the vision

Annual Report / 2005

the partnership

the performance

Investment Bank

A brief history of Bahrain Middle East Bank (B.S.C.)

BMB was established as an exempt joint stock company on 21 March 1982 with Commercial Register Number 12266 to engage in offshore banking under a licence granted by the Bahrain Monetary Agency.

The Bank is principally engaged in investment banking, asset management and proprietary trading.

Originally the Bank was incorporated for a fixed term of 25 years ending in 2007, which was subsequently extended to 2032 pursuant to a resolution of the shareholders and the approval of Bahrain's Ministry of Commerce. In August 2005, the Bank amended its Memorandum and Articles of Association to convert from an Exempt Company "(E.C.)" to a Bahrain Shareholding Company, "(B.S.C.)". As part of that process, BMB acquired an indefinite corporate life.

BMB's shares are listed on the Bahrain Stock Exchange under Reuters code BMEB.BH.

Until July 1999, the Bank's principal shareholder was Burgan Bank SAK of Kuwait, which held a 28.6% stake. Burgan Bank sold its shareholding in BMB late in 1999 with UGB retaining approximately 8%. As a result of that sale, Al-Fawares Construction and Development ("Al Fawares"), a private Kuwaiti company, became the Bank's major shareholder with a stake of about 18%. In August 2005, following a capital reorganization and rights offering, Al-Fawares increased its shareholding to 64.5%. No other single shareholder owns 10% or more of the Bank's shares. The balance of BMB's shares is held by almost 13,150 shareholders throughout the Gulf region.

From 1982 to 1992, the Bank focussed on international commercial banking activities with overseas operations in the USA, UK, Netherlands, Switzerland and Hong Kong. A new management team was appointed in 1993, which implemented a new strategic direction of transforming BMB into a niche investment bank serving selected clients in the Gulf Co-operation Council ("GCC") countries and the Arab world. Determined to compete only in markets where it had a competitive edge, the Bank divested activities that did not meet with its focus on investment banking, treasury products and investor marketing.

BMB has a wide range of business alliances with leading investment banks, commercial banks and private equity asset managers throughout the G-7 countries. It works with these partners to develop innovative investment banking products which add value for its clients and shareholders.

In April 2000, the Bank launched a rebranding campaign and is now known as BMB Investment Bank. BMB's legal name remains Bahrain Middle East Bank (B.S.C.).

the vision to make the best decisions, even when they are not the obvious ones,

the partnership we share with our clients, shareholders and staff and

the performance that vision and partnership can achieve

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Mission, Strategy and Franchise

Our mission

Our goal is to be a premier Gulf-based investment bank, recognised for providing profitable and innovative quality investment products to our clients and sustainable attractive returns to our shareholders.

We aim to deliver a high standard of performance in all aspects of our activity:

- Superior, consistent returns on investment for our shareholders and clients.
- Sustainable, mutually beneficial endeavours with leading global investment and commercial banks.
- A professional and rewarding working environment for our staff.

Our strategy

We seek to grow our business through:

- Anticipating shifts in fundamental macroeconomic and demographic trends.
- Aligning our business strategies to take advantage of these changes.
- Delivering innovative, high quality investment products and services to our clients.

Our franchise

We believe our franchise is the unique combination of:

- The ability to identify shifts in underlying fundamental macro and demographic trends.
- Efficient administration and decision making, which enables us to move quickly to take advantage of changing trends without compromising internal controls or risk management.
- Strong relationships with asset managers and deal originators, which facilitate sourcing investments quickly in our target investment sector.
- Deep knowledge of our investor base, which allows us to identify those opportunities most relevant to our clientele.
- Innovative, sophisticated and dedicated staff, capable of structuring these opportunities into attractive transactions for our clients and for the Bank.
- Solid placement capabilities in the GCC countries and the rest of the Arab world.

Directors’ and Chief Executive’s report to the shareholders

"In a very real sense 2005 marked a turning point for BMB”

On behalf of the Board of Directors, we are pleased to submit the Bank’s annual report for the year ended 31 December 2005.

2005 was a good year and as a counterpoint to the past three years very welcome.

We reported a consolidated net profit of US$7.8 million, a significant improvement over the previous year’s net profit of US$0.6 million. Earnings from private equity funds played a key role in this turnaround. We expect strong results from this asset class to persist as macroeconomic trends in Europe and North America remain favourable. Our earnings remained constrained by the lack of foreign exchange and trading lines which means that the Bank is not able to hedge its non-US dollar denominated assets, chiefly private equity investments. This resulted in non-cash losses and was primarily responsible for the US$5.3 million loss in foreign exchange for the year.

The Group’s results for the year include T&T Beverages Limited which we have consolidated since 2003. However, since T&T is not part of our core business, we believe that its consolidation masks the true performance of our ongoing business. The operations of our banking segment, which is our core franchise, better reflect the performance and future prospects of the Group. For 2005, this segment, which does not include T&T, earned US$12.3 million in profits as compared to US$5.6 million in 2004. Moreover, the Bank is actively pursuing several alternatives for the final disposition of this investment.

In a very real sense 2005 marked a turning point for the Bank.

After finalising negotiations for the refinancing of our US$75 million term facility in late 2004, we took decisive action in 2005 to get BMB “back on track”.

In February we made a US$5 million principal repayment on our US$75 million facility.

In May 2005, we secured shareholder approval for a capital reorganisation and capital raising exercise to restore the Bank’s equity. In July we moved from approval to implementation with the launch of our successful rights offering and private placement. Over US$52.3 million in new capital was raised from cash subscriptions as well as from the conversion of debt of US$36.8 million to equity.

This enabled us to restore the Bank to a positive net worth. The US$36.8 million debt conversion will reduce our interest expenses burden going forward, while providing additional cashflow flexibility.

Since then, we have re-energised our client marketing activity, including the placement of a private equity transaction in the United States involving an integrated email and internet security provider. We have also begun approaching correspondents and other financial intermediaries to rebuild our relationships with this very important group.

In the fourth quarter of 2005, the Board undertook a review of the Bank's lines of business in light of the progress made during the year as well as the constraints BMB faces in the near term. The Board reaffirmed that the Bank will maintain its focus on private equity fund investments and its client business, which have served us well in the past and which we expect to do so in the future. On a more limited basis, BMB will also engage in proprietary trading of foreign exchange, equities, bonds and other interest rate sensitive instruments. A key goal will be the development of less market sensitive revenues to reduce volatility in our earnings. For the near term, the Bank will focus on rebuilding its credibility in the market and securing funding and trading lines.

We accomplished much this year but we know that much has yet to be done. We remain confident in the underlying strength and rationale of our business model. As such, we are resolute in our determination to restore BMB's franchise and position the Bank for ongoing growth.

As we look back on 2005, we recognise that many parties contributed to our success. It is appropriate that we take time to acknowledge and thank them.

We would like to thank His Majesty the King and the Government of Bahrain for their patronage and support. We would also like to express our very sincere appreciation to the Bahrain Monetary Agency for its wise counsel and its constant support during BMB's difficult times.

Finally, we would like to express appreciation to our other business partners – investment and commercial banks, fund managers, other finance industry professionals and our clients – as well as our shareholders, Board of Directors and all of our staff for standing with us during this challenging period. We look forward to continuing our working relationships with all of them in 2006 and beyond.

Sheikh Ali Jarrah Al-Sabah
Chairman

Wilson Benjamin
Member of Board of Directors

Albert I. Kittaneh
Chief Executive

29 January 2006

Board of Directors

Board of Directors

Sheikh Ali Jarrah Al Sabah
Chairman, Independent Non Executive Director

Mr. Wilson S. Benjamin
Vice Chairman, Non Executive Director

Sheikh Ali Khalifa A. Al Sabah
Member, Independent Non Executive Director

Dr. Awadh Kh. Al-Enezi
Member, Independent Non Executive Director

Sheikh Abdulla A. K. Al Sabah
Member, Independent Non Executive Director

Mr. Ebrahim A. S. Bu Hendi
Member, Independent Non Executive Director

Mr. Abdulaziz A. Abdulmalik
Member, Independent Non Executive Director

Executive committee

Sheikh Ali Jarrah Al Sabah
Chairman

Mr. Wilson S. Benjamin
Vice Chairman

Sheikh Abdulla A. K. Al Sabah
Member

Mr. Abdulaziz A. Abdulmalik
Member

Mr. Albert I. Kittaneh
Non-voting member

Audit committee

Dr. Awadh Kh. Al-Enezi
Chairman

Mr. Ebrahim A. S. Bu Hendi
Vice Chairman

Mr. Wilson S. Benjamin
Member

Notes:

(1) The Board of Directors was elected by the Bank's shareholders at the Ordinary General Meeting held on 11 May 2005 for a three-year term ending in 2008.
(2) Designation of Directors as "Executive", "Non-Executive" and "Independent" is in conformity with the definitions established by the BMA in Volume 1 Module HC of its Rulebook for Conventional Banks.
(3) As the representative of Al-Fawares Construction and Development Company on the Bank's Board, Mr. Benjamin is not considered an "Independent Director" as defined by the BMA.
(4) No members of management serve on the Board of Directors. Hence, the Bank has no "Executive Directors".

Sheikh Ali Jarrah Al Sabah (Director since July 1982) Chairman of the Board of Directors and Chairman of the Executive Committee

A member of the ruling family of the State of Kuwait, Sheikh Ali was a former member of the Higher Planning Council in Kuwait. He was formerly the Chairman of the International Bank of Asia in Hong Kong, a board member of Arab Banking Corporation (B.S.C.) and Banco Atlantico.

Mr. Wilson S. Benjamin (Director since March 2000) Vice Chairman of the Board of Directors, Vice Chairman of the Executive Committee and Member of the Audit Committee

Since 1992, he has been the President and Chief Executive Officer of Al-Fawares Construction & Development Company where he is responsible for Al-Fawares' investments and participation in the management of certain of its portfolio companies.

Since 1992, he has also served as the Chairman of the Board of Directors and Chief Executive Officer of ATO Ram 2 Ltd., where he is responsible for managing ATO's operations and its investments in public and private companies in the United States, Europe and the Gulf states. Since 2003, Chairman of Lotus Real Estate Co., a real estate development company in Egypt. Mr. Benjamin received a B.A. in business administration from Al Hikma University in Baghdad, Iraq.

Sheikh Ali Khalifa A. Al Sabah (Director since March 2000) Director

Sheikh Ali Al Sabah is a member of the ruling family of the State of Kuwait. Sheikh Ali was Minister of Oil and Minister of Finance for Kuwait between the years 1978 and 1991. Sheikh Ali was also Chairman and Managing Director of Kuwait Real Estate Bank from 1998 to 2000. He holds a Master of Economics from University of London, England.

Dr Awadh Kh. Al-Enezi (Director since October 1999) Director and Chairman of the Audit Committee

A PhD graduate of Bath University in 1991 and the University of New York in 1995, Dr. Al-Enezi is a lecturer at the University of Kuwait. As a recipient of numerous awards he has published several studies dealing with the socio-economic culture in Kuwait. He is an active board member of several institutions.

Sheikh Abdulla Ali K. Al Sabah (Director since May 2005) Director and Member of the Executive Committee

A member of the ruling family of the State of Kuwait, Sheikh Abdulla is the Chairman of Lotus Air, Managing Director of Lotus Real Estate Development Company, General Manager of Universal Media in Kuwait and serves on the boards of many other companies in Kuwait and the United States. He has a Master's in Finance from George Washington University.

Mr. Ebrahim A .S. Bu Hendi (Director since May 2005) Director and Vice Chairman of the Audit Committee

Over thirty years of banking/treasury experience gained through working with the following institutions: Citibank, Chase Manhattan, Paribas and National Commercial Bank, Saudi Arabia. The last ten years were at Bank of Bahrain & Kuwait as AGM – Treasury, Investment and overseas branches. Mr. Bu Hendi has an MBA from Sheffield Hallam University, UK.

Mr. Abdulaziz A. Abdulmalik (Director since May 2005) Director and Member of the Executive Committee

Over twenty-seven years experience in commercial and investment banking. Sixteen years with Manufacturers Hanover Trust Company and Chemical Bank Bahrain, with his final position as Deputy Branch Manager. Nine years with BMB as AGM – Operations. Mr Abdulmalik is also active in technical consulting for Netlink Consultants Bahrain. He has a B.S. from Riyadh University and attended the INSEAD Executive Programme in Paris and Gulf Executive Programme at Columbia University.

Mr. Albert I. Kittaneh Chief Executive

Over thirty years of experience in investment and commercial banking with The Bank of New York, Manufacturers Hanover Trust, Chemical Bank and BMB. He is also the Vice Chairman of Securities Investment Company (SICO) and Board Member of Oryx Capital International Ltd. and MAK Holdings (Lebanon). He has a BA in Economics from Fordham University and an MBA from Columbia University.

Description of business activities

"We remain confident in the underlying strength and rationale of our business model and we are resolute in our determination to restore BMB's franchise".

Our main activities are:

- investment banking (which forms the core of our activities)
- asset management and funds distribution
- trading and investment

We carry out these activities through dedicated specialist business units.

Investment banking

This activity consists of originating and structuring investments. It is conducted by our Corporate Finance Department.

Private equity

Since 1988, the Bank has developed strong relationships with premier unquoted equity fund managers, both directly and through private equity fund distributors. Drawing on our own fundamental macro trend analysis, we seek out unquoted equity funds and direct investments which meet our stringent investment criteria. These investments are both for the Bank's own account and for clients.

Our primary focus is on fund managers who pursue a strategy of taking a controlling interest in high quality investments with a solid financial history. The fund managers selected by BMB must be able to demonstrate both a proven track record over a number of years and economic cycles, as well as strong institutional backing. They must have a strict pricing discipline, must only make investments with a pre-determined exit strategy and for the most part must not merely be sourcing transactions through the auction process.

Private placements

During 2005, BMB began a new business activity, raising equity on a private placement basis, for mid-size companies. Our Corporate Finance Department and executive management originate transactions drawing on BMB's network of contacts. After a satisfactory internal review, the Bank places the transactions with its customers.

Asset management/funds distribution

This activity consists of marketing investment products to BMB's individual and institutional clients and the management of BMB proprietary funds. Our Investor Marketing Department has responsibility for the former, while our Corporate Finance Department handles funds management.

Investor marketing

Our Investor Marketing Department distributes structured product and private equity transactions to our investor base. This group also markets other specially developed products, including private equity funds, listed funds and hedge funds which are designed to meet our clients' needs. For our proprietary funds, we provide a full range of accounting, reporting and support services.

Our marketing is based upon our knowledge of each client's investment objectives and risk parameters. This detailed understanding enables us to focus product development and marketing efforts more precisely to meet our clients' needs more effectively. It also facilitates the cross-selling of other products and establishment of long-term client relationships.

Investor Marketing is supported by a dedicated Client Operations team within our Operations Department.

Funds management

Our Corporate Finance Department manages BMB's first fund of private equity funds, BMB Tech, a US$70 million fund. We are also actively involved in BMB Shield through our role as Investment Advisors to this fund.

Publicly traded equities, private equities, capital markets, foreign exchange

In 2005, due to the lack of counterparty trading and funding lines, BMB did not trade foreign exchange, capital markets or related derivative instruments. The Bank did engage in limited selective investments in GCC equities and GCC funds. As well, the Treasury managed the Bank’s portfolio of listed equities, which primarily consist of IPOs or listed shares resulting from the realisation of private equity investments.

Financial review 1995-2005

Financial review

Summary of financial performance 31 December 1995-2005

The key financial ratios from 31 December 1995 - 2005 are summarised as follows:

Illustration 1 **summary of financial data 1995-2005** (all figures in thousands of US dollars)

	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995
Net income/(loss) - as reported	7,768	594	(12,754)	(50,786)	(15,647)	(56,985)	30,085	13,711	18,658	9,493	5,582
Add/(deduct):loss/(profit) from discontinued operations	-	-	-	-	-	-	-	9,951	(5,081)	(2,597)	(2,542)
Net income/(loss) from continuing operations	7,768	594	(12,754)	(50,786)	(15,647)	(56,985)	30,085	23,662	13,577	6,896	3,040
Growth/(decline) in net income (%)	1,207.7%	105%	75%	(224%)	73%	(289%)	27%	74%	97%	127%	48%
Total shareholders' equity	27,248	(27,777)	(28,085)	(20,874)	43,170	65,455	131,488	108,741	102,121	105,822	96,310
Total assets	168,411	182,004	180,695	190,548	512,833	622,620	655,579	739,195	751,533	645,036	452,215
Return on average shareholders' equity (%)	N/A	N/A	N/A	(455%)	(28.8%)	(57.9%)	25.1%	23.7%	14.2%	7.1%	3.3%
Return on average assets (%)	4.4%	0.3%	(6.9%)	(14.4%)	(2.8%)	(8.9%)	4.4%	3.2%	2.0%	1.3%	0.7%
Operating expenses/total income (%)	48%	N/A	N/A	N/A	N/A	N/A	28%	28%	41%	40%	60%
Average net income/(loss) per employee	120	9	(196)	(794)	(216)	(712)	421	376	238	134	68
Financial leverage (times)	4.9:1	N/A	N/A	N/A	10.6:1	8.3:1	3.9:1	5.7:1	6.9:1	5.3:1	3.7:1
Net liquid position (US$mill.)	(35)	(107)	(98)	(77)	(47)	45	64	70	51	(36)	(98)

Effective 1 January 2001, BMB adopted IAS 39 which requires application of the new accounting policy only on a prospective basis. While the balance sheet for 2000 has been restated to retrospectively apply IAS 39, the balance sheets for prior periods have not been restated.

Financial review

The following section provides an overview on the Bank’s internal policies and procedures. As well, it analyses BMB's financial performance for the year ended 31 December 2005 compared to 2004.

Regulation and supervision

BMB is regulated by the Bahrain Monetary Agency (BMA or the Agency).

The approval of the BMA is required for major changes to strategy, changes to senior management, the establishment of new subsidiaries and branches and the appointment/election of members of the Board of Directors.

The Agency’s inspection team carries out periodic reviews of BMB and submits reports of their findings directly to the Bank’s Board of Directors.

Compliance with International Financial Reporting Standards

BMB’s accounting policies are set out in Note 2 to the financial statements and are in conformity with International Financial Reporting Standards.

International Financial Control and Corporate Governance

The Bank has designed and implemented procedures for the safeguarding of assets against unauthorised use or disposition, the maintenance of proper accounting records and the integrity of financial information both for internal use and external publication as follows:

- Authority to operate the Bank and its various subsidiaries is delegated to the Chief Executive of the Bank within limits set by the Executive Committee and approved by the Board of Directors. Any transactions exceeding these limits require the concurrence of first, the Executive Committee and, then ratification by the Board of Directors. The appointment and removal of executives to and from the most senior positions (Senior Vice President and above) within the Bank requires the formal approval of the Board of Directors. Functional operating and financial reporting standards have to be approved by the Board of Directors.

- The Bank manages its credit and market risks primarily through its Risk Management Committee ("RMC"). The RMC is composed of the Chief Executive, the Chief Operating Officer, the Head of the Risk Management Department, Head of Corporate Finance and the Head of Treasury (the latter two in a non-voting capacity).

  The Bank's Management Committee is composed of members of the RMC and the functional division heads. The Management Committee serves as a forum for the discussion of the Bank’s overall strategy, product development, marketing, and other significant business issues. As situations require, working groups composed of Management Committee members are tasked with studying specific issues and recommending actions for executive management approval.

- The Bank’s Internal Audit function monitors compliance with policies and procedures and the effectiveness of internal controls. The work of internal audit is focussed on the areas of risks determined through a risk assessment approach. The internal audit reports are submitted directly to the Audit Committee of the Board and the internal auditors conduct their work independently of the Bank’s senior management. During 2005, the Bank’s Internal Audit position was vacant and the Bank could not locate a replacement. For 2006, the Bank has outsourced the internal audit services to an internationally reputed firm.

- To oversee and administer its anti-money laundering and anti-terrorism finance policies and procedures, the Bank has designated a member of senior management to serve as the Bank’s Money Laundering Reporting Officer and appointed another senior officer as deputy to serve in his absence.

Financial review

- The Audit Committee is comprised of three Directors and operates under the terms of reference set forth in a formal charter. The Chairman and Vice Chairman of the Audit Committee are Independent Non-Executive Directors. The Committee assists the Board through the review of the Bank's financial information, internal control systems, risk management process and internal audit functions. The Audit Committee directly manages the internal audit and evaluates the performance of the Bank's external auditors. In addition, the Committee is charged with ensuring the Bank's compliance with applicable laws and regulations.

- The Bank's independent auditors, PricewaterhouseCoopers, have unhindered access to the Audit Committee, the Executive Committee and the Board of Directors, with or without members of management being present, to discuss their audit findings as to the integrity of the Bank's annual financial statements or reports, the adequacy of internal controls and any other matter which they believe should be brought to the attention of the Audit Committee, the Executive Committee and/or the Board of Directors.

Risk Management

In the normal course of its business, the Bank is exposed to various risks, related to the nature of the activities in which it engages. The principal sources of risk are credit risk, market risk, private equity risk, interest rate risk, liquidity risk, operating risk and legal risk.

The Bank applies the following principles in its risk management discipline:
- an established risk governance structure
- defined risk limits and policies
- use of quantitative models and qualitative approaches to identify and assess risks
- ongoing review by an independent monitoring function
- portfolio diversification and the use of risk mitigation tools

Risk management at BMB begins at the Board of Directors level. The Board of Directors exercises oversight and final approval of the risk management process at BMB. It operates through two Board Committees, the Executive Committee and the Audit Committee. With input provided by the Bank's Risk Management Committee, the Executive Committee proposes the overall risk management strategy of the Bank. Based on the recommendations of the Executive Committee, the Board of Directors approves the aggregate levels of risk the Bank can assume as well as the Bank's risk management policies, risk limits and risk control framework. Among its duties, the Audit Committee is charged with reviewing and approving the Bank's policies and procedures as well as overseeing both the internal and external audits of the Bank, including matters related to anti money laundering and anti terrorism finance.

The Board delegates certain authority to the executive management of the Bank to implement the risk control decisions of the Board. To carry out these responsibilities, executive management operates through a Risk Management Committee (the "RMC").

The RMC is chaired by the Chief Executive and comprises members of senior management. It serves as the Bank's credit committee, asset/liability management committee, and private equity approval committee. In addition, it prepares and submits to the Board detailed risk control policies and procedures as well as country, asset class and individual counterparty limits for Board approval. On an ongoing basis, the RMC monitors the environment in which the Bank operates and the risks to which it is exposed and adjusts the Bank's operations as appropriate.

The Risk Management Department ("RMD") plays a key role in this process. The RMD is independent of the Bank's trading and business areas and reports directly to the Chief Executive. It is responsible for identifying and quantifying risk exposures, recommending appropriate limits and monitoring usage of them. As part of its duties, the RMD prepares a variety of daily risk reports, including stress tests, for senior management and the RMC. In addition, the RMD manages problem or past-due assets.

Internal Audit which is independent of both operations and the Bank's business units, also assists in the risk management process. In particular, Internal Audit undertakes periodic reviews of the effectiveness of BMB's policies and internal controls - a review which is independent of the Bank's executive management.

Financial review

As a further step in mitigating risks, the Bank follows a policy of diversification in its activities and seeks to minimise the risk exposure to particular geographical regions, counterparties and instruments and types of business. During fiscal year 2005, external factors have limited the Bank's ability to fully implement this policy, particularly with respect to managing the foreign exchange exposure of the Bank's investments.

In identifying and monitoring the risks it is exposed to, BMB uses a variety of quantitative tools (including Value at Risk) as well as qualitative approaches to measure risks at the "macro" level. The Bank seeks to judiciously balance the use of these two approaches rather than rely on a single approach.

The following sections review the principal risks to which the Bank is exposed in the normal course of its business and how it manages those risks.

Credit risk

Credit risk is the risk of loss arising as a result of the inability of counterparty to meet its obligations to the Bank. The Risk Management Department, under the oversight of RMC, has the responsibility for establishing credit risk standards and defining the overall credit risk management framework.

Credit risks is aggregated for a given economic entity (subsidiaries and affiliates) and are managed at that level. Credit standards are defined in the Bank's Credit Policies and Procedures Manual. Credit standards include a sound credit process addressing obligor, transaction and product risks, on-going performance quality, monitoring rating actions and concentration risk.

The Bank's risk grading system assigns a risk grade under a 10-grade scale, with 1 representing a risk which has the least chance of default. Risk grading is based on quantitative and qualitative risk characteristics and employs an objective measure in determining a risk grade for an exposure. Quantitative factors focus on historical and prospective financial strength such as cash flow, capital adequacy, profitability, asset quality and tenor of risk. Qualitative factors include management quality, market share, industry risk, sovereign risk and operating efficiency. All obligors and countries are risk graded. As part of the process, the Bank compares its internal ratings to publicly available ratings assigned by the major rating agencies.

All lines of credit, counterparty, country and trading limits are subject to annual reaffirmation by the Board of Directors. The limits are also reviewed more frequently as necessary to ensure consistency with the Bank's trading and investment strategies or to take into account latest market developments.

Credit risk can arise from several sources, loans, investments, and trading activities.

The Bank's other bonds portfolio is primarily secured by US Government securities and represents minimal risk.

The installment sale receivable is supported by an appropriate security package.

The Bank is not engaged in retail business and therefore does not use credit "scoring" models. Nor has the Bank securitised any assets. Accordingly, it has no recourse obligations under such transactions. As well, the Bank does not use credit derivatives as a risk mitigation tool. Nor does BMB have exposures to "highly leveraged institutions" as defined by the Financial Stability Task Force.

Additional information on credit risk can be found in the notes to our financial statements as follows:

- Aggregate credit exposures and significant components – Note 29
- Quantitative information on gross positions by major business segments – Note 35
- Exposures by major types of counterparties – Notes 5, 7, and 8
- Risk concentrations – Notes 29, 5, 6, 7, and 8
- Non-performing loans, provisions, interest in suspense – Note 7

Market risk

Market risk is defined as potential adverse changes in the value of a trading position or portfolio of financial instruments resulting from the movement of market variables, such as interest rates, foreign exchange rates, equity and commodity prices, market indices as well as volatilities and correlations between markets.

It is the policy of the Bank to adhere to the quantitative and qualitative standards prescribed by the Basel Committee and the BMA for estimating market risks. The Bank uses the Standardised Approach to calculate capital adequacy requirements for regulatory compliance purposes.

The Bank uses the RiskMetrics™ model to measure market risks based on historical simulation approach under the RiskMetrics™ methodology. VaR is estimated for 99% one tailed confidence for a one-day holding period based on market price changes during the one-year historical observation period (the look back period). The VaR parameters correspond to the maximum potential loss in one out of 100 trading days. The market data such as correlation and volatility estimates are updated on a daily basis as provided by Datametrics™.

While the Bank had no trading activities during 2005, existing interest rate and foreign exchanges exposures (the latter resulting chiefly from foreign currency denominated private equity investments) and existing publicly-trade equity investments were considered by the VaR model as market exposures.

The total VaR for these risks, segregated by the sources of risk, at 31 December were as follows:

Illustration 2 **VaR by source of risk**

Sources of Risk	2005 US$000	2004 US$000
Equity price risk	70	75
Interest rate risk	105	123
Foreign exchange rate risk	657	715
Less: Diversification benefit	(203)	(247)
Total VaR	629	666

The total VaR is less than the sum of the VaR of the individual risk components, due to diversification benefits arising from correlation within and across the risk classes.

During the year, the daily average total 1-day VaR, minimum total VaR and maximum total VaR were US$0.644 million, US$0.495 million and US$1,122 million, respectively, estimated for 99% confidence level for a one day holding period.

In addition to the estimation of daily VaR, the Bank conducts, on a daily basis, stress testing on its market risk portfolio for predetermined and simulated stress scenarios. Stress testing is designed to capture extreme market events and forms an integral part of the Bank's market risk management process. The stress testing results are reported to senior management.

Interest rate risk

Interest rate risk is the risk arising from changes in interest rates, the slope and shape of yield curve and basis risk which may have a potentially adverse impact on the net interest income of the Bank and on the value of trading positions and financial instrument portfolios.

Daily risk analysis reports from the market risk model assist management in measuring and monitoring the Bank's exposure to interest rate risk.

Note 31 provides data on the nature and extent of interest rate sensitive assets.

Financial review

Private equity risk

BMB invests in private equity with the intent of later sale of these investments at a profit to third parties either through a trade sale (sale to another business) or an initial public offering ("IPO"). Private equity risk is the risk that the Bank will not be able to sell its investments at a profit within the intended time period. This risk arises from three factors. The first relates to the specific investment itself: that it does not develop a sustainable business or its line of business is not attractive to other investors. The second factor relates to macro trends in markets for IPOs and mergers and acquisition activity. The state of these markets affects both the price and timing of any "exit" from an investment. Third, as these investments typically are realised over the medium-term and are not traded on organised exchanges, they have limited liquidity.

Private equity investing is a key business for BMB

The Bank manages risks at the specific investment level in the following ways. First, it invests primarily in independently managed third party funds whose managers have a demonstrated track record. Based on its own experience and analysis of the private equity industry, BMB believes that the quality of the fund manager is a key risk mitigant. Second, the Bank seeks to diversify its investments across fund managers, different stages in the investment cycle (various stages of venture capital, buy-out, etc), geographical locations and industries. The goal is to reduce exposure to any one investment. At 31 December 2005, the Bank was effectively invested in over 1,300 companies with an average investment size of US$78,000.

Trends in macro economic events and their effects on the IPO and trade sale market are largely out of the control of the Bank. BMB seeks to mitigate its exposure to these risks by selecting managers who have demonstrated a solid track record over an entire economic cycle and by diversification of investments. Diversification is also the key tool for dealing with the inherent limited liquidity of this asset class. In addition, from time to time, the Bank approaches leading investment banks to determine realistic market opportunities for the securitisation of private equity assets.

As a result of a recent review, the Bank has decided to focus on private equity fund investment and minimise direct private equity investments.

Note 5 discusses private equity.

Liquidity risk

Liquidity risk is twofold. First, it represents the risk that the Bank may not be able to secure funding in amounts sufficient to support its assets or that the interest rates and maturities it can obtain in the market are not appropriate for its assets. Such risk relates to securing funding for new assets as well as for any needed refinancing of existing assets. Second, it represents the risk that the Bank will be unable to sell assets in a timely fashion for prices close to their carrying values. The Bank has strengthened its liquidity position by refinancing its US$75 million medium-term facility, raising US$52.3 million in additional capital, securing a US$20 million liquidity facility, and extending the maturity on the US$10 million subordinated loan.

In its investing activities, BMB seeks to diversify its assets across instruments and markets and to avoid obligor concentrations which could impair liquidity. This is particularly the case for investments in unlisted private equity funds where the Bank consciously implemented a strategy of reducing our average individual investment size. The Bank also from time to time consults with leading financial intermediaries to assess its ability to securitise or otherwise dispose of its less liquid assets.

Note 32 reviews liquidity risk.

Financial review

Operating and legal risk

Operating risk is the risk of loss arising from errors that can be made in processing transactions or from breakdowns in technology or internal control systems.

Currently, the Bank conducts its business from a single location. As an investment bank, BMB does not operate a retail or commercial banking franchise. Accordingly, the number of client relationships and volume of transactions at BMB are lower than at such institutions. The nature of transactions differ as well given the Bank's focus on investing in unlisted private equities for its own and its clients' accounts. These factors mitigate to some extent the operational risks to which the Bank is exposed both in terms of volumes of transactions and the liquidity of the assets underlying these transactions (e.g., the Bank does not offer cash deposit/withdrawal services, ATMs, credit cards, etc). The most significant operating risk involves payments.

BMB’s operations are conducted according to well-defined procedures. These procedures include a comprehensive system of internal controls, including segregation of duties and other internal checks, which are designed to prevent either inadvertent staff errors or malfeasance prior to the release of a transaction.

The Bank also engages in subsequent monitoring of accounting records, periodic reconciliation of cash and securities accounts and other checks to enable it to detect any erroneous or improper transactions, which may have occurred.

Legal risk includes the risk of non-compliance with applicable laws or regulations, the illegality or unenforceability of counterparty obligations under contracts, and additional unintended exposure or liability resulting from the failure to structure transactions or contracts properly. Legal risks are mitigated through legal counsel review of transactions and documentation, as appropriate.

To protect BMB from involvement in money laundering or terrorist finance activities, the Bank has designed and implemented a comprehensive set of policies and procedures. Adherence to the Bank’s policies and procedures is reinforced through periodic staff training and internal and external reviews.

To further mitigate operational and legal risks, the Bank purchases a variety of insurance covers.

Note 28 discusses legal risk.

Financial review

Income statement

Overview of financial results

The main points of BMB's 2005 financial performance were as follows:

- The net profit for the year was US$7.8 million compared to a profit of US$0.6 million in 2004.
- Net interest expense stood at US$5.9 million against US$4.7 million in 2004.
- Income from investments totalled US$26.9 million as compared to US$7.9 million in 2004.
- Loss from foreign exchange totalled US$5.3 million as compared to a profit of US$3.5 million in 2004.
- Operating expenses (general and administrative) totalled US$8.8 million (2004: US$9.0 million) of which US$2.5 million (2004: US$3.2 million) resulted from consolidation of T&T Beverages Limited.
- Impairment provisions totalled US$1.7 million compared to a writeback of US$0.9 million in 2004.

Net profit

The net profit for the year in 2005 amounted to US$7.8 million. The three main contributors to this profit were: income from unquoted equity investments US$22 million (2004: US$9.7 million), income from trading equities US$2.1 million (2004: loss US$2.0 million) and income from other bonds US$2.7 million (2004: nil).

The above profit was also offset by the continued consolidation of T&T Beverages Limited's operations which reported a loss of US$4.5 million (2004: loss US$5.0 million); the increase in net interest expense by US$1.2 million mainly due to higher market interest rates, and an unrealised foreign exchange translation loss of US$5.3 million (2004: gain US$3.5 million).

Income from investments

The income from investments amounted to US$26.9 million compared to US$7.9 million in 2004. This is summarised in the table below:

Illustration 3 **Analysis of income from investments**

Detail	2005 US$000	2004 US$000
Income/(loss) from trading equities	2,067	(2,032)
Income/(loss) from trading funds	71	(53)
Income from other equities and funds	22,000	9,868
Income from sovereign debt and bonds	110	150
Income from other bonds	2,682	-
Total income from investments	**26,930**	**7,933**

Foreign exchange translation

Foreign exchange translation loss was US$5.3 million compared to income of US$3.5 million in 2004. As the Bank's foreign exchange trading and swap lines were cancelled during 2003, it was compelled to carry unhedged long sterling pound and euro currency positions. These positions are revalued against the Bank's functional currency (US dollar) on a daily basis and the resultant income or loss taken to the income statement. At 31 December 2005, the foreign exchange losses resulted from revaluation of these positions.

Financial review

Other income

Other income which mainly comprises fees, commissions and rental income amounted to US$2.6 million compared to US$2.0 million in 2004, an increase of US$0.6 million, or 30%. This is summarised in the following table:

Illustration 4 **Analysis of other income**

Detail	2005 US$000	2004 US$000	Increase/ (decrease) US$000	Increase/ (decrease) %
Marketing related fees	1,899	1,333	566	42%
Rental income	823	809	14	2%
Other (loss)	(180)	(182)	2	(1%)
Total other income	**2,542**	**1,960**	**582**	**30%**

Operating expenses (general and administrative)

Operating expenses amounted to US$8.8 million for 2005 compared to US$9.0 million in 2004, a decrease of US$0.2 million, or 2%. This is summarised in the following table:

Illustration 5 **Analysis of operating expenses (general and administrative)**

Detail	2005 US$000	2004 US$000	(Increase)/ decrease US$000	(Increase)/ decrease %
Staff costs	4,739	3,938	(801)	(20%)
Occupancy and equipment expense	900	1,292	392	30%
Other costs	3,140	3,749	609	16%
Total operating expenses	**8,779**	**8,979**	**200**	**2%**

Of the US$8.8 million (2004: US$9.0 million) in operating expenses, T&T's expenses were US$2.5 million (2004: US$3.2 million), which are included primarily in other costs. T&T Beverages Limited excluded, the Bank's operating expenses remained almost unchanged.

Provisions for impairment

BMB takes provisions if a financial asset is impaired, that is, if its carrying amount is greater than its estimated recoverable amount. Provisions for assets carried at amortised cost are calculated as the difference between the asset's carrying amount and the present value of expected future cash flows discounted at the financial instrument's original effective interest rate.
By comparison, the recoverable amount of an instrument measured at fair value is the present value of expected future cash flows discounted at the current market rate of interest for a similar financial asset.

The required levels of investment provisions are determined after a careful review of the underlying economic factors and the investee company's past and future forecasted financial performance which may eventually impact the recoverable amount of the investment portfolio. In 2005, a provision of US$1.7 million was made compared to a writeback of US$0.6 million in 2004.

Financial review

Balance sheet

Total assets

Total assets at 31 December 2005 were US$168 million compared to US$182 million at 31 December 2004, a decrease of US$14 million, or 7.7%.

This decrease was mainly due to the continued stream of successful realisations of private equity investments within our private equity portfolio, effects of redemption of certain underlying collateral for structured programs within our other bonds portfolio, the continued consolidation of annual operational loss of T&T Beverages Limited which for the year was US$2.5 million, the decrease in functional currency value of foreign currency denominated assets, and provisions taken, mainly against loans and advances.

Illustration 6 **Summary of major balance sheet items**

Detail	2005 US$000	2004 US$000
Trading equities and funds	7,234	4,622
Other equities and funds	87,804	100,415
Other bonds	9,809	23,154
Loans and advances	7,715	9,428

Trading equities and funds

Trading equities and funds increased to US$7.2 million from US$4.6 million in 2004, an increase of US$2.6 million, or 57%. This was mainly due to additional investments made in equity funds, increases in market values and exits from long-term equity and funds to the trading portfolio.

Other equities and funds

Other equities and funds (private equity) decreased to US$87.8 million from US$100.4 million in 2004, a decrease of US$12.6 million, or 12.6%. This decrease resulted mainly from realisations made during the year and foreign exchange rate movements.

Undrawn commitments for other equity fund investment decreased to US$23 million in 2005 from US$39.1 million in 2004, a decrease of US$16 million, or 41%, as the Bank funded previous undrawn commitments. These unfunded investment commitments will be funded over the next 3-6 years.

Other bonds

The Bank's portfolio of other bonds decreased to US$9.8 million from US$23.2 million in 2004. This decrease resulted from the early redemption of certain underlying collateral for structured programs.

An analysis of the other bonds portfolio is given below.

Other bonds comprise:

	Student loans		CDOs		Total	
	2005 US$000	2004 US$000	2005 US$000	2004 US$000	2005 US$000	2004 US$000
Held-to-maturity – at amortised cost						
Structured products	-	-	3,945	17,190	3,945	17,190
Loans and receivables – at amortised cost						
Structured products	864	964	5,000	5,000	5,864	5,964
Total other bonds	**864**	**964**	**8,945**	**22,190**	**9,809**	**23,154**

Financial review

Loans and advances

Loans and advances at 31 December 2005 amounted to US$7.7 million compared to US$9.4 million in 2004, a decrease of US$1.7 million, or 18%. This decrease was mainly due to impairment provisions of US$1.5 million taken against a specific government exposure.

Revolving loan facility

Detail	2005 US$000	2004 US$000
Revolving loan facility	13,600	13,600

On 30 December 2003, the Bank signed a US$20 million three-year revolving facility secured by certain of the Bank's private equity investments. This facility is designed to provide liquidity to the Bank and bears interest at floating US$Libor. The utilised amount at 31 December 2005 was US$13.6 million (31 December 2004: US$13.6 million).

Liquidity

The Bank's net liquidity position is summarised as follows:

Illustration 7 **Summary of net liquid position**

Detail	2005 US$000	2004 US$000
Inter-bank placements and cash	13,263	3,196
Trading equities and funds	7,234	4,622
Other liquid bonds	5,000	5,000
Total liquid assets	25,497	12,818
Customer deposits maturing within 12 months	(33,954)	(36,037)
Medium-term loan/due within 12 months*	(9,500)	(75,263)
Repos on Other bonds	(3,700)	(8,700)
Revolving loan facility	(13,600)	-
Total liquid liabilities	**(60,754)**	**(120,000)**
Net liquid position	**(35,257)**	**(107,182)**

* includes past due interest US$Nil (31 December 2004: US$263,000)

Capital ratios

The guiding principle of the Bank is to maintain risk based capital ratios in excess of the minimum of 12% prescribed by the Bahrain Monetary Agency.

At 31 December 2005, the total capital ratio using the standardised approach was 14.44% compared to (13.11%) at 31 December 2004.

The risk based capital ratio of the Bank includes market risk weighted assets using the standardised approach and credit risk weighted assets based on the 1988 capital accord.

Financial review

Illustration 8 **Capital base and risk weighted assets**

	Average for the year 2005 US$000	At year-end 2005 US$000	Average for the year 2004 US$000	At year-end 2004 US$000
Capital base				
Tier 1 capital	(11,017)	22,192	(32,197)	(32,833)
Tier 2 capital	-	11,056	-	-
Total capital base	(11,017)	33,248	(32,197)	(32,833)
Risk weighted assets				
Credit risk weighted assets	165,696	157,634	192,477	184,907
Market risk weighted assets	74,435	72,610	68,429	65,453
Total risk weighted assets	240,131	230,244	260,906	250,360
Capital ratio (standardised approach)	(4.59%)	14.44%	(12.34%)	(13.11%)
Minimum required		12.00%		12.00%

Earnings per share and price/earning ratio

The Group's earnings per share and price/earnings ratio were as follows:

Illustration 9 **Review of earnings per share and price earnings ratio**

Detail	2005	2004
Net profit	US$7,768,000	US$594,000
Number of shares (fully diluted)	262,512,073	309,081,352
Earnings per share	US$0.03	US$0.00
BMB's year-end share price on the Bahrain Stock Exchange	US$0.26	N/A
Book value per share	US$0.10	US$(0.09)
Price/earnings ratio	8.67	N/A

Effective 4 September 2005, trading of the Bank's shares on the Bahrain Stock Exchange resumed pursuant to the Bank's successfully completing the US$75 million medium-term facility and the planned capital restoration.

Financial review

BMB shareholdings of Directors, their related parties and BMB senior management

The shareholdings of directors, their related parties and BMB senior management were as follows:

Illustration 10 **Directors and senior management shareholdings**

Detail	2005 Number	2004 Number
Directors and their related parties	136,101,632	66,633,378
BMB's senior management	95,003	233,755
Total	**136,196,635**	**66,867,133**

Illustration 11 **Summary of performance by business segments**

The Group is organised into two major business segments, banking and manufacturing. The respective segmental operating results for the year 2005 were as follows:

	Banking		Manufacturing		Consolidated	
	2005 US$000	2004 US$000	2005 US$000	2004 US$000	2005 US$000	2004 US$000
Net interest (expense)	(4,232)	(3,176)	(1,699)	(1,542)	(5,931)	(4,718)
Income from investments	26,930	7,933	-	-	26,930	7,933
Foreign exchange translation (loss)/income *	(8,794)	5,827	-	-	(5,325)	3,544
Other income/(loss)	2,792	2,191	(250)	(231)	2,542	1,960
Total income/(loss) from operations	16,696	12,775	(1,949)	(1,773)	18,216	8,719
Impairment provisions (charged)/released						
Writeback/(impairment provisions)	(1,652)	854	(17)	-	(1,669)	854
General and administrative expenses	(6,234)	(5,754)	(2,545)	(3,225)	(8,779)	(8,979)
Total operating expenses	(7,886)	(4,900)	(2,562)	(3,225)	(10,448)	(8,125)
Net income/(loss) for the year	8,810	7,875	(4,511)	(4,998)	7,768	594

The banking segment represents BMB and all its subsidiaries excluding T&T Beverages Limited (T&T).

The manufacturing segment is represented by T&T only.

The consolidated figures are arrived at after off-setting all intra-group transactions including T&T.

*The foreign exchange translation loss for the banking segment US$8.8 million (2004: income US$5.8 million) includes US$3.5 million (2004: US$2.3 million) loss incurred from the long sterling position held for loans made to T&T. This loss is eliminated on consolidation as the related sterling position is off-set on consolidation.

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Auditors' report to the shareholders and board of directors of Bahrain Middle East Bank (B.S.C.)

We have audited the accompanying consolidated balance sheet of Bahrain Middle East Bank (B.S.C.) (the "Bank") and its subsidiaries (the "Group") as at 31 December 2005, the related statements of income and cash flows and changes in shareholders' equity for the year then ended. These financial statements are the responsibility of the Directors of the Bank. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, the financial position of the Group as at 31 December 2005, and the results of its operations and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

We report that we have obtained all the information that we considered necessary for the purpose of our audit; the Bank has maintained proper books of account and the consolidated financial statements and the financial information contained in the Directors' and Chief Executive's report are in agreement therewith; and nothing has come to our attention which causes us to believe that the Bank has breached any of the applicable provisions of the Bahrain Commercial Companies Law, the Bahrain Monetary Agency Law, the terms of its banking license or its Memorandum and Articles of Association which would materially affect its activities or its financial position as at 31 December 2005.

PricewaterhouseCoopers

Manama, Kingdom of Bahrain
1 February 2006

Financial statements

Consolidated balance sheet at 31 December 2005
(Expressed in thousands of United States Dollars)

	2005	2004
Assets		
Cash and deposits with banks (Note 3)	13,263	3,196
Trading equities and funds (Note 4)	7,234	4,622
Other equities and funds (Note 5)	87,804	100,415
Other bonds (Note 6)	9,809	23,154
Loans and advances (Note 7)	7,715	9,428
Installment sale receivable (Note 8)	21,869	22,485
Fixed assets (Note 9)	11,136	11,511
Other assets (Note 10)	9,581	7,193
Total assets	**168,411**	**182,004**
Liabilities and shareholders' equity		
Liabilities		
Customer deposits (Note 11)	54,158	73,376
Securities sold under repurchase agreements (Note 12)	3,700	8,700
Medium-term loan (Note 13)	53,200	75,000
Revolving loan facility (Note 14)	13,600	13,600
Other liabilities (Note 15)	6,505	9,105
Subordinated loans (Note 16)	10,000	30,000
Total liabilities	**141,163**	**209,781**
Shareholders' equity		
Share capital (Note 17)	52,338	90,809
Fair value reserve (Note 18)	(18,731)	(12,973)
Fixed asset revaluation reserve (Note 18)	5,056	5,056
Other reserves (Note 18)	(11,415)	(84,318)
Treasury shares (Note 17)	-	(26,351)
Total shareholders' equity	**27,248**	**(27,777)**
Total liabilities and shareholders' equity	**168,411**	**182,004**

These financial statements were approved by the Board of Directors on 29 January 2006 and signed on its behalf by:

Sheikh Ali Jarrah Al Sabah
Chairman

Wilson S. Benjamin
Vice-Chairman

Albert I. Kittaneh
Chief Executive

Notes 1-36 form an integral part of these financial statements.

Financial statements

Consolidated income statement for the year ended 31 December 2005

(Expressed in thousands of United States Dollars: unless otherwise stated)

	2005	2004
Interest income	2,109	2,047
Interest expense	(8,040)	(6,765)
Net interest (expense)	**(5,931)**	**(4,718)**
Income from investments (Note 19)	26,930	7,933
Foreign exchange translation (loss)/income (Note 20)	(5,325)	3,544
Other income (Note 21)	2,542	1,960
Total income from operations	**18,216**	**8,719**
Impairment provisions (charged)/released (Note 22)	(1,669)	854
General and administrative expenses (Note 23)	(8,779)	(8,979)
Total operating expenses	**(10,448)**	**(8,125)**
Net income for the year	**7,768**	**594**
Earnings per share (Note 17)		
Basic	US$0.03	US$0.00
Diluted	US$0.03	US$0.00

These financial statements were approved by the Board of Directors on 29 January 2006 and signed on its behalf by:

Sheikh Ali Jarrah Al Sabah Chairman	Wilson S. Benjamin Vice-Chairman	Albert I. Kittaneh Chief Executive

Notes 1-36 form an integral part of these financial statements.

Consolidated statement of changes in shareholder's equity for the year ended 31 December 2005
(Expressed in thousands of United States Dollars)

	Share capital	Fixed asset revaluation reserve	Fair value reserve	Other reserves: Retained earnings	Other reserves: Legal reserve	Other reserves: General reserve	Total other reserves	Treasury shares	Total
At 1 January 2004	90,809	-	(8,320)	(104,544)	10,960	9,361	(84,223)	(26,351)	(28,085)
Exchange translation adjustment	-	-	1,074	(689)	-	-	(689)	-	385
Fixed asset revaluation reserve (Note 9)	-	5,056	-	-	-	-	-	-	5,056
Net fair value (loss) on available-for- sale investments	-	-	(740)	-	-	-	-	-	(740)
Fair value reserve transferred to income statement	-	-	(4,987)	-	-	-	-	-	(4,987)
Net profit for the year	-	-	-	594	-	-	594	-	594
At 1 January 2005	90,809	5,056	(12,973)	(104,639)	10,960	9,361	(84,318)	(26,351)	(27,777)
Exchange translation adjustment	-	-	(379)	899	-	-	899	-	520
Net fair value gain on available-for-sale investments	-	-	7,495	-	-	-	-	-	7,495
Fair value reserve transferred to income statement	-	-	(12,874)	-	-	-	-	-	(12,874)
Increase in capital (Notes 10 and 11)	52,335	-	-	-	-	-	-	-	52,335
Reduction in capital (Notes 10 and 11)	(90,806)	-	-	64,455	-	-	64,455	26,351	-
Rights issue expense	-	-	-	(219)	-	-	(219)	-	(219)
Net profit for the year	-	-	-	7,768	-	-	7,768	-	7,768
Transfer to reserves (Note 18)	-	-	-	(1,554)	777	777	-	-	-
At 31 December 2005	**52,338**	**5,056**	**(18,731)**	**(33,290)**	**11,737**	**10,138**	**(11,415)**	**-**	**27,248**

Notes 1-36 form an integral part of these financial statements.

Financial statements

Consolidated statement of cash flows for the year ended 31 December 2005
(Expressed in thousands of United States Dollars)

	2005	2004
Cash flows from operating activities		
Net income for the year	**7,768**	**594**
Adjustments to reconcile net profit to net cash provided by operating activities:		
Impairment provisions charged/(released) (Note 22)	1,669	(854)
Depreciation and amortisation	(583)	(445)
Net changes in:		
Trading equities and funds	(2,612)	7,073
Other equities and funds	6,853	(7,967)
Other bonds	13,212	(188)
Loans and advances	195	2,173
Accrued interest receivable	2,130	523
Accrued interest payable	(1,063)	77
Other assets	(4,518)	(667)
Other liabilities	(620)	1,066
Customer deposits	(15,876)	(6,369)
Change in exchange rates related to retained earnings of overseas subsidiaries	899	690
Foreign exchange movements on investments and others	115	8
Net Cash provided by/(used in) operating activities	**7,569**	**(4,286)**
Cash flows from investing activities		
Amount received against installment sale receivable	616	508
Purchase of fixed assets (Note 9)	(129)	(59)
Net Cash provided by investing activities	**487**	**449**

Notes 1-36 form an integral part of these financial statements.

Financial statements

Consolidated statement of cash flows for the year ended 31 December 2005 (Continued)
(Expressed in thousands of United States Dollars)

	2005	2004
Cash flows from financing activities		
Net changes in:		
Medium-term loan	(5,000)	-
Securities sold under repurchase agreements	(5,000)	4,795
Revolving loan facility	-	1,500
Prior year dividends claimed and paid	(67)	(69)
Share capital (Note 17)	12,193	-
Net cash provided by financing activities	**2,126**	**6,226**
Effect of exchange rate changes on cash and cash equivalents	**(115)**	**(8)**
Net increase in cash and cash equivalents	10,067	2,381
Cash and cash equivalents at the beginning of the year	3,196	815
Cash and cash equivalents at the end of the year (Note 3)	**13,263**	**3,196**

Notes 1-36 form an integral part of these financial statements.

Notes to the consolidated financial statements
at 31 December 2005

1 Incorporation and principal activity
Bahrain Middle East Bank (E.C.) (the "Bank" or "BMB") was formed in the Kingdom of Bahrain as an exempt joint stock company, pursuant to the notarisation of its Articles and Memorandum of Association on 21 March 1982. Formalities in respect of the registration of the Bank were completed on 5 July 1982, the Bank's date of incorporation. Effective 10 April 2000, the Bank launched a new brand identity and is now known as BMB Investment Bank. The legal name of the Bank continues to be Bahrain Middle East Bank (B.S.C.) which has its registered office at BMB Centre, Diplomatic Area, Manama, Bahrain.

On 30 August 2005, the Bank formally amended its Memorandum and Articles of Association to comply with provisions of the Commercial Companies Law of 2001 of the Kingdom of Bahrain and the Implementing Regulations issued by Ministerial Resolution No. 6 for 2002. As part of this process, the Bank converted from an Exempt Company to a Shareholding Company and the legal duration of the Bank was amended from a twenty-five year period to an indefinite period.

The Group comprises the Bank and its subsidiaries.

The principal activities of the Group are the provision of investment banking, private banking and treasury services.

2 Significant accounting policies
Preparation of financial statements
The Group's consolidated financial statements are prepared in accordance with and comply with International Financial Reporting Standards as promulgated by the International Accounting Standards Board ("IASB"). The consolidated financial statements are prepared under the historical cost convention as modified by the revaluation of land and building, available-for-sale financial assets, all derivative contracts and financial assets at fair value through profit and loss and financial liabilities held for trading.

The United States dollar is the functional currency of the Bank and also the currency in which the Bank's share capital is denominated. Accordingly, the financial statements have been prepared in United States dollars.

Impact of New Accounting Pronouncements: International Financial Reporting Standards
In December 2003, as a part it's project to improve International Financial Reporting Standards, the IASB released a series of new Standards as well as revisions to certain standards including: IAS 1, "Presentation of Financial Statements"; IAS 24, "Related Party Disclosures"; IAS 33, "Earnings per Share"; and IAS 39 "Financial Instruments: Recognition and Measurement". The revised standards apply to annual periods beginning on or after 1 January 2005 and have been adopted in accordance with the respective transition provisions.

The main impact on the Group's consolidated financial statements is:

(i) Critical accounting estimates and judgements in applying accounting policies
IAS 1 (revised) requires the disclosures of judgements, apart from those involving estimations, which management has made in the process of applying the Group's accounting policies that have the most significant effect on the amounts recognised in the financial statements. There are no such judgements made that would affect the carrying value of assets or liabilities at the balance sheet date.

(ii) Financial instruments: recognition and measurement
In accordance with the transition provisions of IAS 39 (revised), the Group designated financial assets previously recognised as "trading" as "financial assets carried at fair value through profit and loss". In previous periods, gains and losses arising from a change in the fair value of trading assets were recognised in the income statement. As a result, the designation of those assets as financial instruments at fair value through profit or loss does not require restatement of financial results in the comparative information.

2 Significant accounting policies (continued)

(iii) Related party disclosures

IAS 24 provides additional guidance and expands the definitions and the disclosures for related parties, the objective being to clarify that the entity's financial statements should contain the disclosures necessary to draw attention to the possibility that the financial position and income may have been affected by the existence of related parties and by transactions and outstanding balances with them. The Group's transactions and balances with related parties are disclosed in Note 25 to these consolidated statements.

There was no impact on opening retained earnings as at 1 January 2004 from the adoption of the above-mentioned standards.

New accounting standards and IFRIC interpretations

As of the date of this consolidated financial statements the Group has not early adopted any amendments to IFRS standards or IFRIC interpretations which were issued but were not yet effective.

Basis of consolidation

The consolidated financial statements include the assets, liabilities and results of the operations of the Group. Subsidiary companies, which are those companies (and other entities) in which the Group, directly or indirectly, has power to exercise control over financial and operating policies, have been consolidated, except for companies that have been acquired for a temporary period and are held exclusively with a view to resale in the near future are not consolidated. These companies are accounted for and disclosed as available-for-sale assets and are included in other equities and funds.

All intra-group balances and transactions have been eliminated.

Foreign currencies

The assets and liabilities of foreign subsidiaries are translated into United States dollars at the rates of exchange prevailing at the balance sheet date. The income statement of foreign subsidiaries are translated into United States dollars at the rates of exchange prevailing on the dates of the transactions or at the average rate of exchange for the year. The exchange differences arising on translation are dealt with in shareholders' equity.

Foreign currency transactions are accounted for at the exchange rates prevailing at the date of the transactions. Income and losses resulting from the settlement of such transactions and from the translation of monetary assets and liabilities denominated in foreign currencies, are recognised in the income statement.

All translation differences on revaluation of debt securities and other monetary financial assets measured at fair value are included in foreign exchange income and losses, whereas translation differences on revaluation of non-monetary items such as equities and funds held for trading are reported as part of trading income or loss. Thus, underlying translation differences on revaluation of available-for-sale equities and funds are included in the fair value reserve in equity.

Financial instruments - recognition and measurement

Financial assets

IAS 39 requires classification of financial assets into the following four categories:

(i) financial assets at fair value through profit and loss;
(ii) loans and receivables;
(iii) held-to-maturity; and
(iv) available-for-sale.

2 Significant accounting policies (continued)

The accounting policies for each category are as follows:

Financial assets at fair value through profit and loss

This category has two sub-categories; financial assets held for trading, and those designated at fair value through profit and loss at inception. The Group classifies a financial asset in this category if it was acquired principally for the purpose of generating a profit from short-term fluctuations in price or dealer's margin or is part of a portfolio for which there is evidence of a recent actual pattern of short-term profit-taking. These financial assets are initially recognised at cost (which include transaction costs) and subsequently re-measured at fair value. All related realised and unrealised gains and losses are included in net trading income.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arise when the Group provides money, goods or services directly to a debtor with no intention of trading the receivable. These assets are initially recognised when cash is advanced to the borrowers and are carried at amortised cost, and de-recognised when the rights to receive cashflows from them have expired or the Group has transferred substantially all risks and rewards of ownership.

Held-to-maturity

Fixed maturity investments having fixed or determinable payments and where the Group has both the positive intent and the ability to hold such investments to maturity are classified as held-to-maturity. Such investments are carried at amortised cost less provision for impairment in value. Amortised cost is calculated using the effective interest rate method. Were the Group to sell other than an insignificant amount of held-to-maturity assets, the entire category would be tainted and reclassified as available-for-sale.

Available-for-sale

Non-trading financial assets not falling within the definition of held-to-maturity or loans and receivables which are intended to be held for an indefinite period of time, which may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. Such assets are initially recognised at cost and remeasured at fair value, unless fair value cannot be reliably measured and any changes in fair values of such assets subsequent to initial recognition are reported as movements in fair value reserve until the investment is sold, collected or otherwise disposed of, or the financial assets are considered impaired, at which time the cumulative gain or loss previously reported in equity is included in the income statement.

Purchases and sales of financial assets at fair value through profit or loss, held to maturity and available for sale are recognised on trade-date – the date on which Group commits to purchase or sell the asset.

Financial liabilities

Financial liabilities are classified either as held for trading or other than held for trading. Liabilities held for trading are those that are held principally for the purpose of generating a profit from short-term fluctuations in price or dealer's margin and are carried at fair value. Liabilities held other than for trading are carried at amortised cost.

Derivative financial instruments and hedging

Derivative instruments are measured at fair value and are deemed held for trading unless they are highly effective hedging instruments and are designated as such. Changes in the fair values of derivatives that do not qualify as hedging instruments are measured at fair value and are recorded in the income statement.

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement along with the corresponding change in fair value of the hedged asset or liability that is attributable to that specific hedged risk.

Notes to the consolidated financial statements
at 31 December 2005

2 Significant accounting policies (continued)
Changes in the fair value of derivatives that are designated and qualify as cashflow hedges are recognised as a separate component of equity. Where the forecasted transaction or firm commitment results in the recognition of an asset or of a liability, the income or loss previously deferred in equity is included in the initial measurement of the cost of the asset or liability. Otherwise, amounts deferred in equity are transferred to the income statement when the hedged firm commitment or forecasted transaction affects the income statement.

Provisions for impairment
A provision is made in respect of a financial asset that is impaired if its carrying amount is greater than its estimated recoverable amount. Provisions for assets carried at amortised cost are calculated as the difference between the asset's carrying amount and the present value of expected future cash flows discounted at the financial instrument's original effective interest rate. By comparison, the recoverable amount of an instrument measured at fair value is the present value of expected future cash flows discounted at the current market rates of interest for similar financial assets.

Trading equities and funds
Trading equities are stated at market value and realised and unrealised income or losses are included in the income statement.

Trading funds are stated at the year-end market valuation supplied by the investment managers. Unrealised income or losses and profits or losses on sale of investments in trading funds are included in income or loss from investments.

Income from trading equities, funds and quoted equities is taken to income.

Dividend income is recognised in the income statement when declared by the investee company.

Other equities and funds
Unquoted equity investments held as available-for-sale are stated at fair value or at cost if the fair value cannot be reliably measured. The fair value is determined after examining various factors including the future prospects of the investee companies.

Unquoted equity fund investments held as available-for-sale are stated at their fair values, based upon the net asset values of the funds provided by the fund managers, expected repayment of management fees (where applicable) and the future prospects for the underlying investments.

Dividend income is recognised in the income statement when declared by the investee company.

Government and Government Agency bonds
Government and Government Agency bonds held for trading purposes are stated at market value. Realised and unrealised income or losses are recorded as income or losses from sovereign debt and bonds and included in the income statement.

Government and Government Agency bonds acquired on the date of their issue are considered as loans and receivables and are carried at amortised cost using the effective interest rate method. Income or losses are recognised upon sale and recorded as income or losses from sovereign debt and bonds and included in the income statement.

Available-for-sale Government and Government Agency bonds are stated at market value. The premium paid or discount received are amortised over the remaining period to maturity of the assets acquired using the effective interest rate method and reflected in the income statement. Unrealised income or losses from changes in fair value are recorded in the fair value reserve in equity. Upon sale or disposal of a Government or Government Agency bond, the related accumulated fair value adjustments in equity are recorded as income or losses from sovereign debt and bonds included in income or loss from investments.

Interest on Government and Government Agency bonds is accrued based on the effective interest rate method.

2 Significant accounting policies (continued)

Other bonds

Other bonds held for trading purposes are recorded at market value. Realised and unrealised income and losses are included in the income statement.

Other bonds held-to-maturity are stated at amortised cost. The premium paid or discount received are amortised over the remaining period to maturity of the bonds using the effective interest rate method.

Other bonds acquired at the date of issue are classified as loans and receivables carried at amortised cost using the effective interest rate method. Income or losses are recognised upon the sale of the bonds.

Interest income on other bonds is accrued based on the effective interest rate method.

Loans and advances

Loans and advances are stated net of impairment provisions which are charged to the income statement.

Interest income is accrued based on contractual interest rates. Fees and commissions received are amortised over the period of the loan.

Installment sale receivable

The installment sale receivable is carried at amortised cost. The interest income on the installment sale receivable is recognised on an accrual basis based on the effective interest rate method.

Fixed assets

Fixed assets are stated at cost as modified by revaluation less accumulated depreciation. Fixed assets, with the exception of freehold land, are depreciated on a straight-line basis over their estimated useful lives as follows:

Buildings	25 years
Other fixed assets	2-8 years

Effective 30 September 2004, the Bank adopted a new policy to revalue its freehold land and buildings based on periodic, but at least once in every three years, valuations by an external independent valuer. Previously, land and building were carried at cost. Effective 30 September 2004, the estimated remaining useful life of the building is 20 years and the revalued amount is being depreciated over this period.

The net impact of revaluation is recognised in the fixed assets revaluation reserve included in shareholders' equity.

Securities purchased/sold under agreements to resell/ repurchase ("Repo agreements")

Repo agreements involve the buying or selling of Government securities, Government Agency bonds, other bonds and trading funds under agreements to resell or repurchase these securities. Repo agreements are treated as financing transactions and are stated at the amounts at which the securities, bonds and funds will subsequently be resold or repurchased as specified in the respective agreements as adjusted for accrued interest using the effective interest rate method.

Provision for restructuring expenses

Provision for restructuring expenses is recognised when the Board of Directors has approved a restructuring and the Bank can reliably estimate the amount of currently existing obligations related to the restructuring.

Dividends

Dividends are recognised as a liability in the period in which they are approved by the shareholders.

Directors' remuneration

Directors' remuneration is recognised as a liability when approved.

2 Significant accounting policies (continued)

Treasury shares
Own shares reacquired by the Bank and held at the balance sheet date are designated as treasury shares. These shares are shown as a one line deduction from the Bank's shareholders' equity. The income and losses on the sale of treasury shares are recognised in shareholders' equity.

Fees and commissions
Fees and commissions are recognised in the income statement on an accrual basis. Fees received upon prepayment of loans are taken to income when received. Underwriting, performance, structuring and placement fees are taken to income when earned.

Offsetting financial instruments
Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to set off the recognised amounts and there is an intention to settle on a net basis or realise the asset and settle the liability simultaneously.

Employee compensation costs
Employee benefits
Employee benefits and entitlements to annual leave, holiday, air passage and other short-term benefits are recognised when they accrue to employees. The Group's contributions to defined contribution pension plans are charged to the income statement in the year to which they relate. In respect of these plans, the Group has a legal and constructive obligation to pay the contributions as they fall due and no obligation exists to pay the future benefits. In respect of end of service benefits, to which certain employees of the Group are eligible, provisions are made in accordance with the labour law requirements of the applicable jurisdiction.

Taxation
Liability toward taxation is calculated in accordance with the tax laws of the applicable country and recognised using the liability method. Currently, there is no corporate taxation in Bahrain.

Use of estimates
The preparation of financial statements in conformity with International Financial Reporting Standards requires the management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses for the year. The estimation process involves judgement and is based on the latest information available. Actual results could differ from those estimates.

Segmental reporting
A segment is a distinguishable component of the Group, that is engaged in either providing products or services (business segment) or in providing products or services within a particular economic environment (geographical segment), which is subject to risks and rewards that are different from those of other segments. Segments with a majority of revenue earned from external customers and whose revenues or assets are 10 percent or more of all the segments are reported separately.

Cash and cash equivalents
Cash and cash equivalents comprise cash and short-term funds and deposits with banks.

Subordinated loans
Subordinated loans are carried at amortised cost. Interest expense is accrued based on contractual interest rates.

Medium-term loan
The medium-term loan is carried at amortised cost; the up-front fees paid on the loan are amortised over the life of the loan.

Notes to the consolidated financial statements
at 31 December 2005

3 Cash and deposits with banks
Cash and deposits with banks comprise:

	2005 US$000	2004 US$000
Placements with banks	12,114	-
Money at call	1,083	3,130
Balances with Central Bank	66	66
Total cash and deposits with banks	**13,263**	**3,196**

4 Trading equities and funds
Trading equities and funds comprise:

	2005 US$000	2004 US$000
Quoted equities	6,435	4,590
Managed funds	799	32
Total trading equities and funds	**7,234**	**4,622**

5 Other equities and funds
Other equities and funds comprise:

	2005 US$000	2004 US$000
Available-for-sale		
Unquoted equity fund investments - at fair value	78,622	87,680
Unquoted equity investments - at fair value	5,968	8,178
Unquoted equity investments - at cost	3,214	4,557
Total other equities and funds	**87,804**	**100,415**

The fair values in respect of unquoted equity investments carried at an amount of US$3,214,000 could not be reliably determined. These unquoted equity investments are measured at cost less provisions for impairment.

At 31 December 2005, the Bank had undrawn investment commitments to private equity funds of US$23,000,000 (31 December 2004: US$39,100,000) (Note 26). Under the terms of the agreements with these equity fund managers, the Group is irrevocably committed to invest funds upon notice from investment managers, except for certain excused investments. Excused investments include those prohibited by local law, and in certain cases, investments contrary to Shari'ah principles where the Bank is a co-investor with its clients who apply Shari'ah principles to their investment activity. Under contractual agreements with certain fund managers, failure to honour a non-excused investment drawdown request from a fund manager can result in the forfeiture of existing investments with that fund manager.

As disclosed in Note 14, certain of the Bank's private equity investments are pledged against the revolving loan facility.

5 Other equities and funds (continued)

Unquoted equity investments are stated at cost less specific impairment provisions which are as follows:

	2005 US$000	2004 US$000
Unquoted equity investments - at cost		
At 1 January	1,614	1,818
Amounts written back during the year (Note 22)	-	(280)
Foreign exchange movements	(142)	76
At 31 December	**1,472**	**1,614**

6 Other bonds

Other bonds comprise:

	2005 US$000	2004 US$000
Held-to-maturity – at amortised cost		
Structured products	3,945	17,190
Loans and receivables – at amortised cost		
Structured products	5,864	5,964
Total other bonds	**9,809**	**23,154**

Other bonds classified as held-to-maturity and loans and receivables had a fair value of US$3,895,000 and US$4,759,000 respectively (31 December 2004: US$17,085,000 and US$4,734,000 respectively).

During 2005, certain assets serving as collateral for the Bank's investment in Other bonds were redeemed, resulting in a US$12,380,000 reduction in the portfolio. Of the remaining bonds held, US$10,000,000 are secured by US Government zero coupon bonds.

Structured products primarily comprise the Group's investments in asset securitisation programmes.

In the normal course of banking business, certain bonds are pledged to parties under Repo agreements (Note 12).

Other bonds are stated after deducting impairment provisions as follows:

	2005 US$000	2004 US$000
At 1 January	24,663	25,238
Amounts recovered	(12,962)	-
(Release)/charge for the year (Note 22)	133	(575)
At 31 December	**11,834**	**24,663**

7 Loans and advances

(a) Composition

The composition of the loans and advances portfolio is as follows:

	Commercial		Government		Total	
	2005 US$000	2004 US$000	2005 US$000	2004 US$000	2005 US$000	2004 US$000
Americas	-	-	609	620	609	620
Rest of the world	55	276	7,051	8,532	7,106	8,808
Total loans and advances	**55**	**276**	**7,660**	**9,152**	**7,715**	**9,428**

Commercial loans are stated at cost less impairment provisions. Government loans include US$685,000 (31 December 2004: US$658,000) which are held for trading and carried at market value.

(b) Provisions for impairment on loans and advances

Loans and advances are stated after deducting provisions for impairment, which are as follows:

	Specific	
	2005 US$000	2004 US$000
At 1 January	31,417	29,898
Amounts written off	(3,000)	-
Amount (charged) for the year (Note 22)	1,518	-
Foreign exchange movement	(4,632)	1,519
At 31 December	**25,303**	**31,417**

The foreign exchange movement relates to the year-end revaluation of provisions against foreign currency denominated loans and is matched by a corresponding movement in the carrying amounts of such loans and advances.

(c) Non-accrual loans

	Over 3 years	
	2005 US$000	2004 US$000
Government		
Americas	609	620
Rest of the world	7,051	8,532
Total non-accrual loans	**7,660**	**9,152**

(d) Unrecognised contractual interest

	2005 US$000	2004 US$000
At 1 January	18,529	17,378
Amounts written off	(1,390)	-
Amounts unrecognised within the year	458	450
Foreign exchange movement	(2,088)	701
At 31 December	**15,509**	**18,529**

8 Installment sale receivable

During 1995, the Bank entered into an agreement to sell its investment in land in the State of Kuwait on an installment sale basis for US$43,200,000. As security, the Bank had taken a first mortgage on the land and any subsequent enhancements to the property. Under the terms of the installment sale transaction, the Bank has no liability with regard to any future costs. During 1998, the Bank entered into a revised agreement with the customer to release the first mortgage on the land and replace it with a guarantee from a bank in Kuwait.

In June 2001, the Bank released the guarantee from the bank in Kuwait that secured the installment sale receivable. In consideration for the release of the guarantee, the Bank obtained the right to set off the interest and principal amounts due under the US$20,000,000 subordinated debt agreement dated 20 June 2001 (Note 16).

In connection with its rights offering and private placement (Note 17), the US $20,000,000 subordinated loan which provided credit support to the Installment sale receivable, was converted to equity. The Bank has obtained appropriate replacement collateral to secure this receivable (Note 25).

9 Fixed assets

Fixed assets comprise:

31 December 2005

	Freehold land and building US$000	Other fixed assets US$000	Total US$000
Cost/Valuation			
At 1 January	11,406	6,739	18,145
Additions	5	124	129
Disposals	(11)	(67)	(78)
Exchange rate adjustments	-	(32)	(32)
At 31 December	11,400	6,764	18,164
Accumulated depreciation			
At 1 January	97	6,537	6,634
Charge for the year	389	104	493
Disposals	(11)	(67)	(78)
Exchange rate adjustments	-	(21)	(21)
At 31 December	475	6,553	7,028
At 31 December 2005			
Cost or valuation	11,400	6,764	18,164
Accumulated depreciation	(475)	(6,553)	(7,028)
Net book amount	**10,925**	**211**	**11,136**

Notes to the consolidated financial statements
at 31 December 2005

9 Fixed assets (continued)
31 December 2004

	Freehold land and building US$000	Other fixed assets US$000	Total US$000
At 1 January 2004			
Cost	16,179	6,688	22,867
Accumulated depreciation	(9,458)	(6,363)	(15,821)
Net book amount	6,721	325	7,046
Year ended 31 December 2004			
Opening net book amount	6,721	325	7,046
Exchange rate adjustments	-	11	11
Revaluation reserve	5,056	-	5,056
Additions	29	30	59
Depreciation charge	(497)	(164)	(661)
Closing net book amount	11,309	202	11,511
At 31 December 2004			
Cost or valuation	11,406	6,739	18,145
Accumulated depreciation	(97)	(6,537)	(6,634)
Net book amount	**11,309**	**202**	**11,511**

As a condition of the refinancing agreement, land and building is mortgaged in favour of the lenders of the US$53,200,000 medium-term loan facility (Note 13).

10 Other assets
Other assets comprise:

	2005 US$000	2004 US$000
Accrued interest receivable	415	2,545
Management fees receivable	200	295
Receivable from investment fund managers	5,926	897
Prepayments	668	321
Other	2,372	3,135
Total other assets	**9,581**	**7,193**

11 Customer deposits
Customer deposits comprise:

	2005 US$000	2004 US$000
Customer participation in funds	23,660	36,268
Government entities, corporates and individuals	30,498	37,108
Total customer deposits	**54,158**	**73,376**

11 Customer deposits (continued)

Customer participation in funds represent amounts received from customers to be invested in private equity funds marketed by BMB and amounts from private equity realisations received by the Bank and not distributed to customers. These funds, although treated as part of customer deposits, are retained by the Bank until drawdowns are made by private equity fund managers or paid to the customers as part of realised distributions. Customer deposits carry market rates of interest for the period until drawdown or payment. Customer participation in funds include US$14,502,000 (31 December 2004: US$21,791,000) in deposits held on behalf of BMB Technology and Telecommunications Fund (Note 27).

12 Securities sold under repurchase agreements

Securities sold under repurchase agreements ("Repos") comprise the following:

	2005 US$000	2004 US$000
Repos on other bonds (Note 6)	3,700	8,700
Total securities sold under repurchase agreements	**3,700**	**8,700**

13 Medium-term loan

The Bank raised an unsecured medium term loan facility of US$75,000,000 on 21 December 1999, which was drawn on 18 January 2000. This loan carried interest at Libor plus 100 basis points and was repayable with a bullet repayment on 23 December 2002. The front-end fee paid on the medium-term loan was 145 basis points. The fees together with all costs associated with this facility were amortised over the life of the loan facility.

On 14 December 2004, the Bank and the lenders signed an agreement to refinance this facility. The refinancing agreement became effective as of 28 July 2005, after the fulfillment of certain conditions precedent. Among these conditions were the following: (a) the raising of at least US $43,500,000 in new equity, (b) a US$5,000,000 principal downpayment, (c) a mortgage in favour of the lenders on the Bank's head office land and building (Note 9), (d) establishment of a pledged account in connection with mechanism under which 50% of the Bank's excess operating cashflow over a minimum cash balance threshold will be dedicated to debt service, and (e) extension of the maturity of the US $10,000,000 subordinated loan (Note 16) to December 2008.

The refinancing bears interest at a rate of Libor plus 150 basis points. After the conversion on 30 August 2005 of US$16,800,000 of this facility under the Bank's capital restoration plan (Note 17), the loan balance was reduced to US$53,200,000 with principal repayments of US$9,500,000 (June 2006), US$15,200,000 (June 2007) and US$28,500,000 (June 2008).

14 Revolving loan facility

	2005 US$000	2004 US$000
Revolving loan facility	**13,600**	**13,600**

On 30 December 2003, the Bank signed a new US$20,000,000 three-year revolving facility secured by certain of the Bank's investments in private equity funds/investments (Note 5). This facility is designed to provide liquidity to the Bank and bears interest at floating US$Libor.

Notes to the consolidated financial statements
at 31 December 2005

15 Other liabilities
Other liabilities comprise:

	2005 US$000	2004 US$000
Accrued interest payable	616	1,679
Unclaimed dividends	3,425	3,492
Employee leaving indemnity (Note 24)	906	647
Accrued expenses	728	980
Other	830	2,307
Total other liabilities	**6,505**	**9,105**

16 Subordinated loans
On 20 June 2001, the Bank raised a subordinated debt facility of US$20,000,000 repayable in 2015. The debt carried interest at 13% per annum, 8% payable annually and the difference payable when realisation of profits on certain private equity investments of the Bank takes place. As part of an arrangement for the rights issue made in June this year, the subordinated debt was fully converted to equity.

On 29 June 2001, the Bank raised a separate subordinated debt facility of US$10,000,000 repayable on 29 December 2006. The debt carried interest at 13% per annum, 8% payable annually and the difference payable when realisation of profits on certain private equity investments of the Bank takes place (Notes 5 and 19).

On 1 November 2001, the interest payable on both the above subordinated facilities was amended to 8% per annum, 5% payable annually and the difference payable when realisation of profits on certain private equity investments of the Bank takes place (Notes 5 and 19).

In connection with the refinancing of its US $75,000,000 medium-term facility (Note 13), the maturity of the US$10,000,000 subordinated loan was extended to December 2008 and the US$20,000,000 subordinated loan was converted to equity (Notes 8 and 17).

17 Share capital
Share capital comprises:

	2005		2004	
	Number 000	Amount US$000	Number 000	Amount US$000
Authorised				
Ordinary shares of US$0.25 each	2,000,000	500,000	2,000,000	500,000
Issued and fully paid				
Ordinary shares of US$0.25 each				
At 1 January	363,238	90,809	363,238	90,809
Reduction in capital	(363,225)	(90,806)	-	-
New shares issued	209,340	52,335	-	-
At 31 December	209,353	52,338	363,238	90,809
Treasury shares	-	-	(54,156)	(13,539)

17 Share capital (continued)

Trading of the Bank's shares on the Bahrain Stock Exchange, which was suspended in June 2004, pursuant to a request by the Bank made pending the finalisation of the refinancing of its US$75 million medium-term facility and the completion of the rights issue, resumed on 4 September 2005.

A distribution of each class of equity security, setting out the number of holders and percentage in the following categories at 31 December:

	2005			2004		
Ordinary shares	No. of Shares	No. of Shareholders	% of Total Outstanding Shares	No. of Shares	No. of Shareholders	% of Total Outstanding Shares
Less than 1%	7,053,068	13,141	3.37%	130,181,898	13,103	35.84%
1% up to less than 5%	7,466,672	1	3.57%	53,056,634	8	14.61%
5% up to less than 10%	59,683,345	4	28.50%	-	-	-
10% up to less than 20%	-	-	-	53,882,440	1	14.83%
20% up to less than 50%	135,148,865	2	64.56%	126,116,735	1	34.72%
50% and above	-	-	-	-	-	-
	209,351,950	13,148	100%	363,237,707	13,113	100%

Treasury shares

The Ministry of Commerce of Bahrain in a prior year granted an approval for the Bank to reacquire its own shares up to 54,485,000 (15%) of its issued and paid-up capital. At 31 December 2005, the Bank owned 1 of it's own shares (31 December 2004: 54,156,000 shares). These shares are treated as a deduction from the shareholders' equity.

In connection with its capital reorganisation, the Bank's treasury shares were reduced to 1 share with a par value of US$0.25 in August 2005.

New capital – Rights issue and private placement

Capital restoration

The shareholders of the Bank, at their Extraordinary General Meeting held on 11 May 2005 approved a capital reorganisation and capital raising plan.

The capital raising took place during the month of July 2005 and was composed of a Rights Offering of US$50 million and a Private Placement and Debt/Deposit Conversion to Equity Program of US$50 million.

An aggregate of US$52.3 million was raised under both programs.

On 30 August 2005, the Bank implemented the capital reorganisation and capital raising programs by formally registering the following changes in its capital with the relevant authorities in the Kingdom of Bahrain.

1. Reduction in capital in paid-in-capital to US$3,281.75 (13,127 shares of stock at par value of US$0.25 each) via the capitalisation of US$90,806,145 of accumulated losses and treasury shares against the issued and paid-in share capital of US$90,809,426.75.

2. A simultaneous increase in paid-in-capital by US$52,334,705.75 (209,338,823 shares of stock at par value of US$0.25 each) representing proceeds of US$35,434,701.75 (141,738,807 shares of stock at par value of US$0.25 each) raised in the Rights Offering and US$16,900,004 (67,600,016 shares of stock at par value of US$0.25) raised in the Private Placement and Debt/Deposit Conversion to Equity Program.

17 Share capital (continued)

As a result, the issued and paid-in-capital of the Bank is US$52,337,987.50 consisting of 209,351,950 shares of common stock with a par value of US$0.25 each. The Bank’s Memorandum and Articles of Association have been amended to reflect this change.

The capital raising exercise resulted in:
1. The conversion of the US$20 million subordinated loan to equity (Note 16).
2. The conversion of US$16.8 million of the medium-term loan to equity. (Note 3)
3. The conversion of US$0.1 million in deposits to equity.

The guiding principle of the Bank is to maintain risk based capital ratios in excess of the prescribed minimum of 12% by the Bahrain Monetary Agency. However, due to accumulated losses, the Bank's Tier 1 Capital was negative until the formal implementation of its capital reorganisation and capital increase in August 2005. As a result, the Bank, was unable to utilise its US$30,000,000 in subordinated loans (Tier 2 capital). Despite a reduction in risk weighted assets, the Bank's capital adequacy ratio fell below the required minimum. Following the August 2005 registration of the new capital, the Bank’s capital ratio using standardised approach was 15.47% as compared to (13.11%) at 31 December 2004.

The risk based capital ratio of the Bank include market risk weighted assets using the standardised approach and credit risk weighted assets based on the 1988 Basle Capital Accord.

Earnings per share

The earnings per share is computed as below:

	Basic		Diluted	
	2005	2004	2005	2004
Net income	US$7,768,000	US$594,000	US$7,768,000	US$594,000
Weighted average number of shares	262,512,073	309,081,352	262,512,073	309,081,352
Earning per share	US$0.03	US$0.00	US$0.03	US$0.00

18 Reserves

The Group's reserves analysed in the consolidated statement of changes in equity comprise:

Legal reserve

Legal reserve comprises amounts set aside in accordance with the Bahrain Commercial Companies Law 2001, which requires that the Bank should make an annual transfer of a minimum of 10% of net profit for the year to a non-distributable legal reserve until such reserve equals 50% of its paid-up share capital.

General reserve

General reserve comprises amounts set aside in accordance with the Bank's Articles of Association, which require that the Bank should make an annual transfer equal to 10% of net profit for the year to a general reserve. This reserve is available for distribution.

Retained earnings

Retained earnings represent distributable profits after transfer of amounts to statutory and general reserves.

Fair value reserve

Fair value reserve represents investment securities classified as available-for-sale. Income and losses arising from changes in the fair value of available-for-sale assets are recognised in the fair value reserve in equity.

18 Reserves (continued)

Fixed asset revaluation reserve

Effective 30 September 2004, the Bank adopted a policy to revalue its land and buildings once in every three years. Such revaluation is to be undertaken by an external independent valuer. In accordance with International Financial Reporting Standards, depreciation is provided on a straight-line basis over the remaining estimated useful life of the building calculated on the revalued amount. The assets are presented in the financial statements at their revalued amounts, being the fair value at the revaluation date less any subsequent accumulated depreciation. Land is not subject to depreciation.

At 30 September 2004, the land and building were fair valued based on open market valuation method, at US$11,405,836 by a firm of an independent professional valuers. The net impact of revaluation US$5,056,000 has been credited to a fixed asset revaluation reserve, being part of shareholders' equity. The building is being depreciated over its estimated useful life of 20 years from 1 October 2004.

19 Income from investments

Income from investments comprises:

	2005 US$000	2004 US$000
Income/(loss) from managed funds – trading	71	(53)
Income/(loss) from quoted equities – trading	1,853	(2,201)
Income from sovereign debt and bonds – trading	110	150
Income from other equities and funds – available-for-sale	21,824	9,761
Income from other bonds	2,682	-
Dividend income	390	276
Total income from investments	**26,930**	**7,933**

20 Foreign exchange translation income

Foreign exchange translation (loss)/income comprises:

	2005 US$000	2004 US$000
Foreign exchange translation (loss)/income	(5,325)	3,544
Total foreign exchange translation (loss)/income	**(5,325)**	**3,544**

The foreign exchange loss results from the translation of positions held in foreign currencies in loans and investments.

21 Other income

Other income comprises:

	2005 US$000	2004 US$000
Fees and commissions	1,899	1,333
Rental income	823	809
Other (loss)	(180)	(182)
Total other income	**2,542**	**1,960**

22 Impairment provisions

The specific provision charge/(release) comprises:

	2005 US$000	2004 US$000
Write off for other assets	17	-
Charge for loans and advances (Note 7)	1,519	-
Net charge/(release) for Other bonds (Note 6)	133	(574)
(Release) for other equities and funds (Note 5)	-	(280)
Total charge/(release) for impairment provisions	**1,669**	**(854)**

23 General and administrative expenses

General and administrative expenses comprise:

	2005 US$000	2004 US$000
Salaries and other personnel expenses (Note 24)	4,739	3,938
Occupancy and equipment	900	1,292
Other	3,140	3,749
Total general and administrative expenses	**8,779**	**8,979**

24 Employee benefits

Employee retirement benefits

The costs associated with contributions made by the Bank towards the pension scheme for Bahraini nationals administered by the Government of the Kingdom of Bahrain amounted to US$68,000 (31 December 2004: US$74,000). The Kingdom of Bahrain pension scheme is a defined contribution plan, and accordingly the Bank has a legal and constructive obligation to pay the contributions as they fall due and no obligation exists to pay the future benefits.

The expatriate employees of the Group based in Bahrain are paid leaving indemnity in accordance with the Kingdom of Bahrain labour laws. The movement in leaving indemnity liability is summarised below:

	2005 US$000	2004 US$000
At 1 January	647	513
Accruals for the year	259	134
At 31 December (Note 15)	906	647

	2005 Number	2004 Number
Employees at 31 December	**67**	**63**

Notes to the consolidated financial statements
at 31 December 2005

25 Related-party transactions

	Directors and key management personnel 2005 US$000	Directors and key management personnel 2004 US$000
Loans		
At 1 January	555	578
Advanced during the year	104	14
Repayments during the year	(35)	(37)
At 31 December	**624**	**555**
Administration charges for the year	**7**	**6**

No loans were advanced to any director of the Bank during the year.

No provisions have been recognised in respect of loans given to related parties (31 December 2004: nil).

The above loans are included as part of Other assets.

The loans made to key management personnel are repayable monthly up to a period of three years except for the loan to the Chief Executive which does not have a set repayment schedule. All loans are fully secured and bear an administration charge of 1% per annum (2004: 1% p.a.).

	Directors and key management personnel 2005 US$000	Directors and key management personnel 2004 US$000
Deposits		
At 1 January	3,363	20
Received during the year	11,580	5,012
Repaid during the year	(14,989)	(1,718)
Interest capitalised during the year	141	49
At 31 December	95	3,363
Interest expense on deposits for the year	141	49

Key management compensation

Compensation to key management personnel including directors were as follows:

	2005 US$000	2004 US$000
Salaries and other short-term employee benefits	1,350	1,235
Termination benefits	100	86
	1,450	1,321
Directors' remuneration	31	4

Guarantee

The Bank has received a corporate payment guarantee from Al Fawares with regard to the Installment sale receivable (Note 8).

Notes to the consolidated financial statements
at 31 December 2005

26 Investments in subsidiaries
Listing of subsidiaries
The principal subsidiaries of the Bank at 31 December were as follows:

	Ownership interest		Country of	
	2005	2004	Incorporation	Nature of business
Subsidiaries				
BMB SP Holdings Limited	100%	100%	Jersey	Investment banking
BMB Investment Company (Jersey) Limited	100%	100%	Jersey	Investment holding
Adhari Limited	100%	100%	Cayman Islands	Investment holding
T&T Beverages Limited (T&T)	93.9%	93.9%	United Kingdom	Softdrinks

At 31 December 2005, all subsidiary companies have been consolidated in the financial statements.

27 Off-balance sheet items
Credit-related financial instruments include commitments to extend credit, standby letters of credit, guarantees and acceptances which are designed to meet the requirements of the Bank's customers.

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

Standby letters of credit, guarantees and acceptances commit the Bank to make payments on behalf of customers contingent upon the failure of the customer to perform under the terms of the contract.

Undrawn investment commitments comprise contractual commitments to make investments in quoted equities and in other equities and funds as amounts are called by fund managers. Commitments to other equities and funds are generally for a period of between four and six years.

The outstanding off-balance sheet items at 31 December were as follows:

	2005 US$000	2004 US$000
Undrawn investment commitments in other equities and funds (Note 5)	23,037	39,100
Funds under management	43,107	47,790
Discretionary accounts	69,627	77,990
Non-cancellable operating lease	50	89

BMB Technology and Telecommunications Investment Company was the only fund under management as at 31 December 2005. Discretionary accounts include funds managed on behalf of customers pertaining to sub-participation in other private equity funds, unquoted equities and other debt instruments.

Undrawn investment commitments in other equities and funds include US$5,020,000 (31 December 2004: US$8,577,000), which the Bank has sold to clients and for which it has received binding commitments from them, the majority of which are secured by deposits with the Bank.

28 Legal claim

The Bank and the Bank of Bahrain and Kuwait were co-defendants in a litigation in Kuwait arising in connection with the issuance of the original shares of BMB in 1982. In May 2002, the Court of First Instance in Kuwait ruled in favour of the Bank and its co-defendant. In April 2003, the Appellate Court upheld the judgement of the Court of First Instance ruling in the Bank's favour. The Kuwaiti litigant had the right to appeal to the Court of Cassation, but did not file a challenge within the stipulated time, and hence, the litigation in Kuwait has come to a final conclusion in the Bank's favour.

On 10 August 2003, the Kuwaiti litigant filed a suit in Bahrain. The case is pending in the courts of Bahrain having been adjourned several times, the latest being 15 January 2006. The case was postponed again to a date to be determined by the Court. Based on the nature of this action and a previous favourable decision in its favour in a similar case in Bahrain, the Bank believes that this case will be decided in its favour and accordingly, no provision has been made in the financial statements.

29 Credit risk and concentrations of 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 both on and off-balance sheet by monitoring credit exposures, limiting transactions with specific counterparties, and continually assessing the creditworthiness of counterparties. The Group's risk grading system assigns a risk grade under a ten grade scale, with one being the highest grade having least chances of default. The risk grading is based on quantitative and qualitative risk characteristics and employs an objective measure in determining a risk grade for an exposure. Quantitative factors focus on the historical and prospective financial strengths such as cash flow, capital adequacy, profitability, asset quality, tenor of risk and qualitative factors include management quality, market share, industry risk, sovereign risk and operating efficiency. All obligors and countries are risk graded.

In addition to monitoring credit limits, the Group manages the credit exposure relating to its trading activities by entering into master netting agreements and collateral arrangements with counterparties in appropriate circumstances, and limiting the duration of exposures.

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 attempts to manage its credit risk exposure through diversification of its equity investments, capital markets and lending activities to avoid undue concentrations of risks with individuals or groups of customers in specific locations or businesses. It also obtains security when appropriate.

The Group controls the credit risk arising from derivative and foreign exchange contracts through its credit approval process and the use of risk control limits and monitoring procedures. The Group uses the same credit procedures when entering into derivative and foreign exchange transactions as it does for traditional lending products.

Overall, Bank management believes that its policies and procedures for managing credit risk in the activities that it undertakes represent a reasonable and prudent approach.

29 Credit risk and concentrations of credit risk (continued)

The Group's assets, liabilities, off-balance sheet items are summarised by geographical area as follows:

	North America		Europe		Rest of the world		Total	
	2005 US$000	2004 US$000	2005 US$000	2004 US$000	2005 US$000	2004 US$000	2005 US$000	2004 US$000
Assets								
Cash and deposits with banks	24	1,994	13,020	1,020	219	182	13,263	3,196
Trading equities and funds	612	372	4,356	3,571	2,266	679	7,234	4,622
Other equities and funds	42,843	45,929	38,004	48,275	6,957	6,211	87,804	100,415
Other bonds	8,945	22,190	864	964	-	-	9,809	23,154
Loans and advances	609	620	-	-	7,106	8,808	7,715	9,428
Installment sale receivable	-	-	-	-	21,869	22,485	21,869	22,485
	53,033	71,105	56,244	53,830	38,417	38,365	147,694	163,300
Other assets							20,717	18,704
Total assets							**168,411**	**182,004**
Liabilities								
Customer deposits	-	-	423	649	53,735	72,727	54,158	73,376
Securities sold under repurchase agreements	-	-	-	-	3,700	8,700	3,700	8,700
Medium-term loan	-	8,000	14,000	18,000	39,200	49,000	53,200	75,000
Revolving loan facility	-	-	-	-	13,600	13,600	13,600	13,600
Subordinated loans	-	-	-	-	10,000	30,000	10,000	30,000
	-	8,000	14,423	18,649	120,235	174,027	134,658	200,676
Other liabilities							6,505	9,105
Shareholders' equity							**27,248**	**(27,777)**
Total liabilities and shareholders' equity							**168,411**	**182,004**
Off-balance sheet credit and investment instruments	5,927	12,760	17,160	26,429	-	-	**23,087**	**39,189**

30 Currency risk

The Group takes on exposure to effects of fluctuations in the prevailing foreign currency exchange rates on its financial positions and cash flows. The table below summarises the Group's exposure to foreign currency exchange rate risk at 31 December, 2005.

	Net on-balance sheet position 2005	Net on-balance sheet position 2004	2005	Off balance sheet commitments 2005
	US$000 Equivalent	US$000 Equivalent	US$000 Equivalent	US$000 Equivalent
Long/(short)				
Pound sterling	20,961	27,832	8,544	7,856
Euro	23,566	16,115	8,451	19,260
Others	8,843	11,774	-	-

31 Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect the value of 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 Bank manages this risk by matching the repricing of assets and liabilities through a variety of means. The Bank's interest rate sensitivity position, based on the contractual repricing or maturity dates, whichever dates are earlier, is as follows:

2005

	Up to 1 month US$000	1 – 3 months US$000	3 - 6 months US$000	6 - 12 months US$000	1 – 3 years US$000	Fixed rate US$000	Non-interest bearing US$000	Total US$000
Cash and deposits with banks	66	-	-	-	-	12,114	1,083	13,263
Trading equities and funds	-	-	-	-	-	-	7,234	7,234
Other equities and funds	-	-	-	-	-	-	87,804	87,804
Other bonds	864	-	-	-	-	8,945	-	9,809
Loans and advances	-	-	-	-	-	-	7,715	7,715
Installment sale receivable	-	-	-	-	-	21,869	-	21,869
Fixed assets	-	-	-	-	-	-	11,136	11,136
Other assets	-	-	-	-	-	-	9,581	9,581
Total assets	930	-	-	-	-	**42,928**	**124,553**	**168,411**
Customer deposits	23,660	-	-	-	-	29,711	787	54,158
Securities sold under repurchase agreements	3,700	-	-	-	-	-	-	3,700
Medium-term loan	-	53,200	-	-	-	-	-	53,200
Revolving loan facility	13,600	-	-	-	-	-	-	13,600
Other liabilities	-	-	-	-	-	-	6,505	6,505
Subordinated loans	-	-	-	-	-	10,000	-	10,000
Shareholders' equity	-	-	-	-	-	-	27,248	27,248
Total liabilities and shareholders' equity	**40,960**	**53,200**	**-**	**-**	**-**	**39,711**	**34,540**	**168,411**
Total interest rate sensitivity gap	**(40,030)**	**(53,200)**	**-**	**-**	**-**			
Cumulative interest rate sensitivity gap	**(40,030)**	**(93,230)**	**(93,230)**	**(93,230)**	**(93,230)**			

31 Interest rate risk (continued)
2004

	Up to 1 month US$000	1 – 3 months US$000	3 - 6 months US$000	6 - 12 months US$000	1 – 3 years US$000	Fixed rate US$000	Non-interest bearing US$000	Total US$000
Cash and deposits with banks	66	-	-	-	-	-	3,130	3,196
Trading equities and funds	-	-	-	-	-	-	4,622	4,622
Other equities and funds	-	-	-	-	-	-	100,415	100,415
Other bonds	964	-	-	-	-	22,190	-	23,154
Loans and advances	-	-	-	-	-	-	9,428	9,428
Installment sale receivable	-	-	-	-	-	22,485	-	22,485
Fixed assets	-	-	-	-	-	-	11,511	11,511
Other assets	-	-	-	-	-	-	7,193	7,193
Total assets	1,030	-	-	-	-	**44,675**	**136,299**	**182,004**
Customer deposits	36,268	-	-	-	-	36,314	794	73,376
Securities sold under repurchase agreements	8,700	-	-	-	-	-	-	8,700
Medium-term loan	75,000	-	-	-	-	-	-	75,000
Revolving loan facility	13,600	-	-	-	-	-	-	13,600
Other liabilities	-	-	-	-	-	-	9,105	9,105
Subordinated loans	-	-	-	-	-	30,000	-	30,000
Shareholders' equity	-	-	-	-	-	-	(27,777)	(27,777)
Total liabilities and shareholders' equity	**133,568**	**-**	**-**	**-**	**-**	**66,314**	**(17,878)**	**182,004**
Total interest rate sensitivity gap	**(132,538)**	**-**	**-**	**-**	**-**			
Cumulative interest rate sensitivity gap	**(132,538)**	**(132,538)**	**(132,538)**	**(132,538)**	**(132,538)**			

31 Interest rate risk (continued)

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 fair value.
The effective interest rate by major currencies for each of the monetary financial instruments which bear interest is as follows:

2005

	Effective interest rate %		
	US$	GBP	EUR
Assets			
Placements with banks	4.3	-	2.4
Other bonds	3.7	5.4	-
Installment sale receivable	4.8	-	-
Liabilities			
Customer deposits	3.9	4.4	1.6
Securities sold under repurchase agreements	4.4	-	-
Medium-term loan	6.0	-	-
Revolving loan facility	4.4	-	-
Subordinated loans	8.0	-	-

2004

	Effective interest rate %		
	US$	GBP	EUR
Assets			
Other bonds	2.3	5.6	-
Installment sale receivable	4.8	-	-
Liabilities			
Customer deposits	2.3	4.7	1.9
Securities sold under repurchase agreements	2.4	-	-
Medium-term loan	4.4	-	-
Revolving loan facility	2.4	-	-
Subordinated loans	8.0	-	-

(a) The effective interest rates are disclosed based upon average rates applicable to several individual instruments held at 31 December.
(b) The effective interest rate for customer deposits has been computed excluding non-interest bearing accounts of US$787,000 (31 December 2004: US$794,000).
(d) Statutory deposit held at the BMA is not included in the above.

Key to currencies:
US$ - United States Dollar
GBP - Great Britain Pound
EUR - Euro

32 Liquidity risk

Liquidity risk is the possibility of the Group being unable to settle its present and future financial obligations. It includes the risk of being unable to fund the portfolio of assets at appropriate maturities and the risk of being unable to realise the stock of liquid assets at desired prices in an unfavourable market. The Group manages its liquidity risk through the avoidance of maturity mismatches and appropriate diversification of its financial assets and liabilities.

As outlined in Note 13, in December 2004, the Bank signed an agreement with its lenders for refinancing of the US$75,000,000 medium-term facility which matured in December 2002. This development accompanied by the raising of US$52,300,000 in new capital in July 2005 and the securing of a US$20,000,000 secured revolving-term liquidity facility has significantly improved the liquidity position of the Bank and enable it to execute its business plan.

The maturity profile of the Group's assets and liabilities is shown below:

2005

	Within 1 month US$000	1 - 3 months US$000	3 - 6 months US$000	6 - 12 months US$000	1-5 years US$000	5-10 years US$000	10-20 years US$000	Over 20 years US$000	Total US$000
Assets									
Deposits with banks	13,263	-	-	-	-	-	-	-	13,263
Trading equities and funds	7,234	-	-	-	-	-	-	-	7,234
Other equities and funds	-	21	5,708	20,544	50,904	10,627	-	-	87,804
Other bonds	-	-	-	-	-	8,945	-	864	9,809
Loans and advances	-	739	2,588	-	-	-	-	4,388	7,715
Installment sale receivable	-	-	-	1,558	6,324	9,795	4,192	-	21,869
Fixed Assets	-	-	-	-	211	-	-	10,925	11,136
Other assets	948	4,760	415	195	3,263	-	-	-	9,581
Total assets	**21,445**	**5,520**	**8,711**	**22,297**	**60,702**	**29,367**	**4,192**	**16,177**	**168,411**
Liabilities									
Customer deposits	12,282	21,672	-	-	20,204	-	-	-	54,158
Securities sold under repurchase agreements	3,700	-	-	-	-	-	-	-	3,700
Medium-term loan	-	-	-	9,500	43,700	-	-	-	53,200
Revolving loan facility	-	-	-	13,600	-	-	-	-	13,600
Subordinated loans	-	-	-	-	10,000	-	-	-	10,000
Other liabilities	23	306	413	1,502	350	1,406	1,000	1,505	6,505
Shareholders' equity	-	-	-	-	-	-	-	27,248	27,248
Total liabilities and shareholders' equity	**16,005**	**21,978**	**413**	**24,602**	**74,254**	**1,406**	**1,000**	**28,753**	**168,411**
Net liquidity gap	**5,440**	**(16,458)**	**8,298**	**(2,305)**	**(13,552)**	**27,961**	**3,192**	**(12,576)**	

Structured products (loans and receivables), included in Other bonds, of US$5,000,000 classified within the maturity band of 5 years to 10 years is a marketable security readily convertible to cash.

32 Liquidity risk (continued)

2004

	Within 1 month US$000	1 - 3 months US$000	3 - 6 months US$000	6 - 12 months US$000	1-5 years US$000	5-10 years US$000	10-20 years US$000	Over 20 years US$000	Total US$000
Assets									
Deposits with banks	3,196	-	-	-	-	-	-	-	3,196
Trading equities and funds	4,622	-	-	-	-	-	-	-	4,622
Other equities and funds	-	176	1,648	18,519	74,049	6,023	-	-	100,415
Other bonds	-	-	-	-	-	22,190	-	964	23,154
Loans and advances	9,152	276	-	-	-	-	-	-	9,428
Installment sale receivable	-	-	531	-	-	-	21,954	-	22,485
Fixed assets	-	-	-	-	202	-	-	11,309	11,511
Other assets	-	295	2,866	-	4,032	-	-	-	7,193
Total assets	**16,970**	**747**	**5,045**	**18,519**	**78,283**	**28,213**	**21,954**	**12,273**	**182,004**
Liabilities									
Customer deposits	3,071	8,775	26,789	-	-	34,741	-	-	73,376
Securities sold under repurchase agreements	8,700	-	-	-	-	-	-	-	8,700
Medium-term loan	-	-	75,000	-	-	-	-	-	75,000
Revolving loan facility	-	-	-	-	13,600	-	-	-	13,600
Subordinated loans	-	-	-	-	10,000	-	20,000	-	30,000
Other liabilities	108	-	1,571	3,357	350	1,147	1,000	1,572	9,105
Shareholders' equity	-	-	-	-	-	-	-	(27,777)	(27,777)
Total liabilities and shareholders' equity	**11,879**	**8,775**	**103,360**	**3,357**	**23,950**	**35,888**	**21,000**	**(26,205)**	**182,004**
Net liquidity gap	**5,091**	**(8,028)**	**(98,315)**	**15,162**	**54,333**	**(7,675)**	**954**	**(38,478)**	

Structured products (loans and receivables), included in Other bonds, of US$5,000,000 classified within the maturity band of 5-10 years is a marketable security readily convertible to cash.

33 Market risk

Market risk is defined as the potential adverse changes in the value of a portfolio of financial instruments resulting from the movement of market rates, prices and volatilities. The Bank uses the standardised approach to measure the market risk-weighted assets for regulatory purposes. Additionally, the Bank employs a sophisticated risk management model that uses the RiskMetrics™ methodology to calculate market risk for internal risk measurement and management purposes. Market Risk is measured as “Value at Risk” (VaR) using probability analysis based upon a common confidence interval and time horizon. The VaR number is a statistical risk measure, which quantifies, within a given confidence level, the maximum fluctuation in portfolio value within a specified time period.

The Group’s policy is to manage its exposure to market risk on an aggregate basis combining the effects of cash instruments and derivative contracts. The Group develops and refines hedging strategies that correlate price and currency movements of assets and liabilities and related hedges. In certain instances, derivative financial instruments are used to hedge other on and off-balance sheet transactions.

Due to the lack of trading lines, the Bank was unable to undertake market risk mitigation activities in 2005.

34 Fair value of financial instruments

The table below compares the estimated fair values of on and off-balance sheet financial instruments with their respective book amounts as of 31 December 2005 and 2004. As set out in Note 2 to the financial statements, certain of the Bank's financial instruments are accounted for under the historical cost convention as modified by the revaluation of available-for-sale financial assets, all derivative contracts and financial assets and financial liabilities held for trading which may differ from the fair value for which the asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Consequently differences can arise between book amounts and the fair value estimates.

2005

	Book amount US$000	Fair value US$000	Over/(under) book amount US$000
Assets			
Other bonds carried at amortised cost	9,809	8,654	(1,155)
Loans and advances	7,030	7,030	-
Installment sale receivable	21,869	21,869	-
Net shortfall of fair value over book amount			**(1,155)**

2004

	Book amount US$000	Fair value US$000	Over/(under) book amount US$000
Assets			
Other bonds carried at amortised cost	23,154	21,819	(1,335)
Loans and advances	8,770	8,770	-
Installment sale receivable	22,485	22,485	-
Net shortfall of fair value over book amount			**(1,335)**

The total shortfall in fair value of US$1,155,000 (2004: US$1,335,000) is not relevant except in a forced sale situation and the Bank has the intention to hold these bonds to maturity when it would recover the nominal amounts. These transactions were carried out to generate long-term net interest income.

The total fair value of other bonds is based on quoted market prices at the balance sheet date.

The fair value of loans and advances, excluding loans held for trading purposes, is based on amounts estimated to be received upon maturity.

The fair value of the installment sale receivable is shown at cost which approximates the value calculated using discounted cash flow method.

No fair value adjustment is appropriate for off-balance sheet financial instruments with contractual amounts representing credit risk as specific provisions are made in respect of individual transactions where a potential loss, if any, has been identified.

34 Fair value of financial instruments (continued)

The estimated fair value of the following assets and liabilities is not significantly different from the corresponding book amounts as the items are short term in nature:

- Cash and deposits with banks
- Other assets
- Bank deposits
- Customer deposits
- Securities sold under repurchase agreements
- Other liabilities

The estimated fair values of the medium-term loan and the revolving loan facility are not significantly different from book amounts as the major proportion of these liabilities are repriced on a monthly basis.

35 Segmental information

(a) Business Segments

The Group is organised into two business segments, namely, banking and manufacturing. The banking segment has three sub-segments, trading, investment activity and other operations.

Trading activity - current investments in bonds, equities and funds and other derivative instruments.
Investing activity - investments in bonds, other equities and funds and hedging activity.
Other operations include investor marketing, building rental, etc.

Manufacturing: softdrinks

35 Segmental information (continued)

Transactions between business subsegments are on normal terms and conditions. The allocation of costs for each business segment is based on estimated time and relevant measurement criteria for each business segment.

2005

	Banking					
	Trading activity US$000	Investing activity US$000	Other operations US$000	Total Banking US$000	Manufacturing US$000	Total US$000
Operational income						
Segmental income/(loss)	(3,326)	20,699	2,792	20,165	(1,949)	18,216
Result						
Segmental result	(3,326)	14,802	803	12,279	(4,511)	7,768
Net Income/(Loss)				**12,279**	**(4,511)**	**7,768**
Other information						
Segmental assets	7,919	139,697	-	147,616	538	148,154
Unallocated corporate assets	-	-	-	20,257	-	20,257
Consolidated total assets	**7,919**	**139,697**	**-**	**167,873**	**538**	**168,411**
Segmental liabilities	-	134,658	-	134,658	537	135,195
Unallocated corporate liabilities	-	-	-	5,968	-	5,968
	-	-	-	140,626	537	141,163
Shareholders' equity						27,248
Consolidated total liabilities and shareholders' equity						**168,411**

35 Segmental information (continued)

2004

	Banking					
	Trading activity US$000	Investing activity US$000	Other operations US$000	Total Banking US$000	Manufacturing US$000	Total US$000
Operational income						
Segmental income/(loss)	1,772	6,530	2,190	10,492	(1,773)	8,719
Result						
Segmental result	1,336	3,406	850	5,592	(4,998)	594
Net income/(Loss)				**5,592**	**(4,998)**	**594**
Other information						
Segmental assets	4,622	158,471	-	163,093	2,436	165,529
Unallocated corporate assets	-	-	-	16,475	-	16,475
Consolidated total assets	**4,622**	**158,471**	**-**	**179,568**	**2,436**	**182,004**
Segmental liabilities	-	200,676	-	200,676	2,097	202,773
Unallocated corporate liabilities	-	-	-	7,008	-	7,008
	-	200,676	-	207,684	2,097	209,781
Shareholders' equity						(27,777)
Consolidated total liabilities and shareholders' equity						**182,004**

(b) Geographical Segments

	North America		Europe		Rest of the world		Total	
	2005 US$000	2004 US$000	2005 US$000	2004 US$000	2005 US$000	2004 US$000	2005 US$000	2004 US$000
Income								
Total operating income/(loss)	8,437	5,971	19,408	7,010	(9,629)	(4,262)	18,216	8,719
Assets								
Total assets	53,033	71,105	56,244	56,266	59,134	54,633	168,411	182,004

Although the Group's two main business segments are managed on a worldwide basis, they operate in two main geographical areas. The Group's exposure to credit risk is concentrated in these areas:

North America - United States of America and Canada
Europe - United Kingdom, Germany and France

36 Consolidated average balance sheet at 31 December 2005
(Expressed in thousands of United States Dollars)

	2005	2004
Assets		
Cash and deposits with banks	17,832	4,098
Trading equities and funds	7,534	5,345
Other equities and funds	87,986	100,130
Other bonds	13,171	22,603
Loans and advances	8,806	8,275
Installment sale receivable	22,044	22,612
Fixed assets	11,272	9,127
Other assets	10,404	6,943
Total assets	**179,049**	**179,133**
Liabilities and shareholders' equity		
Liabilities		
Customer deposits	70,440	77,212
Securities sold under repurchase agreements	6,200	5,032
Medium-term loan	61,600	75,000
Revolving term loan	13,600	13,600
Other liabilities	6,874	7,958
Subordinated loans	20,000	30,000
Total liabilities	**178,714**	**208,802**
Shareholders’ equity	335	(29,669)
Total liabilities and shareholders’ equity	**179,049**	**179,133**

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