 2007, an orientation session for the Human Resources team on Competency Based System was run at AUB Bahrain. This useful session included an introduction to a new Ofoq Human Resources system currently being tested for implementation, thus creating a cohesive Human Resources unity and bond across the Group.

MANAGEMENT REVIEW (CONTINUED)

Risk Management

In an ever-growing complex market, Risk Management becomes an even more invaluable asset to the shareholder. Continuing our efforts to successfully evaluate acceptable risk, this year has seen an enhancement of the risk management process by streamlining the organizational structure to ensure specialization in major risk areas.
During the year we have further strengthened our credit control process to improve overall asset quality.

By implementing new comprehensive Risk Rating models for obligors, we have facilitated a universal assessment of credit worthiness, which is speedier, simpler and more efficient. This, enhanced by better coordination with Business Units on the evaluation of their proposals, has ensured timely and proper credit decisions.

Services have been further improved by process re-engineering for the effectiveness of internal control mechanisms. This has been achieved by implementing Operational Risk Self Assessment (ORSA) and increasing the awareness for bankwide operational risk management by appointing and training business risk officers from each department.

Market risk is managed through a detailed policy and procedure and a set of various limits for each asset class. An independent unit, under the supervision of risk management, is monitoring the limit management the Bank uses stress-testing techniques to ensure that the market risk is managed in a robust manner.

As a group initiative, bkme is being assisted by an external consultant for implementing core activities of Basel II to incorporate best practices in risk management and implement proactive risk control architecture. bkme, along with the AUB Group, is enhancing its risk system infrastructure by implementing new applications for Basel II, including all areas of Risk Management. In addition, a comprehensive document outlining policies and procedures for Basel II compliance were finalized in fulfillment with the requirements of the Central Bank of Kuwait. This, along with the alignment of risk management processes with those adopted at AUB Group, shows a partnership at work and our preparedness for a smooth transition in 2007. Risk management process is further strengthened by maintaining a Disaster Recovery Site. It is supplemented by a comprehensive Business Continuity Plan, which is developed in close coordination with all departments of the bank, designed to minimize the disruption of services to bkme and its customers.

Information Technology

bkme's Information Technology Division continues to realise technological sophistication; it has a rich history of innovation and is one of the leaders in the Middle East in Information Technology in the banking sector. Having implemented the state-of-the-art systems both in hardware and software, our aim is to serve our customers anywhere and anytime, aided by the latest banking technology. bkme's leadership stems from its firm commitment in providing its customers with added value, convenience, confidentiality and security.

In 2006, some of the highlights of the main systems successfully launched were the Customer Contact Center, which is integrated with the Interactive Telephone Banking. In line with our ongoing mission to make life simple, customers now have a varying preference in the ways they choose to interact with the bank on a 24/7 basis.

Information Technology Division continues the development and integration of its remote channels. The Internet Banking system has been enhanced with more online options and the new SMS Banking service now provides its customers with timely alerts on their account updates.

Internal projects implemented in 2006 were mainly to provide high availability, speed and to ensure maximum data security at all levels. This has included a new Local Area Network at Head Office and reorganization of the main Data Center with automated high-tech monitoring screens. bkme values its customers' data integrity and Disaster Recovery has always been of prime importance. To this end, we now have a fully operational remote Business Continuity Plan Site and Anti-Skimming hardware and software on all ATMs; the first in Kuwait and the second in the Middle East.

Automation and enhancements were achieved towards its internal processes/systems, namely the popular Al-Hassad Al-Rabeh Draw, Loans system upgrades and several other enhancements to improve Branch Services based on standards set by the Quality Assurance Division.

In 2007, the Information Technology Division key deliverables will be a new Treasury system with advanced functionality, a new Group Internet Banking System, a Credit Scoring/Collection system and a Loans Workflow system to service customers in terms of application processing and turnaround standards. Enhancements to the Credit Card system with Chip Card technology are planned for greater service and security along with several other group level projects to be launched in 2007 aimed at optimizing resources for mutual benefits. The goal of the Information Technology Division is to maintain its high standards of excellence and to continue to attain a leading edge in the banking industry.

eBanking

The focus and the growth in eBanking business environment have accompanied the local market needs and expectations and lead to a range of sophisticated friendly channels and services. The role of eBanking has expanded and stretched to secure the best level of customer awareness and education. This has been exercised within the new banks' slogan in light of the total strategic approach to the delivery mechanism.

The flagship service of the Online Trading Channel has resulted in a remarkable increase in the number of traders and has generated an inflated demands that have been replied at by launching a new set of countries through which customers became able to trade from a single interface and at own convenience. In addition to Kuwait Stock Exchange, Dubai Financial Market, Abu Dhabi Securities Market and the US Market have all been provided to traders via both traditional and electronic channels, being Private Diwaniyas, Branch eTrading Corners, on-premises alliances, and within special training centers. All of this has been gathered within a professional segmentation of relationship acquiring to cover personal, corporate and international relationships. bkme eBanking continued with its unique approach to the Payment Gateway Activities to lock up reputable local and international bodies' websites for its customers via a state-of-art eSettlement Model. The total solution that bkme has secured to its merchants' aspects

MANAGEMENT REVIEW (CONTINUED)

eBanking (continued)

and partner eventually with one strong financial organization that offers both local and international solutions.

eChannels continued to guard the customer service delivery by ensuring that all segments of its customers are able to bank online via bkme net and continued to separate the range of services offered via full automation of retail and corporate essential transfer modes, utility payments, short messaging system and a drilling marketing tool for capturing the customers necessary details to communicate with them electronically and update them with ongoing enhancements to prepare them for its utilization and eventually secure both customer convenience and eDelivery of bkme set of products and services.

Quality Assurance and Business Planning

The Quality Assurance and Business Planning continued to drive improvements in the provision of services to make life simple for our customers.

Measurement and improvement of service delivery in Retail Banking and the timely resolution of customer complaints was the core of the Division's activities. Enhancements introduced during 2006 included a new IT-based Complaints Management System, extension of our 'mystery shopping' programmes, management information on account attrition, queuing time, branch staff productivity and a number of other significant initiatives.

The scope of service quality assurance was extended to the Customer Contact Center, Corporate Banking and Private Banking including complaints management, measurement of customer satisfaction and measurement of key services including corporate facilities, letters of credit and letters of guarantee.

Customer service was enhanced by the introduction of the 'Service Excellence' employee assessment and coaching programme and the 'Ideal Branch' award scheme. Further improvements in the processing of Retail loan applications were developed and are currently being implemented.

The close of 2006 saw the extension of the Balanced Business Scorecard, driven by Quality Assurance Division, to all Divisions within the Bank and its integration into our overall business and financial planning processes. The Balance Scorecard represents current 'best practice' and places bkme in the forefront of banks in the region. Its use will further enhance the Bank's ability to plan and manage its operations to suit customer needs.

Already, the positive impact of the bkme quality assurance function has been recognized. As we merge with AUB Group, similar units in other Group banks will be implemented in 2007 and beyond.

Technical Facilities

Responsible for new branch projects, renovation of existing branches and Head Office and the operation and maintenance of all building services and systems including telecommunications and security, the Technical Facilities Division had a busy year in 2006.

A key achievement of which we are justly proud was the completion of the new South Surra Branch which is the first based on the new bkme Branch Concept Design and state of the art technology, with the new prestigiously appointed Shamiya branch scheduled to open by the first quarter of 2007. The Yarmouk branch renovation was also completed and, in our continued effort to make life simple and more convenient for our customers, new services including a Safe Deposit area were introduced.

For 2007, branch relocations for two branches namely Ahmadi and Sabah Al Salem to brand new premises based on the new concept will be completed by Feb 2007, and the renovations of four more branches should be completed in the first half of the year. Our target is to further aid customer convenience by obtaining nine new locations for full size branches and three new service branches at different locations of Kuwait.

The Head Office renovation project has continued throughout the year including the newly opened Customer Contact Center and the splendid new Private Banking area expecting completion early 2007. In addition a new Control Room has been opened 24/7 to monitor the branches and technical upgrades include telecommunications from PBX to ISDN lines and CCTV and security systems to digital recorders. Further renovations are planned for the coming year: two office floors and the complete refurbishment of the ground floor branch in line with the new Group branch identity to facilitate a seamless integration with AUB Group.

Customer Contact Center

Further delivering our promise to make life simple and more convenient for our customers by offering new and improved services, one of the crowning achievements of 2006 was the successful implementation of a fully-fledged Customer Contact Center with NCR to serve our customers 24/7.

Fully integrated into bkme's IT infrastructure, the Customer Contact Center offers an extensive range of services both to the customer and the Bank. Features include tele-banking, an interactive voice response system facilitating retail transactions in line with consumer banking services, which include a number of financial specific inquiries, orders, card services and money transactions amongst others. This integration also means an efficient customer contact management system has been effectively introduced covering many key areas including agent management, calls handling, customer profile, information services and general request handling, amongst others, thus ensuring consistent monitoring and quality of service to customers.

Also as a valuable tool for the Bank, campaign management for sales opportunities and automated marketing strategies, in addition to marketing and complaints management can be easily implemented, monitored, assessed and enhanced as desired. This, with the proposed staff development by providing clear job descriptions and career plans as well as arranging formal and informal meetings to discuss agent's performance and quality of calls will also ensure a top notch services to our customers.

Additional services to the customer apart from the obvious requests, complaints and suggestions include an extremely useful and convenient range of credit cards functions building in fraud prevention, which are also applicable to ATM cards as well as handling KTel related issues.

Initiatives for 2007, other than continually improving service levels and further ATM and credit card services, will be to enhance communication between the Customer Contact Center and other areas of the Bank including IT, retail, private banking, marketing and card center making bkme's Customer Contact Center one of the most efficient and extensive in the region. A major project for next year will be automatic routing of branch calls to the Customer Contact Center. This implementation along with the simplicity of a single number will benefit bkme customers by offering a standardized form of delivery via a streamlined process – universal across all outlets. This will also have the added advantage for the Bank of reduced operational costs and improved management.

MANAGEMENT REVIEW (CONTINUED)

Card Business Center

Overall, 2006 has been a very productive and successful year for bkme and the Card Business Center whereby the total number of credit cards have grown by 82%, usage by 30% and outstandings by 50%.

The key success for the Card Business Center this year is the outstanding growth in the number of Cardholders and the launch of two new features, which when coupled with the new promotional campaigns, has had a direct impact on the growth of bkme card business.

One of the new products released this year is the innovative Balance Transfer product. The Balance Transfer product is the first of its kind in Kuwait and allows bkme and non-bkme Cardholders the opportunity to transfer their outstanding balance from another local bank's credit card to their bkme credit card and enjoy three months of free interest on the transferred balance. This new feature aims to drive up the credit card outstanding balance whilst offering the customer a clear benefit with 0% Interest for three months.

Additional enhancements for 2006 have included an up to 25% discount on Emirates airlines, the enhanced new Travel Insurance offer, our successful partnership with Sahara Golf Club facilitating subscription payment by twelve easy installments, and for 2007 much more is planned.

In addition to focusing on new product benefits and enhancing credit card sales, there has been significant success in customer service improvement through the introduction of IVR through the Customer Contact Center. This has greatly improved speed and accessibility for customers with all general enquiries and temporary limit increases being handled by the Center. In addition, the Card Business Center has signed a service contract with K-Post to deliver all bkme credit cards via special courier directly to the customer, thus saving time and trouble for customers. The Card Business Center continues to work closely with the Customer Contact Center on the development of products and services from feedback provided by the customers to ensure we maintain our competitive edge within the market.

Community

As part of our ongoing commitment to the country, we have continued throughout 2006 to help and support the community both through charitable and humanitarian sponsorships as well as recruitment initiatives.

We have broadened our scope further to encourage high caliber Kuwaiti graduates to now become a meaningful part of our employees and constantly aim to source and educate through local schools and universities and actively engender national interest in both the country's growth and development.

We look forward next year to offering even more job opportunities and will continue to actively participate in Kuwait's thriving community in whatever way appropriate and possible.

Private Banking

During 2006, Private Banking has continued to develop and enhance its products and services in order to best serve the interests of its valued clients in Kuwait and to attract new clients to its portfolio. Living up to our award from Euromoney as the 'Best Local Private Bank in the Middle East' as well as AUB being ranked the 'Best Local Private Bank in Bahrain' and the 'Best Private Bank for Real Estate Investment in Bahrain', our aim has been to provide innovative products and unparalleled service from experienced and professional staff.

One of the main initiatives successfully implemented was Investment Management Certificate (IMC) Training. This certificate is an absolute pre-requisite for investment business professionals in the UK but the training undertaken by bkme staff and AUB Group staff from Bahrain and Qatar was a Middle East first. As a result, AUB Group's Private Banking clients will be able to benefit from the highest level of service at international standards from our newly qualified IMC employees across the Group.

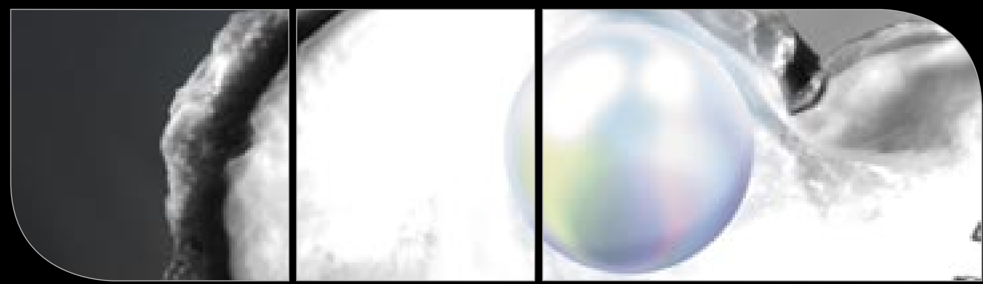
Just some of the services we offer, designed for convenience and simplicity for our clients, include Real Estate Investments, Structured Products, Capital Protected Deposits, Trust and Offshore Companies, Asset Management providing an innovative range of products reflecting the Bank's customer focus on a wide range of investment solutions including Sharia'a compliant Islamic products.

Building on our already excellent reputation in this area, Real Estate Fund Management offers Financial Analysis and Control for both investment and portfolio as well as extensive research on economics, markets and portfolio allocation. Asset Management is also handled exclusively for Real Estate including stock selection, value enhancement and dispositions and areas such as administration and reporting procedures, tax planning and corporate structure are also handled with the added service of Islamic or Sharia'a compliant mortgages being offered as well as conventional to suit our clients' needs.

Our international services and strategic alliances include Russell, MAN, Mellon Global Investors, Henderson Global Investors, specialists in international Real Estate Fund Management, AUB (UK) Trustee Guernsey Ltd offering tax-efficient trusts or companies to hold investments and properties and MFS Investment Management who specialize in investment products. In addition, in 2006, a Real Estate Fund was designed and successfully launched in association with Maple Tree.

The Private Banking profile has been heightened during 2006 by strategic alliances forged with prestigious companies such as Gulf Insurance Company, Tiffany and Company and Sahara Golf Club who offer exclusive benefits and privileges to holders of our select "Exclusiv" ATM card.

In 2007, we look forward to further entrenching our position as the Private Banking and Wealth Management Institution of choice for the region. We will also expand the presence of our Relationship Managers to be in strategic locations where most of the high net worth individuals reside and seek the private banking service. More specifically, Shamiya branch will be the first location.



CONSOLIDATED FINANCIAL STATEMENTS 2006

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INDEPENDENT AUDITORS' REPORT TO THE SHAREHOLDERS

THE BANK OF KUWAIT AND THE MIDDLE EAST K.S.C.

We have audited the accompanying consolidated financial statements of The Bank of Kuwait and The Middle East K.S.C. ('the Bank') and its subsidiary ('the Group') which comprises the consolidated balance sheet as at 31 December 2006, and the consolidated income statement, changes in equity and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

The Bank's management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards as adopted for use by the State of Kuwait. This responsibility includes: designing, implementing and maintaining internal controls relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgement, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Group as of 31 December 2006 and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted for use by the State of Kuwait.

Report on Other Legal and Regulatory Matters

Furthermore, in our opinion proper books of accounts have been kept by the Bank and the consolidated financial statements, together with the contents of the report of the Board of Directors relating to these consolidated financial statements, are in accordance therewith. We further report that we obtained all the information and explanations that we required for the purpose of our audit and that the consolidated financial statements incorporate all information that is required by the Capital Adequacy Regulations issued by Central Bank of Kuwait as stipulated in CBK Circular number 2/BS/184/2005 dated 21 December 2005, Commercial Companies Law of 1960, as amended, and by the Bank's Articles of Association, that an inventory was duly carried out and that, to the best of our knowledge and belief, no violation of Capital Adequacy Regulations issued by Central Bank of Kuwait as stipulated in CBK Circular number 2/BS/184/2005 dated 21 December 2005, Commercial Companies Law of 1960, as amended , or of the Articles of Association have occurred during the year ended 31 December 2006 that might have had a material effect on the business of the Bank or on its financial position.

We further report that, during the course of our examination, we have not become aware of any material violations of the provisions of Law No. 32 of 1968, as amended, concerning currency, the Central Bank of Kuwait and the organisation of banking business, and its related regulations, during the year ended 31 December 2006.

WALEED A. AL OSAIMI
Licence No. 68 A
of Ernst & Young

BADER A. AL-WAZZAN
Licence No. 62 A
of PricewaterhouseCoopers

16 January 2007
Kuwait

CONSOLIDATED INCOME STATEMENT
Year ended 31 December 2006

	Notes	31 December 2006 KD 000	31 December 2005 KD 000
Interest income		**110,806**	77,823
Interest expense		**(68,435)**	(39,888)
Net interest income		**42,371**	37,935
Fees and commissions		**19,607**	18,342
Foreign exchange gains		**2,158**	2,029
Realised/unrealised gains on investments at fair value through profit or loss		**752**	3,061
Gains on sale of investment securities		**7,814**	8,602
Dividend income		**3,478**	3,669
Other income		**976**	964
Total operating income		**77,156**	74,602
Provision for impairment	15	**1,300**	6,151
Operating income after provisions		**75,856**	68,451
Staff costs		**14,389**	12,519
Depreciation		**1,510**	1,569
Other operating expenses		**8,668**	7,675
Total operating expenses		**24,567**	21,763
PROFIT FROM OPERATIONS		**51,289**	46,688
Contribution to Kuwait Foundation for the Advancement of Sciences (KFAS)		**(457)**	(410)
National labour support tax (NLST)		**(1,229)**	(1,152)
Directors' fees	14	**(154)**	(140)
PROFIT FOR THE YEAR		**49,449**	44,986
Attributable to:			
Bank's equity shareholders		**45,111**	39,919
Minority interest		**4,338**	5,067
		49,449	44,986
Basic and diluted earnings per share (fils)	16	**59.3**	49.2

CONSOLIDATED BALANCE SHEET
31 December 2006

	Notes	31 December 2006 KD 000	31 December 2005 KD 000
ASSETS			
Cash and balances with banks	3	**173,727**	92,179
Treasury bonds	4	**277,501**	279,304
Certificates of deposit		**44,457**	-
Investments at fair value through profit or loss		**21,926**	15,408
Due from banks and deposits with financial institutions		**248,105**	224,826
Loans and advances	5	**922,987**	757,827
Investment securities	6	**118,014**	104,215
Kuwait government debt bonds	7	**52,381**	93,067
Premises and equipment	8	**20,178**	16,777
Other assets and intangibles	9	**50,130**	29,114
TOTAL ASSETS		**1,929,406**	1,612,717
LIABILITIES AND EQUITY			
LIABILITIES			
Due to banks and other financial institutions		**428,766**	357,440
Deposits from customers		**1,068,443**	938,997
Certificates of deposit		**103,500**	-
Term loan	10	**28,914**	58,400
Other liabilities	11	**42,852**	31,424
		1,672,475	1,386,261
EQUITY	12		
Share capital		**84,473**	70,394
Reserves		**194,581**	178,480
		279,054	248,874
Treasury shares	13	**(43,957)**	(43,957)
Equity attributable to Bank's equity shareholders		**235,097**	204,917
Minority interest		**21,834**	21,539
		256,931	226,456
TOTAL LIABILITIES AND EQUITY		**1,929,406**	1,612,717

Hamad Abdul Mohsen Al Marzouq
Chairman & Managing Director

Faisal Abdul Rahman Al-Medlij
Deputy Chairman

STATEMENT OF CHANGES IN EQUITY
Year ended 31 December 2006

	Share capital KD 000	Share premium KD 000	Statutory reserve KD 000	General reserve KD 000	Retained earnings KD 000	Cumulative changes in fair values KD 000	Property revaluation reserve KD 000	Treasury shares reserve KD 000	Foreign currency translation reserve KD 000	Total reserves KD 000	Treasury shares KD 000	Minority interest KD 000	Total KD 000
	Attributable to the equity shareholders of the Bank		Reserves										
Balance as at 31 December 2004	70,394	12,883	30,693	13,876	37,224	30,087	-	954	7	125,724	(76)	16,254	212,296
Revaluation of freehold land	-	-	-	-	-	-	9,784	-	-	9,784	-	-	9,784
Changes in fair values of available for sale investments	-	-	-	-	-	17,222	-	-	-	17,222	-	-	17,222
Transferred to income statement on sale of available for sale investments	-	-	-	-	-	(4,423)	-	-	-	(4,423)	-	-	(4,423)
Other equity movements of subsidiary	-	-	-	-	89	-	-	20	-	109	-	218	327
Total income recognised directly in equity	-	-	-	-	89	12,799	9,784	20	-	22,692	-	218	22,910
Profit for the year 2005	-	-	-	-	39,919	-	-	-	-	39,919	-	5,067	44,986
Total recognised income for the year	-	-	-	-	40,008	12,799	9,784	20	-	62,611	-	5,285	67,896
Dividend paid - 2004	-	-	-	-	(9,855)	-	-	-	-	(9,855)	-	-	(9,855)
Transfer to reserves	-	-	4,124	4,124	(8,248)	-	-	-	-	-	-	-	-
Purchase of treasury shares	-	-	-	-	-	-	-	-	-	-	(43,881)	-	(43,881)
Balance as at 31 December 2005	70,394	12,883	34,817	18,000	59,129	42,886	9,784	974	7	178,480	(43,957)	21,539	226,456
Balance as at 31 December 2005	70,394	12,883	34,817	18,000	59,129	42,886	9,784	974	7	178,480	(43,957)	21,539	**226,456**
Changes in fair values of available for sale investments	-	-	-	-	-	4,912	-	-	-	4,912	-	-	**4,912**
Transferred to income statement on sale of available for sale investments	-	-	-	-	-	(822)	-	-	-	(822)	-	-	**(822)**
Translation adjustment	-	-	-	-	-	-	-	-	(8)	(8)	-	-	**(8)**
Net movement in minority interest	-	-	-	-	-	-	-	-	-	-	-	(4,043)	**(4,043)**
Total income recognised directly in equity	-	-	-	-	-	4,090	-	-	(8)	4,082	-	(4,043)	**39**
Profit for the year 2006	-	-	-	-	45,111	-	-	-	-	45,111	-	4,338	**49,449**
Total recognised income for the year	-	-	-	-	45,111	4,090	-	-	(8)	49,193	-	295	**49,488**
Bonus shares issued - 2005	14,079	-	-	-	(14,079)	-	-	-	-	(14,079)	-	-	**-**
Dividend paid - 2005	-	-	-	-	(19,013)	-	-	-	-	(19,013)	-	-	**(19,013)**
Transfer to reserves	-	-	4,660	4,660	(9,320)	-	-	-	-	-	-	-	**-**
Balance as at 31 December 2006	**84,473**	**12,883**	**39,477**	**22,660**	**61,828**	**46,976**	**9,784**	**974**	**(1)**	**194,581**	**(43,957)**	**21,834**	**256,931**

The attached notes 1 to 24 form part of these consolidated financial statements.

CONSOLIDATED STATEMENT OF CASH FLOWS
Year ended 31 December 2006

	Notes	2006 KD 000	2005 KD 000
OPERATING ACTIVITIES			
Profit for the year		**49,449**	44,986
Adjustments for:			
Gains on sale of investment securities		**(7,814)**	(8,602)
Dividend income		**(3,478)**	(3,669)
Depreciation		**1,510**	1,569
Provision for impairment		**1,300**	6,151
Foreign currency adjustment on term loan		**(572)**	(540)
Operating profit before changes in operating assets and liabilities		**40,395**	39,895
Changes in operating assets/liabilities:			
Treasury bonds		**1,803**	(22,671)
Investments at fair value through profit or loss		**(6,518)**	(5,850)
Certificates of deposit		**(44,457)**	-
Due from banks and deposits with financial institutions		**(21,911)**	7,916
Loans and advances		**(167,924)**	59,999
Kuwait government debt bonds		**40,686**	34,057
Other assets		**(19,832)**	(3,685)
Due to banks and other financial institutions		**71,326**	(13,875)
Certificates of deposit		**103,500**	(135,000)
Deposits from customers		**129,446**	(16,047)
Other liabilities		**11,539**	8,960
Net cash from (used in) operating activities		**138,053**	(46,301)
INVESTING ACTIVITIES			
Purchase of investment securities		**(39,862)**	(20,264)
Sale and redemption of investment securities		**34,787**	41,275
Premises and equipment		**(4,911)**	(2,217)
Purchase of Stock Exchange brokerage licences		**-**	(114)
Dividends received		**3,478**	3,669
Net cash (used in) from investing activities		**(6,508)**	22,349
FINANCING ACTIVITIES			
Repayment of the term loan		**(28,914)**	-
Dividend paid to Bank's equity shareholders		**(19,013)**	(9,855)
Purchase of treasury shares		**-**	(43,881)
Dividend paid to minorities		**(2,070)**	(694)
Net cash used in financing activities		**(49,997)**	(54,430)
NET INCREASE (DECREASE) IN CASH AND BALANCES WITH BANKS		**81,548**	(78,382)
Cash and balances with banks at 1 January		**92,179**	170,561
CASH AND BALANCES WITH BANKS AT END OF YEAR	3	**173,727**	92,179

The attached notes 1 to 24 form part of these consolidated financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
31 December 2006

1. INCORPORATION AND ACTIVITIES

The Bank of Kuwait and the Middle East K.S.C. ("the Bank") is a public shareholding company incorporated in Kuwait in 1971. It is engaged in carrying out banking activities and is regulated by the Central Bank of Kuwait. Its registered office is at Darwazat Al-Abdul Razzak, P. O. Box 71, Safat 13001, Kuwait.

The Bank is a subsidiary of Ahli United Bank B.S.C, a Bahraini Bank ("the Parent"), listed on Bahrain and Kuwait Stock Exchanges.

The Bank's principal subsidiary is Kuwait and Middle East Financial Investment Company K.S.C. (closed) (KMEFIC), a company incorporated in the State of Kuwait and engaged in investment and portfolio management activities for its own account and for clients. The Bank held 51.25 % effective interest in KMEFIC as at 31 December 2006 (2005: 50.14%).

The consolidated financial statements comprise the financial statements of the Bank and its subsidiaries ("the Group") as at and for the year ended 31 December each year.

The consolidated financial statements for the year ended 31 December 2006 were authorised for issue in accordance with a resolution of the Board of Directors of the Bank on 16 January 2007.

2. SIGNIFICANT ACCOUNTING POLICIES

2.1 Basis of preparation

The consolidated financial statements of the Group have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted for use by Government of Kuwait for financial services institutions regulated by the Central Bank of Kuwait. These regulations require adoption of all International Financial Reporting Standards (IFRS) except for the International Accounting Standard (IAS) 39: Financial Instruments: Recognition and Measurement requirement for collective provision, which has been replaced by the Central Bank of Kuwait's requirement for a minimum general provision as described under the accounting policy for impairment of financial assets.

The financial statements are presented in Kuwaiti Dinars, which is the functional currency of the Bank, rounded to nearest thousand, except when otherwise indicated.

The consolidated financial statements are prepared under the historical cost basis except for the remeasurement at fair value of financial assets carried as investments at fair value through profit or loss, available-for-sale investments, freehold land and derivative contracts.

The accounting policies are consistent with those of the previous financial year.

2.2 New standards issued but not yet effective

The following standards have been issued by the IASB, but are not yet effective:

IFRS 7 Financial Instrument disclosures and consequent amendments to IAS 1- capital disclosures (effective 2007)
IFRS 8 Operating Segments (effective 2009)

Additional disclosures will be made in the financial statements of 2007 and 2009 respectively when these standards become effective.

2.3 Consolidation

The financial statements of subsidiaries are prepared for the same reporting year as the Bank using consistent accounting policies. Adjustments are made to subsidiaries' financial statements in the consolidation to align the accounting policies for any dissimilarities that may exist.

The financial statements of the subsidiaries are consolidated on a line-by-line basis by adding together like items of assets, liabilities, income and expenses. All material intra-group balances and transactions, including material unrealised gains and losses arising on intra-group transactions, have been eliminated on consolidation. Subsidiaries are consolidated from the date on which control is transferred to the Group and cease to be consolidated from the date on which control is transferred out of the Group. Control is achieved where the Bank has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Where there is a loss of control of a subsidiary, the consolidated financial statements include the results for the part of the reporting year during which the Group had control.

Minority interest represents the share of results and net assets in consolidated subsidiaries attributable to minority shareholders. Profit attributable to minority interest is presented in the consolidated income statement and within equity in the consolidated balance sheet, separately from Bank's shareholders' equity.

2.4 Use of Judgement and Estimates

The preparation of financial statements requires management to make judgements and estimates that affect the reported amounts of financial assets and liabilities and disclosure of contingent liabilities. These judgements and estimates also affect the revenues and expenses and the resultant provisions as well as the fair value changes reported in the equity.

Judgements are made in the classification of financial instruments based on management's intention at acquisition. Judgements are also made in determination of the objective evidence that a financial asset is impaired.

Estimates are made regarding the amount and timing of future cash flows when measuring the level of provisions required for non-performing loans as well as for impairment provisions for available for sale investments, freehold land and intangible assets. Estimates are also made in determining the useful lives of buildings and other premises and equipment, the fair values of financial assets and derivatives that are not quoted in an active market. Such estimates are necessarily based on assumptions about several factors involving varying degrees of uncertainty and actual results may differ resulting in future changes in such provisions. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience.

2.5 Financial instruments - classification, measurement, recognition, and de-recognition

Classification and Measurement
The Group classifies its financial instruments as "investments at fair value through profit or loss", "loans and receivables", "available for sale" or "financial liability". Management determines the appropriate classification of each instrument at the time of acquisition. All financial assets and liabilities are initially measured at fair value of the consideration given plus transaction costs except for financial assets classified as investments at fair value through profit or loss.

Transaction costs on financial assets classified as investments at fair value through profit or loss are recognised in the consolidated income statement.

(i) Date of recognition
All "regular way" purchases and sales of financial assets are recognised on the settlement date, i.e. the date that the Group receives or delivers the asset. Regular way purchases or sales are purchases or sales of financial assets that require delivery of assets within the time frame generally established by regulation or convention in the market place.

(ii) Investments at fair value through profit or loss
These are financial assets that are either held for trading or are designated as investments at fair value through profit or loss upon initial recognition. A financial asset is classified in this category only if they are acquired principally for the purpose of generating profit from short-term fluctuations in price or if so designated by the management in accordance with a documented risk management or investment strategy. Financial assets classified as investments at fair value through profit or loss are subsequently measured and carried at fair value. Resultant unrealised gains and losses arising from changes in fair value are included in the consolidated income statement. This includes all derivative financial instruments, other than those designated as effective hedging instruments.

(iii) Loans and receivables
Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. These are carried at amortised cost using effective interest method, adjusted for effective fair value hedges, less any provision for impairment.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
31 December 2006

2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

2.5 Financial instruments - classification, measurement, recognition, and de-recognition (continued)

(iii) Loans and receivables (continued)
Certificates of deposit, due from banks and deposits with financial institutions and loans and advances are classified as loan and receivables.

(iv) Available for sale
These are financial assets not included in any of the above classifications and are principally those acquired to be held for an indefinite period of time, which may be sold in response to needs for liquidity or changes in interest rate or equity prices. After initial recognition, available for sale investments are remeasured at fair value. Unless unrealised gains and losses on remeasurement to fair value are part of an effective hedging relationship, they are reported as a separate component of equity until the investment is sold or otherwise disposed of, or the investment is determined to be impaired, at which time the cumulative gain or loss previously reported in equity is included in the consolidated income statement for the period. Impairment losses recognised in the consolidated income statement for investment in equity instruments are not reversed through income statement.

For investments in equity instruments, where a reasonable estimate of fair value cannot be determined, the investment is carried at cost less impairment provisions.

Any gain or loss arising from a change in fair value of available-for-sale investments, which are part of an effective hedging relationship, is recognised directly in the consolidated income statement to the extent of the changes in fair value being hedged.

(v) Financial liabilities
Financial liabilities are subsequently measured at amortised cost using the effective yield method, less amount repaid.

Fair values
For financial instruments quoted in an active market, fair value is determined by reference to quoted market prices. Bid prices are used for assets and offer prices are used for liabilities. The fair value of investments in mutual funds, unit trusts or similar investment vehicles are based on the last published bid price.

The fair value of interest bearing financial instruments that are not quoted in an active market is estimated based on discounted cash flows using interest rates for items with similar terms and risk characteristics. The estimated fair value of deposits with no stated maturity, which includes non-interest bearing deposits, is the amount payable on demand.

The fair value of forward exchange contract is calculated by reference to forward exchange rates with similar maturities.

For unquoted financial instruments fair value is determined by reference to the market value of a similar investment, on the expected discounted cash flows, other appropriate valuation models or brokers' quotes.

The fair value of unquoted derivative instruments is determined by discounted cash flow method or option pricing model.

Impairment of financial assets
A financial asset is impaired if its carrying amount is greater than its estimated recoverable amount. An assessment is made at each balance sheet date to determine whether there is objective evidence that a specific financial asset, or a group of similar assets, may be impaired. If such evidence exists the recoverable amount is estimated and an impairment loss is recognised in the consolidated income statement.

Loans and receivables of the Group are subject to credit risk provision for loan impairment if there is objective evidence that the Group will not be able to collect all amounts due. The amount of the provision is the difference between the carrying amount and the recoverable amount, being the present value of expected future cash flows, including amounts recoverable from guarantee and collateral, discounted based on the contractual interest rate.

In addition, in accordance with Central Bank of Kuwait instructions, a minimum general provision of 2% is made on all applicable credit facilities (net of certain categories of collateral) that are not provided for specifically.

Recognition and de-recognition
A financial asset or a financial liability is recognised when the Group becomes a party to the contractual provisions of the instrument. A financial asset is derecognised either (i) when the Group has transferred substantially all the risks and rewards of the ownership or (ii) when it has neither transferred nor retained substantially all risks and rewards and when it no longer has control over the asset or portion of the asset.

Derivative financial instruments and hedging
The Group enters into derivative financial instruments transactions, including futures, forwards, swaps, and options to manage exposures to interest rate, foreign currency and credit risks. In order to manage particular risks, the Group applies hedge accounting for transactions that meet the specified criteria. Derivatives are stated at fair value. Derivatives with positive market values are included in other assets and derivatives with negative market value are included in other liabilities in the consolidated balance sheet. For the purposes of hedge accounting, hedges are classified into two categories (a) fair value hedges which hedge the exposure to changes in the fair value of a recognised asset or liability and (b) cash flows hedges which hedge exposure to variability in cash flows of a recognised asset or liability or forecasted transaction.

In case of fair value hedges that prove to be highly effective any gain or loss from re-measuring the hedging instruments to fair value are recorded in the consolidated income statement, along with the corresponding change in fair value of the hedged asset or liability that is attributable to that specific hedged risk.

Changes in the fair value of cash flow hedges that prove to be highly effective in relation to the hedged risk, are recognised in equity. The gains and losses previously deferred in equity are transferred from equity and either included in the initial measurement of the related asset or liability or transferred to the consolidated income statement for the period the hedged firm commitment or forecasted transaction affects the consolidated statement of income.

For hedges which do not qualify for hedge accounting, any gains or losses arising from changes in the fair value of the hedging instrument are taken directly to the consolidated income statement.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated or exercised, or no longer qualifies for hedge accounting. For fair value hedges of financial instruments with fixed maturities any adjustment arising from hedge accounting is amortised over the remaining term to maturity. For cash flow hedges, any cumulative gain or loss on the hedging instrument recognised in equity remains in equity until the hedged transaction occurs. If the hedged transaction is no longer expected to occur, the net cumulative gain or loss recognised in equity is transferred to the consolidated income statement.

Offsetting
Financial assets and financial liabilities are only offset and the net amount reported in the consolidated balance sheet when there is a legally enforceable right to set off the recognised amounts and the Group intends to settle on a net basis.

2.6 Foreign currency

Foreign currency transactions are initially recorded in the functional currency rates of exchange ruling at the date of transactions. Monetary assets and liabilities denominated in foreign currencies outstanding at the year-end are re-translated into Kuwaiti Dinars at the rates of exchange ruling at the balance sheet date. Any resultant gains or losses are taken to the consolidated income statement. Translation difference on non-monetary investments at fair value through profit or loss are reported as part of the fair value gain or loss in the consolidated income statement whilst those for available-for-sale non-monetary assets are included in the cumulative changes in fair value in equity, unless it is part of an effective hedging strategy, using exchange rates when the fair value was determined.

Translation differences arising on consolidation of the subsidiaries are taken to foreign currency translation reserve in equity.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
31 December 2006

2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

2.7 Revenue recognition

Interest income and expenses are recognised using the effective interest method taking into account the principal outstanding and the rate applicable. Loan interest that is overdue for 90 days or more is excluded from income. Notional interest is recognised on impaired loans and advances and other financial assets based on the rate used to discount future cash flows to their net present value. When the Group enters into an interest rate swap to change interest from fixed to floating (or vice versa) the amount of interest income or expense is adjusted by the net interest on the swap. Credit origination fee are treated as an integral part of the effective interest rate of financial instruments and are recognised over their lives, except when the underlying risk is sold to a third party at which time it is recognised immediately. Other fees and commission income are recognised when earned. Dividend income is recognised when right to receive payment is established.

2.8 Intangible assets

Intangible assets acquired separately are measured on initial recognition at cost. The useful lives of intangible assets are assessed to be either finite or indefinite. Intangible assets with finite lives are amortised over their useful economic lives and assessed and adjusted for impairment whenever there is an indication that an intangible asset may be impaired. Intangible assets with indefinite useful lives are not amortised but are tested annually for impairment and adjusted for the same, if any.

2.9 Premises and equipment

Freehold land is initially recognised at cost. After initial recognition freehold land is carried at revalued amount, which is the fair value at the date of revaluation. The revaluation is carried periodically by professional property valuers. The resultant revaluation surplus or deficit is recognised, as a separate component under equity to the extent the deficit does not exceed the previously recognised surplus. The portion of the revaluation deficit that exceeds a previously recognised revaluation surplus is recognised in the consolidated income statement. To the extent that a revaluation surplus reverses a revaluation decrease previously recognised in the consolidated statement of income, the increase is recognised in the consolidated statement of income. Upon disposal the revaluation reserve relating to the freehold land sold is transferred to retained earnings.

Buildings, other premises and equipments are stated at cost, less accumulated depreciation and impairment losses if any. Freehold land is not depreciated. Depreciation of buildings and other premises and equipment is provided on a straight-line basis over their estimated useful lives.

The estimated useful lives of the assets for the calculation of depreciation are as follows:

Freehold buildings	20 to 30 years
Leasehold buildings	Over the period of lease or 20 years which ever is less
Other premises and equipment	2 to 5 years

2.10 Cash and balances with banks

Cash and balances with banks include cash, balances with other banks, money at call and short notice with banks and financial institutions maturing within seven days.

2.11 Provisions

Provisions are recognised when, as a result of past events, it is probable that an outflow of economic resources will be required to settle a present, legal or constructive obligation and the amount can be reliably estimated.

2.12 Fiduciary assets

Assets held in trust or in a fiduciary capacity are not treated as assets of the Group and accordingly are not included in these consolidated financial statements.

3. CASH AND BALANCES WITH BANKS

	2006 KD 000	2005 KD 000
Balances with the Central Bank of Kuwait	**6,775**	14,861
Cash in hand and current account balances with other banks	**35,156**	19,203
Money at call and short notice (maturing within seven days)	**131,796**	58,115
	173,727	92,179

4. TREASURY BONDS

These financial instruments are issued by the Central Bank of Kuwait on behalf of the Ministry of Finance and are carried at amortised cost.

5. LOANS AND ADVANCES

The movement in provision for impairment of loans and advances is as follows:

	2006 KD 000	2005 KD 000
At 1 January	**37,692**	32,537
Ceded to Central Bank of Kuwait	**(22)**	(142)
Amount written off	**(487)**	(361)
Charge for the year (Note 15)	**1,326**	5,658
At 31 December	**38,509**	37,692

As at 31 December 2006, cash advances on which income had ceased to be recognised amounted to KD 31,439 thousand (31 December 2005: KD 27,750 thousand).

The split of non-performing facilities granted and related provision for impairment between pre-invasion and post-liberation are as follows:

	Pre-invasion KD 000	Post liberation KD 000	Total KD 000
AT 31 DECEMBER 2006			
Loans and advances	**1,970**	**29,469**	**31,439**
Provision for impairment	**1,970**	**17,122**	**19,092**
At 31 December 2005			
Loans and advances	1,980	25,770	27,750
Provision for impairment	1,980	15,839	17,819

The policy of the Group for calculation of the impairment provision for loans and advances complies in all material respects with the specific provision requirements of Central Bank of Kuwait.

The analysis of provisions set out above is based on the requirements of the Central Bank of Kuwait. According to the Central Bank of Kuwait instructions, a general provision of minimum 2% has been made on all applicable credit facilities (net of certain categories of collateral), that are not provided for specifically. The Central Bank of Kuwait in accordance with Decree No. 32/1992 and Law No. 41/93, as amended, has funded provisions in respect of pre-invasion loans and advances. Any recoveries made against these provisions are ceded to the Central Bank of Kuwait in accordance with the prevalent law, and are not included in the consolidated income statement.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
31 December 2006

6. INVESTMENT SECURITIES

	2006 KD 000	2005 KD 000
Available for sale investments		
Debt securities - unquoted	**9,980**	8,951
Equity securities - quoted	**82,312**	59,465
Equity securities - unquoted	**25,722**	32,663
	118,014	101,079
Investment in associate	**-**	3,136
	118,014	104,215

7. KUWAIT GOVERNMENT DEBT BONDS

The Central Bank of Kuwait purchased resident Kuwaiti and GCC customers' debts existing at 1 August 1990, in addition to related interest up to 31 December 1991, on behalf of the Government of Kuwait in accordance with Decree Law No. 32/1992 and Law No. 41/1993, as amended by Law No. 80/1995, in respect of the financial and banking sector. Pursuant to the provisions of Law No. 41/1993, some amendments may be made to customers' debt balances, which are being reviewed by the Central Bank of Kuwait.

The purchase value of these debts was determined in accordance with the Decrees and was settled by the issue of a bond with a value date of 31 December 1991. The bond matures over a maximum period of twenty years from the value date. The Central Bank of Kuwait has redeemed during 2006 amounts of KD 40,686 thousand (2005: KD 34,057 thousand). Interest on these bonds is fixed semi-annually by the Central Bank of Kuwait and is payable semi-annually in arrears; the average rate for 2006 was 4.04% (2005: 2.63%) per annum.

The Group is required to manage the purchased debts without remuneration in conformity with the regulations in Decree Law No. 32/1992 in this respect. Kuwait government debt bonds are carried at amortised cost.

8. PREMISES AND EQUIPMENT

Premises and equipment include KD 9,784 thousand (2005: KD 9,784 thousand) being the increase in value of freehold land due to revaluation. The revaluation, being the fair value of the land, was based on valuation report of independent valuation experts carried out during 2005.

9. OTHER ASSETS AND INTANGIBLES

	2006 KD 000	2005 KD 000
Interest receivable	**12,662**	7,921
Stock exchange brokerage licences	**12,614**	12,614
Positive fair value of derivatives	**1,312**	2,169
Others	**23,542**	6,410
	50,130	29,114

Stock exchange brokerage licenses are classified as intangible assets with an indefinite life.

10. TERM LOAN

In 2004, the Bank entered in an unsecured medium term loan facility agreement for USD 200 million (equivalent to KD 58.4 million) maturing in 2007 for full repayment. This facility bears interest at the rate of 0.375% per annum above the London Inter Bank Offered Rate (LIBOR) for three-month US dollar deposits, payable quarterly in arrears. During the year, the Bank made an early repayment of USD 100 million.

11. OTHER LIABILITIES

	2006 KD 000	2005 KD 000
Interest payable	**12,969**	7,698
Provision for staff indemnity	**4,440**	4,522
Provision for non-cash credit facilities (Note 15)	**4,019**	4,173
Negative fair value of derivatives	**105**	745
Other liabilities	**21,319**	14,286
	42,852	31,424

12. EQUITY

i) The authorised, issued and fully paid share capital as at 31 December 2006 and 31 December 2005 comprises 844,726,807 and 703,939,006 ordinary shares respectively of 100 fils each. Extra Ordinary General Assembly of the Bank held on 8 April 2006 approved the increase of authorised share capital pursuant to approval of stock dividend (note 14) by the Annual General Assembly held on 8 April 2006.

ii) As required by the Commercial Companies' Law and the Bank's articles of association, 10% of the profit for the year attributable to the Bank's equity shareholders before KFAS, NLST and Board of Directors' fees has been transferred to the statutory reserve. The Bank may resolve to discontinue such annual transfers when the statutory reserve equals 50% of the paid up share capital. Distribution of the statutory reserve is limited to the amount required to enable the payment of a dividend of up to 5% of share capital in years when retained earnings are not sufficient for the payment of such dividend.

iii) The balances of share premium and treasury shares reserve are not available for distribution. The balance in the property revaluation reserve is not available for distribution unless the relevant assets are derecognised.

iv) The articles of association of the Bank require that an amount of not less than 10% of the profit for the year attributable to the Bank's equity shareholders before KFAS, NLST and Board of Directors' fee should be transferred annually to a general reserve account.

v) The cost of the Bank's own shares purchased, including directly attributable costs, is recognised in equity. In accordance with the instructions of the Central Bank of Kuwait the Bank may purchase treasury shares equal to 10% of the issued shares. Gains or losses arising on sale of treasury shares are separately disclosed under equity and are not available for distribution. No cash dividend is paid on treasury shares held by the Bank.

13. TREASURY SHARES

There was no purchase or sale of treasury shares during the current year.

	2006 KD 000	2005 KD 000
Number of treasury shares	**84,180,000**	70,150,000
Treasury shares as a percentage of total shares	**9.97%**	9.97%
Cost of treasury shares (KD'000s)	**43,957**	43,957
Market value of treasury shares (KD'000s)	**53,875**	47,000

14. PROPOSED DIVIDEND AND DIRECTORS' FEES

The Board of Directors of the Bank have proposed a cash dividend of 50% (2005: 30%) amounting to 50 fils per share (2005: 30 fils per share) and stock dividend of Nil (2005: 20%) The proposed dividend and directors' fees are subject to the approval of the shareholders at the Bank's Annual General Assembly.

The cash and stock dividends along with directors' fees for the year ended 31 December 2005 were approved by the Bank's Annual General Assembly held on 8 April 2006 and paid during the year.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

31 December 2006

15. PROVISION FOR IMPAIRMENT

	2006 KD 000	2005 KD 000
Loans and advances (Note 5)	**1,326**	5,658
Non-cash credit facilities (Note 11)	**(154)**	(202)
Investment securities	**15**	123
Others	**113**	572
	1,300	6,151

16. BASIC AND DILUTED EARNINGS PER SHARE

	2006	2005
Profit for the year attributable to the Bank's equity shareholders (KD 000s)	**45,111**	39,919
Weighted average number of shares outstanding during the year	**760,546,807**	810,946,807
Basic and diluted earnings per share (fils)	**59.3**	49.2

The weighted average number of shares outstanding during the year is calculated after adjusting for treasury shares.

Weighted average number of Bank's issued and paid up shares	**844,726,807**	844,726,807
Less: Weighted average number of treasury shares	(84,180,000)	(33,780,000)
	760,546,807	810,946,807

Basic and diluted earnings per share for years presented in the consolidated income statement have been recomputed based on adjusted number of shares following the bonus issue.

17. RELATED PARTY TRANSACTIONS

The Group enters into transactions with major shareholders, directors, associates, key management and companies of which they are principal owners in ordinary course of business. The terms of these transactions are approved by the Group's management.

The year-end balances included in the consolidated financial statements are as follows:

	Number of directors and executive officers		Number of parties related to directors and executive officers		Amount	
	2006	2005	2006	2005	2006 KD 000	2005 KD 000
Directors						
Loans and advances	**3**	4	**7**	3	**26,501**	18,233
Commitments and contingent liabilities	**1**	-	**-**	1	**3,465**	4,043
Credit cards	-	3	**-**	-	**-**	1
Deposits taken	**1**	2	**7**	5	**11,095**	3,774
Key Management						
Loans and advances	**1**	3	**-**	5	**386**	203
Commitments and contingent liabilities	**-**	-	**-**	1	**-**	203
Credit cards	**-**	3	**-**	3	**-**	48
Deposits taken	**-**	3	**-**	9	**-**	421

	2006 KD 000		2005 KD 000	
	Parent	Other related parties	Parent	Other related parties
Loans and advances	**-**	**17,120**	4,234	18,995
Deposits placed	**21,823**	**5,810**	19,227	5,812
Deposits taken	**24,880**	**6,703**	-	27,683
Participation in term loan	**1,446**	**-**	2,920	-
Commitments and contingent liabilities	**8,242**	**-**	130	1,146
Foreign exchange contracts	**23,224**	**-**	5,913	-
Interest rate swaps	**-**	**-**	1,460	-

The related interest income and interest expense of the above balances is included in the consolidated income statement.

During the year, as part of ongoing asset/liability management, the Bank entered into transactions of KD 1,337 million (2005: KD 450 million) of deposits placement, loans and advances , deposits taken and foreign exchange contracts with related group entities in the normal course of business.

The transactions included in the consolidated income statement are as follows:

	2006 KD 000	2005 KD 000
Directors and key management compensation:		
Salaries and other short term benefits	**1,149**	836
Post employment benefits	**171**	59
	1,320	895

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
31 December 2006

18. COMMITMENTS AND CONTINGENT LIABILITIES

Credit- related commitments

Credit-related commitments include commitments to extend credit, standby letters of credit, guarantees and acceptances, which are designed to meet the requirements of the Group's customers.

Letters of credit (including standby letter of credit) guarantees and acceptances commit the Group to make payments on behalf of customer's contingent upon failure of the customers to perform under the terms of the contract.

Commitment to extend credit represents contractual commitments to make loans and revolving credits. Commitments generally have fixed expiration dates, or other termination clauses. Since commitments may expire without being drawn upon, the total contract amounts do not necessarily represent future cash requirements.

The Group has the following credit related commitments:

	2006 KD 000	2005 KD 000
Acceptances	**7,479**	9,215
Letters of credit	**64,480**	46,387
Guarantees	**96,490**	125,648
Others	**369**	568
	168,818	181,818

Commitments to extend credit at the balance sheet date amounted to KD 155,133 thousand (2005: KD 92,912 thousand).

19. DERIVATIVES

In ordinary course of business the Group enters in to various types of transactions that involve derivative financial instruments. A derivative financial instrument is a financial contract between two parties where payments are dependent upon movements in price of one or more underlying financial instruments, reference rate or index.

The table below shows derivative financial instruments with the notional amounts analysed by the term to maturity. The contractual or notional amount is the amount of a derivative's underlying asset, reference rate or index and is the basis upon which changes in the value of derivatives are measured. The contractual or notional amounts indicate the volume of transactions outstanding at the year-end and are neither indicative of the market risk nor the credit risk.

31 DECEMBER 2006		Notional amounts by term to maturity			
	Net fair value KD 000	Total KD 000	Within 3 months KD 000	3 – 12 months KD 000	Above 1 year KD 000
Derivatives held for trading:					
Forward foreign exchange contracts	**1,207**	**84,557**	**82,919**	**1,638**	-
Interest rate swaps	**-**	**210**	**210**	**-**	-
	1,207	**84,767**	**83,129**	**1,638**	**-**

31 DECEMBER 2005		Notional amounts by term to maturity			
	Net fair value KD 000	Total KD 000	Within 3 months KD 000	3 – 12 months KD 000	Above 1 year KD 000
Derivatives held for trading:					
Forward foreign exchange contracts	1,424	48,842	41,411	7,431	-
Interest rate swaps	-	1,650	1,460	-	190
	1,424	50,492	42,871	7,431	190

20. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Strategy in using financial instruments

The Group's activities are principally related to the use of financial instruments including derivatives. It accepts deposits from customers at both fixed and floating rates and for various periods and seeks to earn above average interest margins by investing these funds in high quality assets. It also seeks to increase these margins by consolidating short-term funds and lending for longer periods at higher rates while maintaining sufficient liquidity to meet all claims that may fall due.

The Group also seeks to raise interest margins by obtaining above average margins, net of provisions, through lending to commercial and retail borrowers with a range of credit standing. Such exposures include guarantees and other commitments such as letters of credit and performance and other bonds.

With the exception of specific hedging arrangements, foreign exchange and interest rate exposures associated with derivatives are normally offset by entering into counterbalancing positions, thereby controlling the variability in the net cash amounts required to liquidate market positions.

RISK MANAGEMENT

The use of financial instruments also brings with it associated inherent risks. The Group recognises the relationship between returns and risks associated with the use of financial instruments and the management of risks forms an integral part of the Group's strategic objectives.

The strategy of the Group is to maintain a strong risk management culture and manage the risk/reward relationship within and across each of the Group's major risk-based lines of business. The Group continuously reviews its risk management policies and practices to ensure that it is not subject to large asset valuation volatility and earnings volatility.

The following sections describe the several risks inherent in the banking process, their nature and how they are managed.

A. CREDIT RISK

Credit risk is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss. The Group attempts to control credit risk by monitoring credit exposures, limiting transactions with specific counterparties, and continually assessing the creditworthiness of counterparties. In certain cases the Group may also close out transactions to mitigate credit risk.

Concentrations of credit risk arise when a number of counterparties are engaged in similar business activities, or 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 risk indicate the relative sensitivity of the Group's performance to developments affecting a particular industry or geographic location.

The Group seeks to manage its credit risk exposure through diversification of lending activities, to avoid undue concentrations of risks with individuals or groups of customers in specific industries or business. It also obtains security when appropriate.

In accordance with the instructions of the Central Bank of Kuwait dated 18 December 1996, setting out the rules and regulations regarding the classification of credit facilities, the Bank has internal credit committees which are composed of competent professional staff and which have as their purpose the study and evaluation of the existing credit facilities of each customer of the Bank. These committees are required to identify any abnormal situations and difficulties associated with a customer's position, which might cause the debt to be classified as irregular and to determine an appropriate provisioning level.

Geographical risk analysis

Geographical concentration of assets, liabilities and off balance sheet items

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

31 December 2006

20. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (CONTINUED)

A. CREDIT RISK (CONTINUED)

AT 31 DECEMBER 2006:

	Assets KD 000	Liabilities KD 000	Contingencies & Commitments Representing Credit risk KD 000
Geographic region:			
Kuwait	1,593,096	1,474,575	150,742
Other Middle East	163,319	139,372	13,882
Europe	153,464	43,035	1,203
U.S.A. and Canada	9,068	9,390	2,073
Rest of the World	10,459	6,103	918
	1,929,406	**1,672,475**	**168,818**
Industry sector:			
Trading and manufacturing	210,890	321,287	100,741
Banks and financial institutions	838,688	563,968	14,037
Construction and real estate	196,664	27,861	35,361
Other	683,164	759,359	18,679
	1,929,406	**1,672,475**	**168,818**

AT 31 DECEMBER 2005:

	Assets KD 000	Liabilities KD 000	Contingencies & Commitments Representing Credit risk KD 000
Geographic region:			
Kuwait	1,377,091	1,271,520	148,878
Other Middle East	129,686	89,345	25,238
Europe	85,729	16,284	4,002
U.S.A. and Canada	9,214	2	2,742
Rest of the World	10,997	9,110	958
	1,612,717	**1,386,261**	**181,818**
Industry sector:			
Trading and manufacturing	165,779	260,910	75,376
Banks and financial institutions	872,058	430,706	22,786
Construction and real estate	215,663	34,716	66,893
Other	359,217	659,929	16,763
	1,612,717	**1,386,261**	**181,818**

B. INTEREST RATE RISK

Interest rate risk arises from the possibility that changes in interest rates will affect the value of the underlying financial instruments. The Group is exposed to interest rate risk as a result of mismatches or gaps in the amounts of assets and liabilities and off balance sheet instruments that mature or reprice in a given period. The Group manages this risk by matching or hedging the repricing profile of assets and liabilities through risk management strategies.

The majority of the Group's assets and liabilities reprice within one year. Accordingly there is a limited exposure to interest rate risk.

The effective interest rate (effective yield) of a monetary financial instrument is the rate that, when used in a present value calculation, results in the carrying amount of the instrument. The rate is a historical rate for a fixed rate instrument carried at amortised cost and a current market rate for a floating rate instrument or an instrument carried at fair value.
The table below details the Group's exposure to interest rate risk. Financial instruments are reported based on the earlier of their contractual repricing date or maturity date.

20. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (CONTINUED)

AT 31 DECEMBER 2006	Up to 1month KD 000	1 to 3 months KD 000	3 to 12 months KD 000	Over one year KD 000	Non- interest sensitive KD 000	Total KD 000	Effective interest rate range Kuwait Dinar From	Kuwait Dinar To	Foreign currency From	Foreign currency To
Assets:										
Cash and balances with banks	171,452	-	-	-	2,275	173,727	1.50%	6.50%	0.30%	5.35%
Treasury bonds	-	-	158,885	118,616	-	277,501	5.13%	6.63%	-	-
Certificates of deposit	41,457	3,000	-	-	-	44,457	5.75%	5.88%	5.84%	5.84%
Investments at fair value through profit or loss	-	-	-	-	21,926	21,926	-	-	-	-
Due from banks and deposits with financial institutions	186,596	57,503	3,614	-	392	248,105	5.88%	6.00%	3.63%	5.83%
Loans and advances	792,623	70,226	53,696	-	6,442	922,987	6.25%	11.25%	1.92%	8.36%
Investment securities	4,337	1,445	-	4,198	108,034	118,014	5.37%	5.87%	4.93%	6.59%
Kuwait government debt bonds	-	-	52,381	-	-	52,381	Refer note 7		-	-
Premises and equipment	-	-	-	-	20,178	20,178	-	-	-	-
Other assets and intangibles	-	-	-	-	50,130	50,130	-	-	-	-
	1,196,465	**132,174**	**268,576**	**122,814**	**209,377**	**1,929,406**				
Liabilities:										
Due to banks and other financial institutions	226,741	70,788	125,199	-	6,038	428,766	-	7.13%	1.20%	6.15%
Deposits from customers	667,062	150,419	124,350	5,808	120,804	1,068,443	-	6.88%	0.15%	6.67%
Certificates of deposit	22,000	34,500	47,000	-	-	103,500	5.75%	6.13%	-	-
Term loan	-	28,914	-	-	-	28,914	-	-	5.33%	5.74%
Other liabilities	-	-	-	-	42,852	42,852	-	-	-	-
	915,803	**284,621**	**296,549**	**5,808**	**169,694**	**1,672,475**				
On-balance sheet interest rate sensitivity gap	**280,662**	**(152,447)**	**(27,973)**	**117,006**	**39,683**	**256,931**				

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

31 December 2006

20. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (CONTINUED)

B. INTEREST RATE RISK (CONTINUED)

AT 31 DECEMBER 2005	Up to 1month KD 000	1 to 3 months KD 000	3 to 12 months KD 000	Over one year KD 000	Non- interest sensitive KD 000	Total KD 000	Effective interest rate range Kuwait Dinar From	Kuwait Dinar To	Foreign currency From	Foreign currency To
Assets:										
Cash and balances with banks	92,179	-	-	-	-	92,179	4.00%	6.00%	0.80%	4.70%
Treasury bonds	-	32,623	246,681	-	-	279,304	3.50%	4.88%	-	-
Investments at fair value through profit or loss	-	-	-	-	15,408	15,408	-	-	-	-
Due from banks and deposits with financial institutions	171,682	48,034	3,650	-	1,460	224,826	4.94%	7.00%	2.32%	5.50%
Loans and advances	646,571	66,605	37,244	-	7,407	757,827	6.00%	10.00%	1.50%	7.53%
Investment securities	4,380	2,927	167	1,477	95,264	104,215	5.75%	5.75%	4.55%	7.20%
Kuwait government debt bonds	-	-	93,067	-	-	93,067	Refer note 7		-	-
Premises and equipment	-	-	-	-	16,777	16,777	-	-	-	-
Other assets and intangibles	-	-	-	-	29,114	29,114	-	-	-	-
	914,812	**150,189**	**380,809**	**1,477**	**165,430**	**1,612,717**				
Liabilities:										
Due to banks and other financial institutions	266,031	53,047	19,722	-	18,640	357,440	0.75%	5.50%	0.04%	5.30%
Deposits from customers	468,543	191,824	167,760	5,844	105,026	938,997	-	7.00%	-	6.02%
Term loan	-	58,400	-	-	-	58,400	-	-	2.92%	4.90%
Other liabilities	-	-	-	-	31,424	31,424	-	-	-	-
	734,574	**303,271**	**187,482**	**5,844**	**155,090**	**1,386,261**				
On-balance sheet interest rate sensitivity gap	**180,238**	**(153,082)**	**193,160**	**(4,367)**	**10,507**	**226,456**				

C. CURRENCY RISK

The Group is a Kuwaiti entity with Kuwaiti Dinars as its functional currency. Hedging transactions are used to manage any significant risk in other currencies. Non-monetary assets carried at fair values that are not denominated in Group's base currency, are hedged using non-derivative financial liabilities for foreign currency risk. The hedged portion of such non-monetary assets at 31 December 2006 is KD 5,131 thousand (2005: KD 7,905 thousand).

The Group had the following significant net exposures denominated in foreign currencies.

	2006 KD 000 Equivalent Long (Short)	2005 KD 000 Equivalent Long (Short)
US Dollars	**21,645**	15,059
GCC Currencies	**5,438**	2,792
Others	**(16,327)**	278

D. LIQUIDITY RISK

Liquidity risk is the risk that the Group will be unable to meet its net funding requirements. Liquidity risk can also be caused by market disruptions or credit downgrades which may cause certain sources of funding to dry up immediately. To guard against this risk, management has diversified funding sources and assets are managed with liquidity in mind, maintaining an adequate balance of cash, cash equivalents, and readily marketable securities.

The table below summarises the contractual maturity profile of the Group's assets and liabilities. The contractual maturities of assets and liabilities have been determined on the basis of the remaining period at the balance sheet date to the contractual maturity date and do not take into account the effective maturities as indicated by the Group's deposit retention history and the availability of liquid funds. The maturity profile is monitored by management to ensure adequate liquidity is maintained.

The maturity profile of the assets and liabilities **at 31 December 2006** was as follows:

	Up to 1 month KD 000	1 to 3 months KD 000	3 to 6 months KD 000	6 months to 1 year KD 000	Over 1 year KD 000	Total KD 000
ASSETS						
Cash and balances with banks	173,727	-	-	-	-	173,727
Treasury bonds	-	-	22,958	135,927	118,616	277,501
Certificates of deposit	41,457	3,000	-	-	-	44,457
Investments at fair value through profit or loss	21,926	-	-	-	-	21,926
Due from banks and deposits with financial institutions	186,596	57,895	-	3,614	-	248,105
Loans and advances	73,804	208,798	167,589	65,975	406,821	922,987
Investment securities	69,373	296	4,014	7,030	37,301	118,014
Kuwait government debt bonds	-	-	-	-	52,381	52,381
Premises and equipment	-	-	-	-	20,178	20,178
Other assets and intangibles	29,625	3,394	4,497	-	12,614	50,130
Total assets	**596,508**	**273,383**	**199,058**	**212,546**	**647,911**	**1,929,406**
LIABILITIES						
Due to banks and other financial institutions	233,659	69,908	92,484	32,715	-	428,766
Deposits from customers	787,866	150,419	76,122	48,228	5,808	1,068,443
Certificates of deposit	22,000	34,500	47,000	-	-	103,500
Term loan	-	-	-	28,914	-	28,914
Other liabilities	25,933	4,739	6,981	1,171	4,028	42,852
Total liabilities	**1,069,458**	**259,566**	**222,587**	**111,028**	**9,836**	**1,672,475**
Net liquidity gap	**(472,950)**	**13,817**	**(23,529)**	**101,518**	**638,075**	**256,931**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

31 December 2006

20. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (CONTINUED)

D. LIQUIDITY RISK (CONTINUED)

The maturity profile of the assets and liabilities at 31 December 2005 was as follows:

	Up to 1 month KD 000	1 to 3 months KD 000	3 to 6 months KD 000	6 months to 1 year KD 000	Over 1 year KD 000	Total KD 000
Total assets	483,017	249,973	430,679	61,123	387,925	1,612,717
Total liabilities	876,354	248,176	125,492	69,396	66,843	1,386,261
Net liquidity gap	(393,337)	1,797	305,187	(8,273)	321,082	226,456

E. OPERATIONAL RISK

The Group has a set of policies and procedures approved by the Board of Directors and are applied to identify, assess and supervise operational risk in addition to other types of risk relating to the banking and financial activities of the Group.

Operational risk is managed by the Risk Management Division. This Division ensures compliance with policies and procedures to identify, assess, supervise and monitor operational risk as part of overall Global Risk Management.

This complies in all material respects with the Central Bank of Kuwait instructions dated 14 November 1996 regarding general guidelines for internal control systems and directives issued on 13 October 2003 regarding "Sound Practices for the Management and Control of Operational Risks".

F. EQUITY PRICE RISK

Equity price risk arises from the change in fair values of equity investments. The bank manages this risk through diversification of investments in terms of geographical distribution and industry concentration. The majority of the Group's available for sale investments include equity investments (Note 6) which are quoted on the Kuwait and Bahrain stock exchanges.

21. FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES

Fair value is the amount at which an asset, liability or financial instrument could be exchanged or settled between knowledgeable parties in an arm's length transaction. Underlying the definition of fair value is the presumption that the Group is a going concern without any intention, or need, to liquidate, curtail materially the scale of its operations or undertake a transaction on adverse terms.

The estimated fair values of financial assets and liabilities and off balance sheet financial instruments approximated their respective net book values at the balance sheet date. Fair value of Kuwait government debt bonds cannot be determined with sufficient accuracy, as future cash flows are not determinable. Information about the principal characteristic of these bonds is presented in note 7 to the consolidated financial statements.

22. FIDUCIARY ASSETS

Fiduciary assets comprise assets held in trust, investments and funds managed by the Group on behalf of clients and are not included in the consolidated balance sheet. As at the balance sheet date total fiduciary assets managed by the Group amounted to KD 1,410 million (2005: 1,239 million).

23. SEGMENT REPORTING

Primary segment information

The Group is organised into functional divisions in order to manage its various lines of business.

- Retail and Commercial Banking – comprising a full range of credit and deposit services provided to retail and corporate customers;
- Treasury and Investment Management – comprising correspondent banking, clearing, money market, foreign exchange, government bills and bonds, other treasury and miscellaneous operations, proprietary investment, securities trading activities and fiduciary fund management activities.

Segment results include revenue and expenses directly attributable to a segment and an allocation of cost of funds to segments based on the daily weighted average balance of segment assets.

Segment assets and liabilities comprise those operating assets and liabilities that are directly attributable to the segment.

Capital expenditure represents the total cost incurred during the period to acquire assets that are expected to be used in more than one reporting period.

	Retail and Commercial Banking		Treasury and Investment Management		Total	
	2006 KD 000	2005 KD 000	**2006 KD 000**	2005 KD 000	**2006 KD 000**	2005 KD 000
Segment revenue	**56,181**	52,463	**20,975**	22,139	**77,156**	74,602
Segment result	**31,865**	31,212	**17,584**	13,774	**49,449**	44,986
Profit for the year					**49,449**	44,986
Segment assets	**1,020,538**	914,354	**851,279**	653,217	**1,871,817**	1,567,571
Unallocated assets					**57,589**	45,146
Total assets					**1,929,406**	1,612,717
Segment liabilities	**444,698**	470,767	**1,185,030**	884,815	**1,629,728**	1,355,582
Unallocated liabilities					**42,747**	30,679
Total liabilities					**1,672,475**	1,386,261
Capital expenditure					**4,911**	2,331
Provisions for impairment	**1,285**	6,028	**15**	123	**1,300**	6,151

Secondary segment information

The Bank's head office and all its branches are located in the State of Kuwait. The Bank's subsidiary (KMEFIC) has some of its subsidiaries located outside Kuwait. The segment revenue earned by the KMEFIC from customers located outside Kuwait is immaterial.

The distribution of the assets, liabilities and off-balance sheet items by geographical area is set out in note 20A to the consolidated financial statements.

24. CAPITAL ADEQUACY

The disclosures relating to the Capital Adequacy Regulations issued by Central Bank of Kuwait (CBK) as stipulated in CBK circular number 2/BS/184/2005 dated 21 December 2005 are included in section Pillar 3 of the annual report.

PILLAR 3 – DISCLOSURES
31 December 2006

INFORMATION ON SUBSIDIARIES AND SIGNIFICANT INVESTMENTS

The public disclosures under this section have been prepared in accordance with the Central Bank of Kuwait (CBK) Rules and Regulations concerning Capital Adequacy Standard (Basel II) vide circular reference 2/RB/184/2005 dated December 12, 2005 which apply to The Bank of Kuwait and The Middle East ("the Bank"). The disclosures under this section comprise of disclosures of the Bank and its subsidiary together known as "the Group".

The Bank's principal subsidiary is Kuwait and Middle East Financial Investment Company K.S.C. (closed) {subsidiary}, a company incorporated in the State of Kuwait and engaged in investment management activities and regulated by the CBK.

Subsidiaries are fully consolidated on a line by line basis for both accounting and regulatory reporting purposes. Minority interest arising on consolidation is reported as a part of equity for accounting purposes and recognized as part of Tier 1 Capital for regulatory reporting purposes.

Fund transfer transactions within the Group are in accordance with the CBK instructions BS/101/1995 on Maximum Credit Concentration Limits and subsequent amendments / updates. Investments by the Bank in the Group are in accordance with the CBK instruction No.2/BS/79/2000 on Organization of Local Bank's Investment Policy and subsequent amendments / updates.

INFORMATION RELATED TO THE CAPITAL STRUCTURE OF THE LICENSED BANK

The authorized, issued and fully paid share capital as at 31 December 2006 comprises of 844,726,807 ordinary shares of 100 fils each. Cost of treasury shares acquired by the Bank are reduced from the Tier 1 capital. In accordance with the CBK instruction vide circular 2/BS/75/1999 and subsequent amendments / updates, the Group may purchase treasury shares equal to 10% of the issued shares. No cash dividend is paid on treasury shares held by the Group.

TABLE 1 – CAPITAL STRUCTURE Particulars	KD 000
Tier 1 capital	
Paid up share capital	84,473
Reserves	99,795
Minority interest in the equity of consolidated subsidiary	21,834
Less:	
Treasury shares	(43,957)
Goodwill	(80)
Total Tier 1 capital	**162,065**
Total Tier 2 and Tier 3 capital	**38,048**
Total eligible capital (Tier 1+ Tier 2+ Tier3) after deductions	**200,113**

INFORMATION ON LICENSED BANK'S CAPITAL ADEQUACY

The process of assessing the capital requirements of the Group commences with the compilation of the annual business plan by individual business units which are then consolidated into the annual budget plan of the Group. The annual budget plan provides an estimate of the overall growth in assets, its impact on capital and targeted profitability.

Annual dividend payout, is prudently determined and proposed by the Board of Directors (the Board), endeavoring to meet shareholder expectations while ensuring adequate retention of capital to support budgeted growth.

The Group ensures that capital adequacy ratios are maintained above the regulatory minimum.

The Group assesses the adequacy of its capital to support its current and future activities on an ongoing basis. Risk weighted assets and capital are monitored periodically to assess the quantum of capital available to support assets growth and optimally deploy capital to achieve targeted returns.

The Group regularly monitors its credit and market risks exposures, limits transactions with specific counterparties, and continually assesses the creditworthiness of counter parties to avoid any unexpected capital charge.

The Bank's credit rating continues to be rated "A" by Capital Intelligence and upgraded by Fitch Rating review to "A-" from "BBB+". Given the favorable ratings, the Bank is confident of meeting any additional capital requirements by resorting to eligible subordinated debt at competitive pricing to support any need for regulatory capital requirement and maintaining it at optimal levels.

Currently the Group's measurement of capital requirement is based on the CBK guidelines on capital adequacy. However the Group ultimately, aims to achieve a convergence of the regulatory capital with economic capital as it adopts advanced risk measurements for performance evaluation and capital adequacy.

TABLE 2 – CAPITAL REQUIREMENT FOR CREDIT, MARKET AND OPERATIONAL RISKS Standard portfolio	KD 000
Claims on sovereigns	69
Claims on Public sector entities	9
Claims on banks	12,021
Claims on corporates	57,307
Regulatory retail exposures	31,446
Past due exposures	753
Other exposures	17,265
Total credit risk capital charge	**118,870**
Total market risk capital charge (standardized approach)	**5,368**
Total operational risk capital charge	**8,148**
TOTAL	**132,386**

Tier 1 - Capital adequacy ratio	**14.70%**
Total Capital adequacy ratio	**18.14%**

INFORMATION RELATED TO A LICENSED BANK'S RISK MANAGEMENT

The Bank maintains a strong risk management culture and manages the risk / reward relationship within and across each of the major risk-based lines of business. The Bank continuously reviews its risk management policies and practices to ensure that it is not subject to large asset valuation and earnings volatility. The Board, senior management, risk officers, and line managers contribute to effective bank wide risk management. The Board defines its expectations, and through its oversight determines its accomplishment. The Board also has ultimate responsibility for risk management as they set the tone and other components of an enterprise wide risk management framework. Risk officers have the responsibility for monitoring progress and for assisting line managers in reporting relevant risk information. The line managers are directly responsible for all business booked in their respective domains. The effective relationship between these parties significantly contributes to the improvement in the Bank risk management practices as this leads to the timely identification of risk and facilitation of appropriate response.

The Risk Management Division (RMD) structure has a distinct identity and independence from business units. The division is comprised of units to address the pertinent risk exposure of the Bank. Its main responsibilities are to:

1) Evaluate and analyze the Bank wide risk profile by developing risk monitoring techniques;
2) Set up and develop criteria for defining the Bank's risk threshold in terms of various risk;
3) Develop and establish tools for the measurement of the Bank's various risk types; and
4) Recommend appropriate strategies / actions for mitigating risk and ensuring a sound risk asset structure for the Bank.

The following committees have the overall responsibility and authorities vested in them for the day-to-day risk management activities of the Bank. Authorities vested in the committees are exercised within the objectives and policies approved by the Board, and subject to the rules and regulations laid down by the CBK.

1. Senior Credit Committee (SCC) approves credit, investment, liquidity and market risks in excess of limits assigned to individual executives or other committees. The committee likewise reviews bank and country exposures and makes appropriate recommendations to the Board, where needed.
2. Credit Committee (CC) reviews and approves credit proposals which exceed individual credit authority limits provided the proposal meets the Bank's credit criteria.
3. Credit Classification and Evaluation Committee (CCEC) studies and evaluates classified accounts and determines an appropriate provisioning level.
4. Assets and Liabilities Committee (ALCO) meets periodically to review and approve strategies relating to the management of assets and liabilities including liquidity, interest rate, foreign exchange, cost of funds, cost allocation, deposit pricing matrix, and strategic trading positions.
5. Risk Management Committee (RMC) reviews effectiveness of the Bank's overall risk management processes and procedures, amendments to the credit risk, market risk, operational risk and treasury polices. It monitors compliance with financial regulatory ratios, corporate legislations and recommends to the Board, changes in the Bank's policies and methodologies needed to identify, measure, manage and monitor the multiple dimensions of risks inherent in the Bank's business activities.

The risk management function of the subsidiary is managed by its independent Board of Directors and Senior Management. The Bank's nominee directors on the Board of Directors of the subsidiary through its oversight manage and monitor the risk management activities of the subsidiary.

The following sections below, detail the risks inherent in the activities undertaken by the Bank, their nature and approach adopted towards management/ mitigation of these risks.

PILLAR 3 – DISCLOSURES (CONTINUED)
31 December 2006

INFORMATION RELATED TO A LICENSED BANK'S RISK MANAGEMENT (CONTINUED)

Credit Risk

Credit risk is the risk that one party to a financial instrument will fail to discharge an obligation on time and in full as contracted and cause the other party to incur a financial loss. Credit risk include the major risks mentioned below :

Direct Lending Risk
The risk that actual customer obligations will not be repaid on time. Direct lending risk occurs in products offered by the bank, ranging from loans and overdrafts to credit cards and residential mortgages. It exists for the entire life of the transactions.

Contingent Lending Risk
The risk that potential contingent obligations will become actual obligations and will not be repaid on time. Contingent lending risk occurs in products offered by the bank ranging from letters of credit and guarantees to unused loan commitments. It exists for the entire life of the transaction.

Issuer Risk
The risk that the market value of a security or other debt instrument may change when the perceived or actual credit standing of the issuer changes thereby exposing the Bank to a financial loss. It is interrelated to price risk.

Pre-Settlement Risk
The risk that a counter-party with which the Bank trades may default on a contractual obligation before settlement of the contract.

Settlement Risk
The risk occurs when the counter-party fails to settle the transaction on settlement date.

The Bank's Credit Policy aims to promote a strong credit risk management architecture that includes credit policies, procedures and processes. The policy defines the areas and scope of lending activities undertaken by the Bank and its main goal is not simply to avoid losses, but to ensure achievement of targeted financial results with a high degree of reliability in an efficient manner. The Bank's credit risk management focuses on the dynamic and interactive relationship between three credit extension process: Portfolio strategy and planning, credit origination and maintenance, and performance assessment and reporting discussed below.

Portfolio Strategy and Planning

The portfolio strategy and planning phase defines desired financial results (in each Business Unit and for the Bank) and the credit standards required to achieve them. Business strategies integrate risks and meet defined hurdles for risk-adjusted return on capital. Facility structure translates this risk-conscious business strategy into terms and conditions that mitigate risk.

Portfolio management establishes composition targets, monitors the results of these diverse business strategies on a continual basis, and allows the Bank to manage concentrations that can result from seemingly unrelated activities. Specifically, portfolio management involves setting concentration limits by standard dimensions so that no one category of assets or dimension of risk can materially harm the overall performance of the Bank.

The Risk Management Committee reviews portfolio concentrations in terms of economic sectors and credit risk rating. These sector and risk rating limits are reviewed annually to ensure that there are no undue concentrations in one sector or risk rating, and that the limits are within those set out by the Bank.

The Credit Committees (SCC and CC) approve bank-wide portfolio credit concentration limits to corporate or individual counterparties based on the Bank's overall risk capacity, capital considerations, and assessment of the internal and external environments. The Bank's credit exposure to individuals or group of counterparties are in accordance with the CBK instructions BS/101/1995 on Maximum Credit Concentration Limits and subsequent amendments / updates.

Financial Institutions Group (FIG) assesses the correspondent bank counter-party limits and recommends the same to the Senior Credit Committee (SCC) for onward approval of the Board.

On a quarterly basis, a summary of bank wide risk exposure is reported to the Board incorporating all the above concentration limits plus discussion on past due vintage, non performing loans (NPLs), collateral concentration, funding profile, capital adequacy, and other risk management initiatives.

Credit Origination and Maintenance

In the credit origination and maintenance phase, each Business Unit solicits, evaluates, and manages credit according to the strategies and portfolio parameters established in the portfolio strategy and planning phase. Transactions are generated within well-defined target market criteria, product structure, and are approved on risk-adjusted basis through the use of risk rating models.

The Bank uses a Credit Risk Rating ("CRR") model to assess the credit worthiness of borrowers. The credit risk measurement methodology is geared towards measuring credit risk for corporate and private banking portfolio. The risk gradations that the CRR adopts has been expanded to ten (10) grades: risk ratings 1 to 6 for performing assets; and risk ratings 7 to 10 for classified accounts. The expansion in risk grades puts the Bank in line with the Bank for International Settlements (BIS) requirements.

Credit maintenance involves processes to control documentation and disbursement, monitor timely repayment, value collateral and review the status of exposures. Within this phase, origination and underwriting for distribution to investors take place. A Post Fact Approval Unit independently reviews credit approvals to ensure that the approvals are consistent with policy and that all covenants of the approvals are met prior to disbursement of loan proceeds and throughout the tenure of the credit facilities.

Credit maintenance also includes early problem identification and remedial management of troubled exposures. The Special Asset Management Unit established within Risk Management Division provides a more focused attention to irregular and delinquent accounts. The primary objective of the unit is to develop effective strategies in order to either rehabilitate or restructure impaired credits.

Performance Assessment and Reporting

The performance assessment and reporting phase allows both the Senior Management and Business Units to monitor results and improve performance continually. Both portfolio and process trends are monitored in order to make appropriate and timely adjustments to business strategies, portfolio parameters, credit policies and credit origination and maintenance practices. This phase of the credit process draws on information within the Bank and external benchmarks to help evaluate performance.

Credit performance is assessed through analysis of:

1) Portfolio concentrations by obligor, industry, risk rating, tenor, product, collateral and other dimensions
2) Credit quality indicators
3) Exceptions to risk acceptance criteria
4) Other policy exceptions

The Bank has adopted an internal account profitability model (APM) to determine the profitability of corporate and private banking accounts. The methodology is based on the risk-adjusted return on capital (RAROC).

In addition, periodic review of both portfolio and process are performed not only by the Business Units, but by Risk Management and Audit Divisions as well.

In accordance with the instructions of the CBK dated 18 December 1996, setting out the rules and regulations regarding the classification of credit facilities, the Bank has a Credit Classification and Evaluation Committee which is composed of senior management. The committee studies and evaluates existing credit facilities of each customer of the Bank, and identifies any abnormal situations and difficulties associated with a customer's position which might cause the debt to be classified as irregular and to determine an appropriate provisioning level.

Market Risk

The Bank defines 'Market risk' as the uncertainty in future earnings, of the Bank's on and off Balance Sheet positions, resulting from changes in market conditions, i.e. changes in prices of assets and interest rates. Market risk pertains to the interest, equity foreign exchange and commodity risks in the Bank's trading and banking books.

Market Risk Management addresses the following areas:

- Quantitative parameters that define the acceptable level of market risk;
- Authorised instruments and hedging policies for managing risk exposures; and
- Exposure limits.

The Market Risk Management policy covers the following broad areas:

Interest rate risk management in the trading book and banking book

Interest rate risk arises from the possibility that changes in interest rates will affect the value of the underlying financial instruments. Interest rate risk in the trading book arises from the sensitivity of interest bearing instruments to interest rate volatility.

The Bank is exposed to interest rate risk as a result of mismatches or gaps in the amounts of assets and liabilities and off balance sheet instruments that mature or re-price in a given period. The Bank manages this risk by matching or hedging the re-pricing profile of assets and liabilities through risk management strategies.

The Bank assesses its interest rate risk in the balance sheet through gapping analysis based on the interest re-pricing mismatches of interest sensitive assets and liabilities. This report is complemented by an EaR (Earnings-at-Risk) analysis. EaR measures the net interest income volatility given a 1% parallel instantaneous change in interest rate. The main strength of the applied EaR approach is its simplicity in providing senior management a general picture of interest rate risk on the Bank's balance sheet.

The majority of the Bank's assets and liabilities re-price within one year. Accordingly there is a limited exposure to interest rate risk in the Banking Book.

Foreign exchange risk management in the trading and banking book

Foreign exchange risk in the trading book may arise when the rights to receive future assets are not equivalent to liabilities or obligations in a given currency. Examples of rights include currencies purchased in a forward exchange market and positions taken in currency futures. Obligations may include currency options.

Foreign exchange risk in the banking book arises from a currency mismatch between the Bank's assets and liabilities. The Bank views itself as a Kuwaiti entity with Kuwaiti Dinars as its functional currency. Hedging transactions are used to manage any significant risk in other currencies. Non-monetary assets carried at fair values that are not denominated in Bank's functional currency, are hedged using non-derivative financial liabilities for foreign currency risk.

PILLAR 3 – DISCLOSURES (CONTINUED)

31 December 2006

INFORMATION RELATED TO A LICENSED BANK'S RISK MANAGEMENT (CONTINUED)

Foreign exchange risk management in the trading and banking book (CONTINUED)

Foreign exchange trading and interest rate gap limits, together with ancillary limits (e.g., daylight, overnight, stop loss, etc.) are recommended by Treasury for the review of ALCO and RMC, and eventual approval by the Board.

Equity risk management in the trading book and banking book

Equity price risk arises from the changes in fair values of equity investments. Values of individual securities can fluctuate in response to a variety of factors, other than movements in the interest or exchange rates. For example market valuations of equity securities may respond to factors such as operating results of the company, rights issues, key corporate decisions, changes in credit ratings of the securities and other market changes.

The Bank manages the equity risk in its trading book by setting up position limits and closely monitoring breaches. Equity risks in the banking book are mitigated through diversification of investments in terms of geographical distribution and industry concentration. The majority of the Bank's equity investments in the banking book are quoted on the Kuwait and Bahrain stock exchanges.

Liquidity risk

The Bank defines liquidity risk as its ability to meet all present and future financial obligations in a timely manner and without undue effort and cost.

A periodic Liquid Asset Ratio (LAR) report is prepared to measure the level of liquid assets available to fund short term contractual liability obligations including unused standby commitments. Under normal circumstances, the LAR report assumes that private deposits are reduced by 10% and inter-bank borrowings and financial deposits are fully withdrawn. Assumptions could be modified depending on the change in the characteristics of deposit liabilities. To stress-test the LAR, the reduction in private deposits is increased to 25% and results are reviewed by senior management and appropriate actions are taken when needed.

A weekly liquidity gapping report is likewise prepared following the CBK guidelines which shows periodic and cumulative net outflows between asset and liability run-off profiled in terms of their contractual maturities.

In order to supplement the existing liquidity risk monitoring reports, a set of liquidity ratios, collectively known as "Management Action Triggers" (MAT), are monitored on a daily basis to manage the day-to-day liquidity funding profile of the Bank. A guiding range for each ratio has been set by ALCO and appropriate actions are taken, whenever the ratios are breached.

A liquidity contingency plan to address systemic and localised liquidity emergencies is reviewed periodically to ensure that it is kept up to date and in line with the business continuity plan.

Criteria for the allocation of transactions into the trading book have been set by RMC. Treasury Operations reviews the compliance to the established criteria for allocation of financial instruments to the trading book. Internal Audit conducts an independent review to ensure compliance on an annual basis. Any exceptions are brought to the attention of the RMC.

Operational Risk

The Bank defines operational risk as the risk of direct and indirect loss resulting from inadequate or failed internal processes, people or systems or from external events. This definition clearly includes disaster recovery planning as a function of operational risk management. It is for this reason that the Bank finds it prudent to include the same consideration, namely, unexpected significant and unusual one-time events, such as disaster events in its framework for operational risk management.

The operational risk management framework provides the Bank with the foundation for a comprehensive and an effective operational risk management program with the following major objectives:

1) Provide a clear understanding throughout the Bank of what constitutes an operational risk event;
2) Promote communication among senior management and risk taking units on various elements that impact operational risk, thereby clarifying accountability; and
3) Systematically track relevant operational risks by business lines across the Bank and build up an operational loss data base.

The framework likewise outlines the quantitative approach the Bank adopts in measuring operational risk unique to the Bank's own risk profile as well as the allocation of economic capital. As a preliminary step in the application of a quantitative approach, an operational risk self assessment (ORSA) exercise was conducted. The primary objective of the exercise were two-pronged: first, to promote greater understanding of inherent operational risks associated with business undertaken; and second, strengthen the discipline of consciously monitoring operational risks on an ongoing basis. The Bank's ORSA approach is in line with the BIS requirements and recommendations.

The Bank defines "contingency planning", Disaster Recovery Plan (DRP) and Business Continuity Plan (BCP) as the process of identifying critical information systems and business functions and developing plans to enable those systems and functions to be resumed in the event of a disruption. This process includes regular testing to ensure that contingency plans are effective. During the testing process, management verifies that the business unit plans complement the information systems plans that are in effect for mainframe functions.

The Bank's DRP, in its entirety, constitute four critical factors, namely (a) Technical DRP, (b) Business Continuity Plans, (c) logistical requirements in the event of a disaster, and (d) procedures to be followed to activate during the implementation of the DRP. Integral to the DRP is the assignment of key individuals who will be tasked to trigger and oversee the DRP until the Bank regains normal operations.

The Technical DRP is the foundation on which the remaining three factors have been built up e.g. the business continuity plan or recovery process is developed, reviewed and updated based on the progress in the technical disaster recovery front.

The Bank has been performing DRP test annually. The latest DRP test focused on "data integrity" and branch "off-host" system and procedures. The "off host" tests were conducted for all branches in 2006. All "off host" transactions posted by the branches were accepted as soon as the system was shifted back to "on-host" mode. The data integrity test was also conducted at the Disaster Recovery Site. The results of both "off-host" and data integrity tests were satisfactory.

BCP procedures have been updated to consider the recent technical changes implemented by IT. The exercise also required the end-users to accomplish a "business impact analysis" to assess whether or not additional systems will be required to support business continuity in the end-users' respective areas.

The above operational risk initiatives comply in all material respects with the CBK instructions dated 14 November 1996 regarding general guidelines for internal control systems and directives issued on 13 October 2003 regarding "Sound Practices for the Management and Control of Operational Risks".

Data Security Management

Although data security is somewhat related to disaster recovery planning, it is often a more immediate threat. Lapses in data security could result in breaches of privacy, theft or corruption of information, contamination of programs, and theft of resources or assets. An unsecured network may allow access to some very sensitive information (e.g., personnel, loan, or payroll records), corporate financial records, or similar information that might be of value to competitors, the media, or thieves. The elements discussed below are included in the Bank's security policy and standards.

The Bank has a security policy that informs the employees, customers, partners, and others that the Bank takes the security of data seriously. In addition, in the event of legal action, it notifies the court that the Bank has made a reasonable effort to secure its data. It also provides guidance to those who implement security so that they use an equitable and standard approach.

The Bank's main statement of policy is to implement a secure information system by identifying the responsibilities at every level of information handling, i.e. from data ownership (encoding) to data access. Periodic audits are conducted to ensure compliance with the policies and standards set by the Bank.

The comprehensive security policy covers not only the technical aspects of security, but also issues dealing with how Bank employees should treat sensitive information which includes the following:

1) Data privacy
2) Availability of resources
3) Data integrity

Internet or network security deals with many technical issues, including firewalls, network configuration, and encryption of data. The security policy identifies the minimal configurations and the expected uses of encrypted data.

Maintaining host and network security also depends largely on the definition and maintenance of password. The policy identifies how passwords are maintained and provides guidelines for the importance of password confidentiality and how to maintain it.

Legal and Compliance

Legal risks represent the possibility of incurring a monetary loss as a result of inability to enforce contracts/ agreements signed by the Bank due to faulty documentation / improper drafting. As a general rule, the Bank ensures that the counterparties and customers have legal and necessary authorities to engage in contracts and transactions with the Bank and that obligations arising from these transactions are enforceable.

Legal Division ensures that the Bank is compliant with all legislation applicable to the Bank's business activities. Meanwhile, a Compliance Officer ensures that the Bank is compliant with all the requirements of the CBK. Part of the Compliance Officer's main responsibilities is to comply with the CBK's instruction regarding combating money laundering and terrorist financing. Policy and procedures manual related to anti-money laundering have been implemented.

The Bank, whenever required, follows international standards and adopts best market practices when it comes to risk management activities. RMD stays aware of developments both within the organization as well as in the marketplace to ensure that the Bank may quickly adapt its risk management policies for any significant changes. The risk control programs are periodically benchmarked against regulatory standards and industry best practices.

Whilst the Bank adheres to the regulatory standards and best market practices, it also recognizes the fact that the myriad of risks, affecting different parts of the Bank's risk-taking activities is continuously evolving. The biggest challenge, therefore, is keeping the information updated and relevant to facilitate better understanding of risk and effective response. To this end, RMD periodically performs a re-evaluation of significant risk management policies and procedures and develops action plans to correct any weaknesses. This also ensures that the Bank moves further along the continuum in terms of sophistication and analytical tools with respect to each of the risk dimensions.

INFORMATION RELATED TO A LICENSED BANK'S CREDIT EXPOSURES

Credit facilities with overdue amounts of over 90 days are identified as past due and in line with regulatory guidelines; facilities with overdue amounts are classified as either sub-standard, doubtful or bad depending on the number of days which the amounts are overdue. Other credit exposures are considered as impaired if its carrying amount is greater than its estimated recoverable amount. An assessment is made at each balance sheet date to

PILLAR 3 – DISCLOSURES (CONTINUED)
31 December 2006

INFORMATION RELATED TO A LICENSED BANK'S CREDIT EXPOSURES (CONTINUED)

determine whether there is objective evidence that a specific credit exposure, or a group of similar exposures, are impaired.

Credit facilities identified and classified as past due are subject to specific provision for impairment, the amount of provision is the difference between the carrying amount and the recoverable amount, being the present value of expected future cash flows, including amounts recoverable from guarantee and collateral, discounted based on contractual interest rate.

The provision for impairment of credit facilities covers losses where there is objective evidence that losses may be present in components of the credit facilities portfolio at the balance sheet date. These have been estimated based on historical patterns of losses in each component, the credit ratings allotted to the borrowers and reflecting the current economic climate in which the borrowers operate. Besides, as per the CBK's requirements, a minimum general provisions of 2% is made on all credit facilities not subject to specific provision.

Where available, the Group uses External Credit Assessment Institutions (ECAI) ratings for categorizing riskiness of credit assets.

ECAI's have been used for the following standard portfolios

Standard portfolio	ECAI
Claims on sovereigns, banks and corporates	Fitch, Moody's and Standard & Poor's

TABLE 3 – GROSS CREDIT RISK EXPOSURES BEFORE CRM (KD 000)

Standard portfolio	Year end balances Funded	Year end balances Unfunded	Year end balances Total	Monthly average balances Funded	Monthly average balances Unfunded	Monthly average balances Total
Cash items	9,366	-	9,366	5,206	-	5,206
Claims on sovereigns	350,135	-	350,135	381,804	-	381,804
Claims on public sector entities (PSEs)	-	3,040	3,040	-	1,756	1,756
Claims on multilateral development banks (MDBs)	97	-	97	95	-	95
Claims on banks	451,983	3,854	455,837	298,607	7,457	306,064
Claims on Corporates	578,864	73,815	652,679	656,886	71,450	728,336
Regulatory retail exposures	353,870	1,652	355,522	296,238	6,355	302,593
Past due exposures	12,347	12	12,359	17,051	-	17,051
Other exposures	143,877	-	143,877	132,642	-	132,642
TOTAL	**1,900,539**	**82,373**	**1,982,912**	**1,788,529**	**87,018**	**1,875,547**

TABLE 4 – GEOGRAPHIC DISTRIBUTION OF EXPOSURES (KD 000)

Standard portfolio	Kuwait	Other Middle East	Europe	U.S.A. & Canada	Rest of the World	TOTAL
Cash items	9,365	1	-	-	-	9,366
Claims on sovereigns	342,704	4,540	-	-	2,891	350,135
Claims on public sector entities (PSEs)	3,040	-	-	-	-	3,040
Claims on multilateral development banks (MDBs)	-	97	-	-	-	97
Claims on banks	205,287	103,345	144,170	2,102	933	455,837
Claims on corporates	591,267	43,997	11,632	-	5,783	652,679
Regulatory retail exposures	355,004	473	-	-	45	355,522
Past due exposures	12,359	-	-	-	-	12,359
Other exposures	103,560	38,399	1,037	656	225	143,877
TOTAL	**1,622,586**	**190,852**	**156,839**	**2,758**	**9,877**	**1,982,912**

TABLE 5 - DISTRIBUTION OF GROSS EXPOSURES BY INDUSTRY (KD 000)

Industry	Funded	Un funded	Total
Trading and manufacturing	220,702	38,627	259,329
Banks and financial institutions	828,532	5,291	833,823
Construction and real estate	189,350	16,458	205,808
Other	661,955	21,997	683,952
TOTAL BANKING BOOK ASSETS	**1,900,539**	**82,373**	**1,982,912**

TABLE 6 - DISTRIBUTION OF GROSS EXPOSURES BY RESIDUAL CONTRACTUAL MATURITY (KD 000)

Standard Portfolio	Up to 1month	1 to 3 months	3 to 12 months	Over one year	Total
Cash items	9,366	-	-	-	9,366
Claims on sovereigns	8,355	641	169,360	171,779	350,135
Claims on public sector entities (PSEs)	11	698	1,281	1,050	3,040
Claims on multilateral development banks (MDBs)	-	-	-	97	97
Claims on banks	387,434	59,763	7,769	871	455,837
Claims on corporates	69,072	219,503	250,269	113,835	652,679
Regulatory retail exposures	1,507	7,218	25,859	320,938	355,522
Past due exposures	12,359	-	-	-	12,359
Other exposures	82,711	2,374	1,161	57,631	143,877
TOTAL	**570,815**	**290,197**	**455,699**	**666,201**	**1,982,912**

TABLE 7 - IMPAIRED LOANS AND PROVISION (KD 000)

Industry	Impaired loans	Specific provision	Charge for the year	Write off
Trading and manufacturing	1,970	1,410	(43)	319
Banks and financial institutions	29	29	22	22
Construction and real estate	4,430	1,949	39	-
Other	25,010	15,704	1,764	168
TOTAL BANKING BOOK ASSETS	**31,439**	**19,092**	**1,782**	**509**

As at 31 December 2006, the Bank carries a total provision of KD 38,509 thousand including the above mentioned specific provision and general provision of minimum 2% on all claims on corporates and regulatory retail exposure (net of certain categories of collateral), that are not provided for specifically in line with CBK instructions.

The amount of impaired loans outside Kuwait is not material.

TABLE 8 - EXPOSURE POST RISK MITIGATION AND CREDIT CONVERSION (KD 000)

Standard Portfolio	Rated	Unrated	Total
Claims on sovereigns	578	-	578
Claims on Public Sector Entities	146	-	146
Claims on banks	100,171	-	100,171
Claims on corporates	723	483,371	484,094
Regulatory retail exposures	-	265,353	265,353
Past due exposures	-	6,274	6,274
Other exposures	-	143,877	143,877
TOTAL	**101,618**	**898,875**	**1,000,493**

INFORMATION RELATED TO CREDIT RISK MITIGATION

Collateral is obtained from clients pursuant to the Bank's appraisal of the financial position, solvency, reputation and past experience of the client and the Bank's estimation of the degree of financing risks. Adequate collateral coverage ratios are maintained by the Bank in line with CBK guidelines. In the event of a decline in value of collateral, additional coverage is sought by the Bank. A significant portion of the Bank's lending portfolio is adequately covered either by tangible collateral or assignment of revenues and third party receivables.

In order to mitigate the credit risk the Bank is exposed to, it accepts collateral in the form of cash (e.g., fixed deposits, deposit certificates and/or other savings instruments); shares / portfolio of shares traded on recognized exchanges; debt securities issued by sovereign entities having acceptable credit quality grade, multilateral development banks and commercial banks with acceptable credit quality grade; guarantees and stand-by letters of credit issued by banks with acceptable credit quality grade and having available guarantor line.

In addition to the above, the Bank accepts lien on sponsored funds, mortgages on real estate properties and chattel, legal assignment of contracting works or supply contracts as well as legal assignment of rentals or leases.

With respect to counter-party guarantors, the Bank accepts only those that are considered investment grade risks.

Where applicable, on and off-balance sheet netting are used to the extent allowed as per the provisions of the contracted documentation, legal right to set-off and there are no maturity mismatches.

PILLAR 3 – DISCLOSURES (CONTINUED)
31 December 2006

INFORMATION RELATED TO CREDIT RISK MITIGATION (CONTINUED)

The Bank has a system of periodic collateral valuation, monitoring, and follow-up for inadequate coverage. This ensures that the Bank has an effective collateral management process, wherein:

1) the collateral are appraised periodically, following the CBK guidelines as the minimum time interval, e.g. real estate properties are appraised every year while shares / portfolio of shares traded on recognized stock exchanges are monitored every day / month respectively;
2) the minimum Loan to Value (LTV) as set by the CBK is applied whenever practicable bearing in mind, that LTV for individual obligor maybe lower than that set by CBK depending on the credit circumstances, structure of facility, and creditworthiness of the obligor;
3) the Bank maintains the right to liquidate or take legal possession of the collateral in a timely manner in the event of obligor default; and
4) the obligor and the value of the collateral do not have a material positive correlation.

Credit exposure is reviewed monthly by the RMC to ensure that there is no undue concentration. In the event that there is heavy concentration towards specific economic sector or counter-party, the Bank sells down the related assets and / or requires the client to put up sufficient liquid security.

TABLE 9 - ELIGIBLE FINANCIAL COLLATERAL AND GUARANTEES KD 000

Standard Portfolio	Gross Exposure	Eligible CRM
Claims on corporates	652,679	167,863
Regulatory retail exposures	355,522	1,718
Past due exposures	12,359	5,520
TOTAL	**1,020,560**	**175,101**

INFORMATION RELATED TO MARKET RISK FOR TRADING PORTFOLIO, FOREIGN EXCHANGE AND COMMODITIES EXPOSURE

The Group currently follows the standardized approach in determining capital requirement for market risk on the trading book. The Group' proprietary positions in financial instruments, include positions in derivative products and off-balance instruments, held for short-term resale and/or which are taken on by the Group with the intention of benefiting in the short-term from actual and/or expected differences between their buying and selling prices, or from interest rate variations, and positions taken in order to hedge other elements of the trading book.

For measuring the market risk in the trading book, all positions are marked to market daily, including recognition of accrued interest, dividends or other benefits as appropriate. Foreign exchange positions are marked to market using a close-out valuation based on a mid-market price for spot positions and forward swap points for the forward positions. Financial instruments that impact interest rate risk positions, including derivatives, are valued based on industry accepted valuation models. Equities and commodities, are marked to market, using bid prices

TABLE 10 - CAPITAL REQUIREMENT FOR COMPONENTS OF MARKET RISK KD 000

Standard Portfolio	Capital charge
Interest rate risk	92
Equity position risk	3,508
Foreign exchange risk	1,770
Total	**5,370**

INFORMATION RELATED TO OPERATIONAL RISK

Operational risk is defined by Group as the risk of direct and indirect loss resulting from inadequate or failed internal processes, people or systems or from external events.

The operational risk capital charge is calculated using standardized approach. Under this approach the Group allocated the gross revenue to various business lines such as:

1. Commercial Banking
2. Retail Banking
3. Trading and sales
4. Assets management

Gross income includes income directly attributable to the business line. Gross income attributable to individual business lines are further broken down into net interest income, net non interest income and profit or loss on securities trading. Beta factors are applied to the average of previous three year Gross income to calculate the operational risk capital charge.
The Basel II accord requires banks to hold capital against operational risk. The accord offers a continuum of approaches from the simplest basic indicator approach to the more advanced measurement approaches. The Group likewise realizes that the current spectrum of possible quantitative approaches to operational risk is already broad, and that there is no consensus yet on the acquisition of high-quality data that will support these approaches.

In its endeavor to adopting a risk sensitive approach and address the lack of operational loss database, the Group views operational risk management as a progression involving four layers of activity. These could be summarized as follows:

Level 1 - Risk Self Assessment deals with words more than numbers. It involves:
- Qualitative review of inherent risks
- Review of controls and procedures
- Specification of corrective actions if necessary and follow-up on implementation of such actions

The self-assessment process involves both line management (business risk officer) and external facilitator (ORSA facilitators are officers from both Risk Management and Internal Audit Divisions) to encourage frank and open discussions of issues and remedial actions. This activity is seen to generate significant amounts of descriptive and subjective rating information.

Level 2 - Key Risk Indicators (KRI) is the process of collecting and reporting on an eclectic set of quantitative measures that correlate with the likelihood of potential failures in a process. These indicators are not readily combined into a single aggregate. Rather, they are useful on a comparative basis across similar processes and over time. They allow effective benchmarking of processes. When tracked over time, they can give valuable early warning of possible problems and can facilitate timely corrective action.

Level - 3 Loss Data Collection. The Bank's collection of historical operational risk losses as well as "near misses" had commenced in early 2003 and is ongoing. Internal loss data are not the only, or necessarily the most important, indicators of operational risk. But such losses do represent the ultimate negative consequences of process failures. Combined with external loss data (where available), they are central to scaling the magnitude of an aggregate risk capital allocation.

Level - 4 Analytics relates to quantitative analysis applicable to fragmentary data of very low probability but very high impact loss events. The aim at this level is to allow the Bank to manage operational risk and measure internally the capital requirement, compliant with the Advanced Measurement Approaches (AMA) recommended by Basel II. In general, the objective is to estimate a loss distribution and to derive functions of interest from it, such as value-at-risk (VaR).

The Bank is resolute in reducing and controlling operational risk, and to this end, has adopted a disciplined approach to all layers of operational risk identified above. This qualitative to quantitative approach to operational risk is in line with the recommendations of the BIS.

TABLE 11 – CAPITAL CHARGE FOR OPERATIONAL RISK KD 000

Business Line	Capital Charge
Trading and Sales	588
Commercial Banking	3,789
Retail Banking	2,479
Asset Management	1,292
Total	**8,148**

INFORMATION RELATED TO EQUITY POSITION

Investments in the banking book are classified at the time of acquisition into those acquired for capital gains and strategic investments. Investments acquired with a view of generating income and profits from capital appreciation are reviewed periodically and disposed off at opportune instances. The Bank reviews its strategic investment portfolio based on the industry, market and economic developments and then either liquidates or further consolidates holdings in these investments.

In accordance with International Financial Reporting Standard, equity positions in the banking book are classified as available for sale securities. These investments are fair valued periodically and revaluation gains / losses are accounted as cumulative changes in fair value in equity. For equity investments quoted in organized financial markets, fair value is determined by reference to quoted bid prices. Fair values of unquoted equity investments are determined by reference to the market value of a similar investment, on the expected discounted cash flows, or other appropriate valuation models. Equity investments whose fair value cannot be estimated accurately are carried at cost less impairment if any.

TABLE 12 – EQUITY POSITION IN BANKING BOOK KD 000

Investment Type	Carrying value	Capital requirement
Publicly traded	82,312	7,365
Privately held	25,722	2,576
TOTAL	**108,034**	**9,941**

INFORMATION RELATED TO EQUITY POSITION (CONTINUED)

Publicly traded investments represent quoted equities traded on local and international stock exchanges. Privately held investments represent investments in unquoted entities and venture funds. The total value of investments in the banking book in the balance sheet is KD 118,014 thousand. Cumulative realized gain from sale of available for sale securities is KD 7,816 thousand. The total un-realized gain recognized in the equity is KD 46,976 thousand of which KD 21,139 thousand is included in Tier 2 capital.

INFORMATION RELATED TO THE LICENSED BANK'S INTEREST RATE RISK IN THE BANKING BOOK (IRRBB)

The Bank periodically monitors the interest rate mismatch in assets and liabilities through gap analysis based on the interest re-pricing mismatches of interest sensitive assets and liabilities. The Bank uses Earnings-at-Risk (EaR) model to assess the volatility of the Bank's Net Interest Income (NII). The EaR provides an approximation of the likely NII impact of a given change in interest rate. The following assumptions are considered in calculation of the EaR:

1. Change in interest rate of 1%;
2. The rate change is instantaneous for all time buckets; and
3. Assets and liabilities are spread evenly within the time bucket.

The EaR approach provides the Bank the volatility in its NII and the interest rate risk in the Bank's banking book.

The Bank's EaR position is periodically reviewed by Assets and Liability Committee (ALCO) to enable the management to assess the sensitivity of the Bank to changes in market conditions and other risk factors that could impact NII. The ALCO has the authority and responsibility to develop strategies and implement tactical plans to ensure that NII volatility remain within acceptable bounds.

TABLE 13 – IMPACT OF 1% SHOCK ON INTEREST RATE RISK IN BANKING BOOK KD 000

	1-7 Days	Upto 1M	Upto 2M	Upto 3M	Upto 4M	Upto 5M	Upto 6M	Upto 1Y
Consolidated								
Cumulative Impact	3,716	3,519	2,892	2,175	1,525	1,145	1,185	1,346
KWD								
Cumulative Impact	3,538	4,128	3,355	2,581	1,964	1,549	1,520	1,663
FC								
Cumulative Impact	178	(609)	(463)	(406)	(439)	(404)	(335)	(317)