Annual Report and Accounts 1998

Gulf International Bank B.S.C.

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Front cover calligraphy:

"Every place that spurs glory is gratifying"

Knowledge of and Commitment to the Gulf Cooperation Council region

GIB is the only bank in the region that really understands the intricacies and requirements of all the GCC states and is totally committed to this region.

بنك الخليج الدولي ش.م.ب

Gulf International Bank B.S.C.

Gulf International Bank is a wholesale commercial bank based in Bahrain. It is wholly owned by Gulf Investment Corporation (GIC), the international investment banking corporation owned equally by the governments of the six member states of the Gulf Cooperation Council (GCC) – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates. The Bank's primary business focus is on the GCC market and the associated trade and financial flows between this area and the industrialised world.

Target clients include major indigenous private-sector corporations, Gulf-based financial institutions, multinational companies active in the region and the governments of the GCC states themselves. Branches in London and New York and representative offices in Singapore, Abu Dhabi and Beirut assist in servicing this client base. GCC market knowledge, expertise in its industries, extensive product skills, international reach and a commitment to excellence are distinguishing features of the bank.

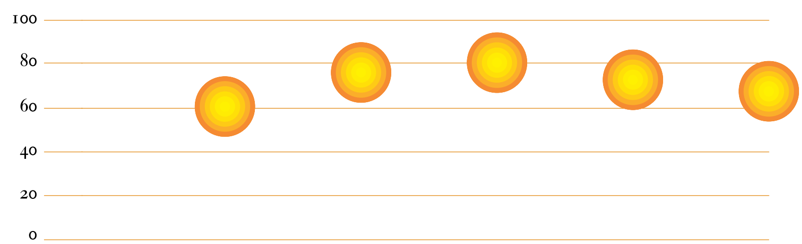
2 Financial Highlights

	1998	1997	1996
Earnings (US$ millions)			
Net Income after Tax	**82.1**	86.4	94.5
Net Interest Revenue	**115.3**	109.6	110.3
Other Income	**49.2**	54.0	38.8
Operating Expenses	**52.9**	46.7	44.3
Financial Position (US$ millions)			
Total Assets	**10,209.0**	9,523.9	8,982.9
Loans	**4,000.7**	3,478.7	3,436.5
Trading Securities	**139.6**	192.1	86.2
Investment Securities	**3,229.6**	3,047.0	2,817.6
Shareholders' Equity	**731.0**	693.9	652.5
Ratios (%)			
Profitability			
Return on Shareholders' Equity	**11.2**	12.5	14.5
Return on Assets	**0.8**	0.9	1.1
Capital			
BIS Risk Asset Ratio			
– Total	**11.3**	12.0	11.7
– Tier 1	**10.1**	10.7	10.4
Shareholders' Equity as % of Total Assets	**7.2**	7.3	7.3
Loans as a multiple of Equity (times)	**5.5**	5.0	5.3
Asset Quality			
Loans as % of Total Assets	**39.2**	36.5	38.3
Securities as % of Total Assets	**33.0**	34.0	32.3
GCC Country Risk as % of Total Assets	**34.0**	25.8	25.2
GCC & OECD Country Risk as % of Total Assets	**86.6**	84.4	83.8
Liquidity			
Liquid Assets Ratio	**59.1**	61.6	60.2
Deposits to Loans Cover (times)*	**2.2**	2.3	2.2
Long-Term Debt Ratings			
BankWatch	**A-**	A-	A-
Moody's	**Baa2**	Baa2	Baa2
Standard & Poor's	**BBB+**	BBB+	BBB+

*Deposits include Term Financing

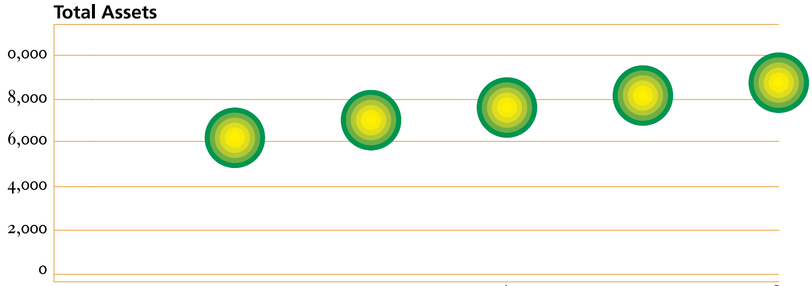
Financial Highlights

Net Income After Tax



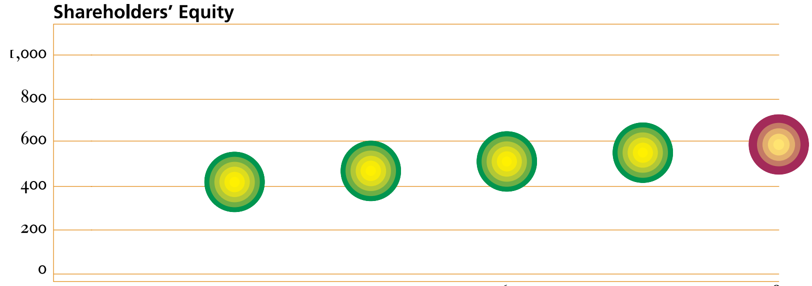
US$ millions	94	95	96	97	98
Net Income after Tax	74.8	89.8	94.5	86.4	**82.1**

Total Assets



US$ millions	94	95	96	97	98
Total Assets	7,574	8,433	8,983	9,524	**10,209**

Shareholders' Equity



US$ millions	94	95	96	97	98
Shareholders' Equity	558	603	653	694	**731**

Board of Directors

H.E. Ibrahim Abdul-Karim
Chairman
Minister of Finance & National Economy,
State of Bahrain

Dr. Khaled Al-Fayez
Vice Chairman
Chief Executive Officer,
Gulf Investment Corporation,
State of Kuwait

Bader Abdullah Al-Rushaid Al-Bader *
Chairman & Managing Director,
Kuwait Investment Company,
State of Kuwait

Saker Dhaher Al-Moraikhi
Director of General Financial Affairs,
Ministry of Finance, Economy & Commerce,
State of Qatar

Hisham Abdul Razzak Razzuqi *
General Manager,
Gulf Investment Corporation,
State of Kuwait

Saleh Abdullah Alnaim
Director General,
Saudi Industrial Development Fund,
Kingdom of Saudi Arabia

Hussain Bin Mohammed Hassan Al Saleh *
Director General of Financial Planning,
Ministry of Finance,
Sultanate of Oman

Mohammed Bin Saif Al Shamsi
Director of Industrial Property Right,
Ministry of Finance & Industry,
United Arab Emirates

Rashid Ismail Al-Meer *
Assistant Under-Secretary for Financial Affairs,
Ministry of Finance & National Economy,
State of Bahrain

* Audit Committee Members

“Balance is a source of happiness”

International and Diversified

With the merger with SIB, GIB is becoming more international in scope. Its lines of business will also be more diversified allowing it to offer a broader array of products and services to its customers.

Chairman's Statement

On behalf of the Board of Directors, I am pleased to present the Annual Report of Gulf International Bank (GIB) for the year ended 31st December 1998 in this, our twenty-second annual report.

The year 1998 was a year of solid growth and profitability for GIB. This was an impressive achievement seen in the context of the highly challenging and difficult financial environment that prevailed. GIB's extremely positive performance against the generally uncertain economic backdrop is a credit to the sound and prudent management policies of the Bank together with its continued focus on key areas of business and the maintenance of a liquid balance sheet. The future development of the Bank has been dramatically enhanced this year by the announcement of the merger with Saudi International Bank (SIB), a move that will bring many new and exciting business opportunities and areas of activity to GIB.

In 1998, GIB generated an operating profit of $112.1 million, representing a 3.7 per cent decrease compared with 1997. The allocation to provisions for credit losses has been maintained at $30 million, the same level as the previous year. In the market conditions that prevailed in 1998, the Bank continued to adopt a prudent approach to provisions for credit losses. Net Income, after allocation of $30 million for credit provisions, was $82.1 million, representing an 11.2 per cent return on Shareholders' Equity. On the basis of these solid results, the Board proposes a 10 per cent dividend on the paid-up capital of $450 million. Total Assets increased by 7.2 per cent over 1997 to $10.2 billion, reflecting increases in both the loans and investment securities portfolios.

Throughout 1998, the Bank reviewed its strategy and made the decision to renew its emphasis on strengthening its position in the GCC states. Lending remains GIB's core activity, particularly to public bodies, major corporations and governments within the Gulf region. The Bank's commitment to providing financing for the Gulf region remains strong and in line with regional priorities. As privatization strategies are increasingly implemented, specifically within the telecommunication, transportation and electricity industries, GIB is well positioned to benefit from the many opportunities this new dynamism in the GCC economies will present.

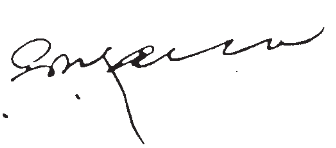
At the same time, GIB maintained a high quality, low-risk investment securities portfolio principally comprising investment grade rated securities of institutions located in G10 countries. This portfolio provided the Bank with a geographical diversification of risk assets plus a balance between lending and investment which was supported by the Bank's risk management policy of maintaining a high liquid assets ratio.

A number of important project finance deals were undertaken during the year which underlined GIB's expertise in several key areas and confirmed its position as the leading bank for project finance and syndications in the Gulf region. Loan deals were notable for the quality of the clients they represented and the size of the deals.

GIB's position and reputation were endorsed during 1998 through the strong rating assessments assigned by the main international rating agencies. The ratings reflected the Bank's strong franchise in the Gulf, solid capitalization at both bank and shareholder levels, and strong financial performance. The Bank's stability, broad funding base and the liquidity of its balance sheet were also key factors underpinning its positive rating assessments. New risk management and information technology systems, together with the introduction of a new method of assessing, managing and developing key skills of Bank staff, will help GIB to maintain its prestigious title of 'Best Bank in Bahrain', the award Euromoney magazine bestowed on GIB for the second consecutive year.

At the end of 1998, GIB announced a merger with Saudi International Bank, a London-based investment bank. Expected to be completed by the end of the first quarter of 1999, the merger will create a bank with combined assets in the region of $15 billion and enable GIB to diversify both its ownership and its business beyond its chiefly lending related activities. In 1999 its revenue will be enhanced by more market-based and fee-earning activities, further justifying the Bank's expansion into the GCC.

The sound progress the Bank has achieved in many areas this past year and the exciting opportunities now presented by the merger with SIB are the result of vision, expertise and hard work. I am grateful to the Board and to the management and staff for their invaluable efforts and their contribution to the success of GIB. The Bank will continue to reward its people and support their development with training that is appropriate for their needs and the future strategy of the Bank. We are also investing heavily in information technology to help our staff meet the needs of our expanding list of clients. We are confident of GIB's position and its potential for growth in 1999 and look forward to the challenges and opportunities that lie ahead.



Ibrahim Abdul-Karim
Chairman

"To reach your destination you have to travel, for a small crescent moves on to blossom into a full moon"

Striving for Perfection

GIB's commitment to excellence and its professionalism are its utmost priorities.

The year that ended in December 1998 was a challenging year. For many financial institutions, particularly those with exposure to the troubled South East Asian and Russian markets, it was a time of considerable difficulty and uncertainty. For Gulf International Bank (GIB), however, it was a year in which it demonstrated once again great stability and the strength and expertise of its management.

The Bank's robust performance during the year is testimony to its acknowledged expertise, solid reputation, the quality of its loan and investment portfolios, a track record of quality projects and a policy of fiscal discipline. Given these positive factors, GIB remains in an excellent position to continue to perform strongly under the current market conditions, and to benefit significantly from any improvement in the economic conditions of the region.

The market in which GIB operated last year was characterised by tighter liquidity, slower growth and controlled spending by all GCC governments. Within the GCC region in particular, low oil prices were a major contributor to the slower growth rates. If the current trend continues and oil prices remain depressed, most economies in the Gulf will begin to feel the effects during 1999 and beyond. For GIB, however, with its exposure carefully restricted to governments and major corporations, prospects remain very positive despite the general economic background.

The Bank remains committed to its policy of maintaining a diversified portfolio of high quality assets and of retaining a high level of liquidity. This balanced and cautious approach to risk will continue to bolster the Bank's profitability levels against adverse market fluctuations. At the same time, GIB continues its drive to enhance both the range and the quality of the products and services it offers. Whereas GIB is operating within a market increasingly characterised by tightening liquidity, it nevertheless remains focused on maintaining the high quality of its asset portfolio and continues to forge working relationships with business partners of quality and integrity.

A leading player in the Gulf region in project finance and syndications, corporate lending and asset-backed finance, the Bank will continue to build on its strengths and develop and promote new areas of business that offer added value to clients. The merger of GIB with the London-based Saudi International Bank (SIB) announced at the end of 1998 will help in this respect, bringing additional areas of expertise to the Bank, enabling it to expand its range of services to clients, and making new business opportunities possible. The merger will help to accelerate considerably GIB's existing plans to expand into Saudi Arabia where three new branches are planned to be opened over the next eighteen months, at six-month intervals, followed by expansion into another GCC country.

The international rating agencies, Standard & Poor's, Moody's and BankWatch have once again recognised GIB's asset quality, effective risk management strategies and solid financial performance. This recognition is reflected in their ratings, which are among the highest assigned to a Gulf bank.

Project Finance and Syndications

GIB is recognised as the leading player in project finance and syndications in the Gulf. Its large capital base and expertise have enabled it to lead many large and important project finance transactions as well as arrange and lead manage an increasing

Management Review

continued

number of syndications. During 1998 the Bank continued to place special emphasis on servicing industries in the Gulf region based on clearly defined strategic objectives.

The difficulties in the Far East meant that many financial institutions avoided this market and turned their attention elsewhere, chiefly the Middle East, where competition was intense, particularly at arranger level. In the face of this competition, GIB has maintained its high standards and retained its position as one of the top lead arrangers in the region. Although the current market conditions have had the effect of reducing the number of deals of an appropriate quality, GIB had the foresight to book many high quality deals in 1996 and 1997 when project finance and syndications activities were very buoyant and growing rapidly in the GCC. GIB is now acknowledged to be a specialist in regional project development, evaluation and financing. The Bank is also recognised as the most active Gulf-based bank in arranging and lead managing the region's syndicated deals.

GIB's regional project financing activities are supported by the Bank's successful syndication division, which has arranged a number of high profile syndicated transactions, such as loan facilities to the governments of Oman and Qatar.

In late 1997 and early 1998, GIB was one of a group of lead arrangers and underwriters which collectively arranged the 'Deal of the Year' in the petrochemicals industry. The US$2.2 billion loan to the Saudi Yanbu Petrochemical Company (Yanpet), a joint venture between Mobil and Sabic, had the exceptional distinction of being the largest petrochemical financing ever in the world, as well as the largest non-sovereign loan deal ever undertaken. The purpose of the loan is to finance the development of a major expansion plant at the Yanpet site. The new facility will more than double Yanpet's ethylene, polyethelene and ethylene-glycol production and supplement its range of products with the addition of polypropylene.

In another project of distinction, GIB arranged and underwrote the Middle East syndication of a US$2.0 billion facility for a liquefied natural gas plant in the Sultanate of Oman. This was a challenging deal through which GIB once again strongly reinforced its full commitment to the region.

A loan facility for United Arab Shipping was unique in that it was the first deal of its size to one of the most prominent shipping companies in the region. It was also notable in that it was priced prior to the difficulties in the South East Asia market, but GIB adhered to its original pricing position, demonstrating its commitment to its clients and underlying credit confidence.

Although competition for project finance and quality syndicated deals is likely to remain intense throughout 1999, the viability of the region is unquestioned because of its central position, access to cheap energy and the private sector's increasing role and accelerating initiatives. As oil prices recover, the demand for project finance and syndicated borrowing will reach its traditional high levels.

Trade Finance and International Network

GIB's Bahrain operation is supported internationally by branches in London and New York, and by representative offices in Lebanon, Singapore and the United Arab Emirates.

Treasury was a significant area of activity for the London branch. The number and quality of foreign exchange counterparties was expanded and the range of liabilities continued to increase. Banking activity concentrated on two areas, the first was the traditional servicing of corporate clients in support of their banking, contracting, investment activities, and their dealings between Europe and the Arab world. The second activity leveraged the Bank's strength in risk analysis to enlarge its portfolio of assets in debt finance. During 1998, the London branch part financed the acquisition of the largest Moroccan refinery by a leading Saudi Arabian group. In addition, the branch increased its European Export Credit Agency related financing of several major projects in Oman and Qatar, and confirmed large project-related letters of credit in Tunisia, the United Arab Emirates, Oman, Saudi Arabia and other Arab countries.

In terms of non-strategic structured finance in Europe, the branch continued to enjoy a reputation as a reliable and professional participant in the specialised field of providing senior bank debt to management buyouts and other cashflow driven transactions.

During the year, the New York branch participated in several new transactions of varying complexity for a range of top name clients. In particular, there were a lot of activities in the telecommunications industry. The New York branch participated in the arrangement of $12.0 billion in credit facilities for WorldCom, the fourth largest long distance telecommunications company in the US, when it announced its merger with MCI Communications Corporation.

Following its participation in the funding of Atlantic Crossing in 1997, a fibre optic cabling system linking the US to Europe, the New York branch participated in the launch of $850.0 million in credit facilities for Pacific Crossing, which will connect the U.S. with Japan.

In the more traditional energy sector, the New York branch is a direct participant in the $2.0 billion US and Canadian Alliance Pipeline project that will see a natural gas pipeline operating between Western Canada and Chicago.

GIB's representative office in Lebanon participated in a $100 million syndicated facility for the Lebanese Company for the Development and Reconstruction of Beirut Central District (SOLIDERE) and also extended credit to other corporate customers. Now responsible for the account relationship with Syria, the Lebanon office worked to enhance relationships between GIB and major Syrian institutions.

The Singapore representative office activities were focused on conducting valuable market research, monitoring and managing GIB's exposure in the Asian region, while activity in the United Arab Emirates representative office has concentrated on developing relationships and business locally with a range of multinationals.

Islamic Banking

Islamic Banking experienced a major growth in deposits during 1998, particularly from Islamic financial institutions. The Bank was responsible for arranging a number of deals on an Islamic basis and for delivering them to Islamic clients. The strengthening of activity in this important and increasingly competitive area of banking is expected to increase further in 1999.

Continued diversification in the area of Islamic Banking will lead to the introduction of further Islamic products throughout 1999, with an emphasis on project finance and syndication. This area of banking, which is still in its infancy, offers considerable

Management Review

continued

potential for growth and GIB is committed to providing a diverse range of Islamic products and services for this rapidly burgeoning market.

Treasury and Capital Markets

Treasury recorded another profitable year, with income principally being derived from its money market and securities activities. The benefits derived from exposure to the G7 government bond markets were partially offset by the deterioration in the valuation of the Bank's holdings in emerging market debt funds.

The main focus of GIB's Treasury and Capital Markets activities continued to be the provision of value-added products to customers. An ongoing policy of prudent asset and liability management underpins Treasury's ability to support the commercial banking operations while also generating steady investment and trading income. The Bank has developed substantial Treasury expertise and uses sophisticated techniques for trading and risk management. It is therefore well placed for future challenges and opportunities, both regionally and globally.

The high quality of the Bank's securities continued to be maintained in accordance with the Bank's stringent rating, liquidity and diversification guidelines. The securities portfolio is comprised largely of debt of investment grade issuers in the G10 countries.

The implementation of a new Treasury front-office system, which is already in progress and will be completed in phases during the second and third quarters of 1999, will significantly boost GIB's asset and liability management and risk management capabilities. As one of the first banks in the Gulf to have introduced a Value-at-Risk (VaR) based market risk management system in 1996, GIB already has a solid reputation as a technology leader within the market.

GIB was well prepared for the Euro and had a smooth transition when the new currency was launched on 1st January 1999. GIB is very optimistic about the opportunities the Euro presents for supporting and promoting the Bank's presence in the European capital markets.

Technology

The past year was dominated by the implementation of a new banking system, which went live in Bahrain at the beginning of February 1999. London and New York are scheduled to follow by the end of March 1999.

Designed to process products cost efficiently, the new system offers the advantage of 'straight through processing' which allows deals to flow through the system with minimal manual processing. The system incorporates central data processing in Bahrain, helping to eliminate the re-keying of information, while offering considerable cost savings, and catering for the future increase in the volume of business.

GIB has begun upgrading its treasury information to a digital platform to allow the Bank to disseminate real-time market information more effectively to dealers across its network. A new treasury dealing and risk management system is also currently being implemented and is scheduled for completion by the third quarter of 1999.

Like many other financial institutions, GIB has been taking the necessary steps to prepare itself for the year 2000. Last year was devoted to upgrading all information technology systems and physical plant that could be adversely affected and the elimination of any non-compliant units. The Bank is now engaged in fully testing these new and upgraded systems. The testing phase for mission critical systems is scheduled for completion at the end of the first quarter of 1999, with less critical systems to follow by the end of the second quarter. The Bank is confident that its systems will be completely operational and thoroughly tested well in advance of the year 2000.

Other activities in 1999 will be centered on consolidation and preparation to ensure that the Bank is adequately protected against operational risk. Covering such events as a computer system failure, the departure of key people or major operational errors, operational risk is now regarded as central a concern as credit risk or market risk within the financial services industry. The Bank is carrying out extensive training and putting into place procedures that will enhance its already highly developed approach to operational risk management.

Personnel

As part of its goal to be the leading player in Gulf banking, GIB is supporting its market activities by introducing a new management information system for human resource development. During 1999 the Bank will develop a competency framework that evaluates both jobs and people. The Bank will be able to create a skills inventory that will enable it on an ongoing basis to match people with positions, identify training needs, and promote succession and rotation planning. The objective is to create an institution that is flexible, responsive, and makes best use of the skills and talents of its employees.

The quality and professionalism of its staff is one of the most important strengths of GIB. The Bank is acknowledged to have one of the best teams in the Gulf, particularly in the areas of syndication, project finance, treasury and risk management. Each year it recruits three or four of the GCC's brightest and most promising graduates to embark on its executive training program. The Bank offers these graduates excellent employment and advancement prospects. It also encourages staff to study for the Banking Studies Diploma and qualifications in accounting. It is by training and developing its human resources that GIB is able to keep excellent people contributing to the success of the business and carrying it forward into the future.

Looking Ahead to 1999

The merger with SIB presents GIB with many new and exciting opportunities. Its complementary areas of expertise will enable GIB to diversify the products and services it offers customers, to augment its branch presence significantly and more rapidly in Saudi Arabia, and to enhance and deepen its relationships with its customers. Within the banking industry generally the merger with SIB is regarded as a very positive step forward.

The Bank's extensive investment in technology and people, as well as the anticipated economic upturn, are expected to reinforce the Bank's already very strong position, enabling it to concentrate on its strengths with confidence and make the most of the new opportunities that lie on the horizon. Looking forward to 1999 and beyond, GIB is optimistic and confident that its solid management skills, specialist expertise, sound strategy and ambitious plans will enable the Bank to maintain and strengthen further its position as the leading financial institution in the Gulf.

"What is better than corals and pearls is a man's positive impact on another"

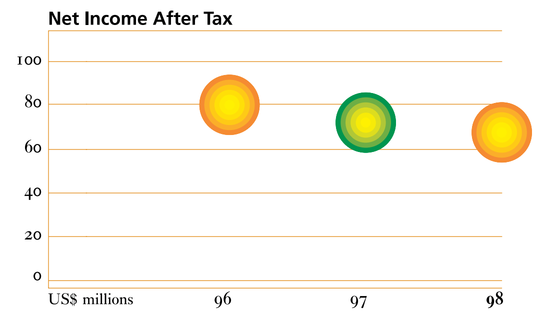
Professionalism and Teamwork

GIB's staff are of the highest quality and this is demonstrated through their professionalism and teamwork. GIB is totally committed to the continuous development and training of its staff.

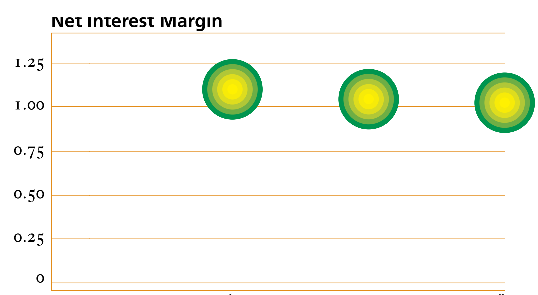
Net Income after Provisions and Tax was $82.1 million for the year, representing an 11.2 per cent return on Shareholders' Equity. At the operating level the Bank generated a profit before provisions of $112.1 million. Year-on-year advances were recorded in earnings from the Bank's core commercial banking business and treasury and capital markets activities. A higher volume of margin generating assets contributed to a 5.2 per cent year-on-year rise in Net Interest Revenue. This more than offset a $4.8 million decrease in Other Income. The decrease was entirely attributable to the inclusion of an exceptional profit on the sale of an associated company in prior year income. The Bank continued to generate strong non-interest revenues from its diversified business activities.

Net Interest Revenue

Net Interest Revenue at $115.3 million was $5.7 million or 5.2 per cent up on the prior year. A lower interest rate environment prevailed in most economies in 1998. The Bank was nevertheless able to sustain the level of interest earnings on the investment of its net free capital funds. Prudent management contributed to the maximisation of the yield generated on the investment of the net free capital funds and a higher amount of capital was available for investment. A significant increase was recorded in interest earnings from the Bank's core commercial banking portfolio with improved margins combined with a higher average volume of performing loans. Money book earnings in 1998 were also up on the prior year with advantage being taken of lower interest rates to minimise the overall cost of funding. In addition, margin income on the floating rate investment security portfolio benefitted from a widening in credit spreads during the second half of the year with maturing assets being replaced at higher margins.



US$ millions	96	97	98
Net Income after Tax	94.5	86.4	82.1



Per cent	96	97	98
Interest Revenue	5.96	6.24	6.33
Interest Expense	4.69	5.02	5.14
Net Interest Margin	1.27	1.22	1.19

During the year under review the Bank continued to increase, on a selective basis, investments in externally managed funds from which income is derived in the form of dividends and capital gains. The increased funding cost associated with the higher average volume of these non-interest bearing investments contributed to a slight decrease in the net interest margin, based on the average of opening and closing interest-bearing assets, to 1.19 per cent from 1.22 per cent in the prior year.

Other Income

Other Income at $49.2 million compared to $54.0

Financial Review

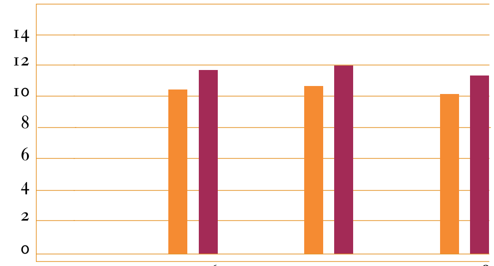
continued

million in 1997. However, prior year income included an $8.6 million profit realised on the sale of the Bank's investment in an associated company, GIBCorp Oman LLC. On a continuing business basis, Other Income rose by 8.4 per cent. An analysis of Other Income with prior year comparatives is contained in Note 15 to the Financial Statements. Profits on Investment Securities of $25.1 million comprised profits realised on fixed income securities and realisations from equity fund investments. The Bank took advantage of the dislocation in the fixed income markets during the third quarter to modify the risk profile of the fixed income investment portfolio while maintaining the attractive yield characteristics. Dividend income of $23.3 million was received from equity investments of a structured finance nature and from externally managed funds. The significant year-on-year increase in dividend income reflected a higher level of investment in 1998. Profits on Foreign Exchange of $3.9 million reflected a continued emphasis on customer-driven business and strong customer demand across all products. Trading activities recorded a $10.6 million loss for the year. This resulted from the extreme market turbulence witnessed in the debt markets during the second half of the year. During that period, there were sharp market declines as a result of a sudden widening in credit spreads and a loss of liquidity for certain debt securities, most particularly emerging market debt securities. Unrealised losses were incurred on externally managed funds adversely affected by these unusual market conditions although these were partly compensated by dividend income received from the funds.

Operating Expenses

Operating Expenses at $52.9 million were $6.2 million or 13.3 per cent up on the prior year. Staff Expenses recorded a $4.8 million increase to $35.1 million. This

BIS Risk Asset Ratio



Per cent	96	97	98
Total	11.7	12.0	11.3
Tier 1	10.4	10.7	10.1

was largely attributable to a number of exceptional, non-recurring expenses relating to an early retirement programme and the implementation of a new computer system although also partly reflected increases in client-focussed areas. Premises Expenses at $4.8 million were $0.5 million up on the prior year while Other Expenses recorded a $0.9 million advance against the prior year. This principally reflected increased technology-related expenditure resulting from an ongoing enhancement of the Bank's computer systems and costs associated with preparing systems for the introduction of the Euro and for the Year 2000. The Bank continues to focus on the containment of recurring costs while making the necessary investments for the future.

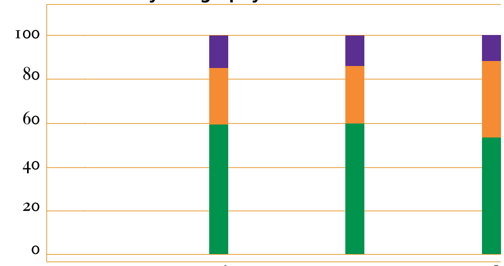
Capital Strength

Shareholders' Equity rose by 5.3 per cent to $731.0 million. This resulted from earnings retentions of $37.1 million after a 10.0 per cent Proposed Dividend of $45.0 million. Shareholders' Equity and Tier 1 Capital both represented 7.2 per cent of Total Assets, ratios that are high by international comparison. The average Tier 1 capital to total assets ratio of the top 1,000 banks in 1998 was 4.6 per cent according to a survey published in *The Banker* magazine in July 1998.

With a total capital base of $821.7 million and total risk-weighted exposure of $7,259.6 million the risk asset ratio calculated according to the guidelines of the Basle Committee on Banking Supervision was 11.3 per cent. The risk asset ratio incorporates market risk-weighted exposure. Exposure to market risk has been calculated utilising a Value-at-Risk (VaR) model in accordance with the provisions of the Amendment to the Capital Accord to Incorporate Market Risk. The high proportion of Shareholders' Equity within the total capital base resulted in a Tier 1 ratio of 10.1 per cent. This ratio is particularly high by international standards. Note 22 to the Financial Statements provides further detail on capital adequacy. The risk asset ratio calculated in accordance with the guidelines of the Bank's regulatory authority, the Bahrain Monetary Agency (BMA), was 12.8 per cent at the 1998 year end (1997: 12.7 per cent). Under the BMA guidelines GCC governments and government-owned entities are accorded the same risk weighting as for OECD governments. With effect from 1st January 1998 the BMA instituted a minimum risk asset ratio of 12 per cent compared to a minimum of 8 per cent prescribed by the Basle Committee.

Factors which contribute to the favourable capital adequacy position are the strong capital base, the level of general provisions and significant exposure to major OECD country governments and to the banking community. It is management's objective to maintain the strong capital adequacy position. The Bank utilises a range of risk management benchmarks against the capital base. For example in terms of credit risk management, exposures by industry, customer and country are also controlled against the capital base. Absolute and segmented loan volumes are monitored against the equity base.

Asset Mix By Geography



Per cent	96	97	98
Other Countries	14.9	13.9	11.9
GCC Countries	25.6	26.3	34.6
OECD Countries	59.5	59.8	53.5
Total	**100.0**	**100.0**	**100.0**

Asset Quality

The Bank's principal strategic focus is on the GCC states and their major trading partners in the industrialised world. Geographic diversification of risk therefore occurs to a significant degree naturally. In order to obtain an assessment of the geographic diversification of risk assets particular reference should be made to Note 18 to the Financial Statements. Further assessment of asset quality can be facilitated by reference to Note 25 to the Financial Statements on the fair value of financial instruments. Based on the valuation methodology set out in that note the net fair values of all on- and off-balance sheet financial instruments exceeded their net book values at 31st December 1998 by $27.8 million.

At the 1998 year end Loans and Advances represented 39.2 per cent of Total Assets while Investment Securities accounted for 31.6 per cent.

Loans and Advances

Loans and Advances increased by $522.0 million to $4,000.7 million at the 1998 year end. Based on contractual maturities at the balance sheet date 45.1 per cent of the portfolio was due to mature within

Financial Review

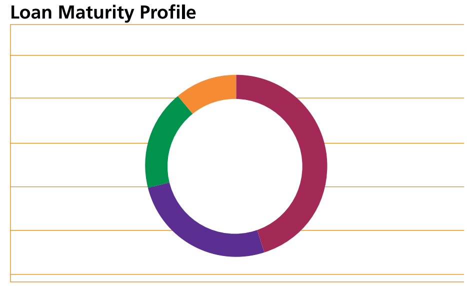
continued

one year while 71.3 per cent was due to mature within three years. Details of exposure within the portfolio to GCC and OECD country governments are contained in Note 7 to the Financial Statements while the geographic distribution of Loans and Advances is set out in Note 18 to the Financial Statements. 56.6 per cent, or a little over half, of the portfolio represented lending within the GCC states while the balance was largely made up of exposure to the GCC countries' major trading partners in Europe, North America and Asia. The portfolio contained no significant concentrations by industrial sector. As discussed in Note 25 the net fair value of Loans and Advances exceeded their net book value by $8.3 million.

Total loan loss provisions at 31st December 1998 amounted to $779.4 million. Country and counter-party specific provisions amounted to $601.8 million while general provisions were $177.6 million. The loan loss provision charge for the year of $8.0 million – which was in addition to a $22.0 million charge in respect of investment securities as commented on in more detail in the following section of the review – comprised increases in the specific and general provisions of $4.4 million and $3.6 million respectively. A $31.0 million utilisation of specific provisions during the year arose on the completion of a Brady-type country debt restructuring as a result of which loans were converted to bonds and transferred to the investment securities portfolio at their net book value. A $12.9 million increase in specific provisions resulting from exchange rate movements was offset by an equivalent increase in the related loan exposures. The general provision at the year end represented 4.3 per cent of loans net of specific provisions.

Specific provisions in respect of troubled sovereign exposures are determined with reference to matrices of the relevant regulatory authorities. Specific provisions

Loan Maturity Profile



	Per cent	US$ millions
Year 1	45.1	1,806.0
Years 2 and 3	26.2	1,047.7
Years 4 and 5	17.7	705.6
Over 5 Years	11.0	441.4
Total	**100.0**	**4,000.7**

in respect of other loans are made to the full extent of the estimated potential loss while general provisions are maintained to cover possible future losses which as yet have not been identified. It is Bank policy to write off loans after all reasonable restructuring and collection activities have taken place and the possibility of further recovery is considered to be remote.

The gross and net book values of non-performing loans amounted to $534.6 million and $39.0 million respectively. The average provisioning coverage for non-performing loans was therefore 92.7 per cent. The gross volume of non-performing loans also continued to be substantially below the total of specific and general provisions. Total provisions for loan losses exceeded the gross volume of non-performing loans by $244.8 million. This means that rather than the earnings on the Bank's net free capital funds being impaired, there is a positive earnings enhancement. Non-performing loans at their net book value of $39.0 million represented just 1.0 per cent of net loans. Non-performing loans at their net book value also represented only 5.3 per cent of Shareholders' Equity. Loans on which interest or principal is 90 days or more overdue are without exception placed on a non-accrual basis and all unpaid and accrued interest is reversed from income. Interest on non-accrual loans is accounted for only when received.

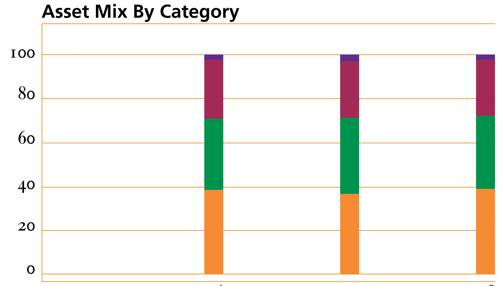
Investment Securities

Investment Securities increased by $182.6 million to $3,229.6 million at 31st December 1998. The investment securities portfolio is used as a means of providing geographic diversification of the Bank's risk assets with 80.5 per cent of the portfolio comprising securities of North American and European issuers.

Investment Securities comprise two debt security portfolios and a more limited investment in equities and equity funds. The larger debt security portfolio comprises floating rate securities or fixed rate securities that have been swapped to floating to yield constant spreads over LIBOR. These accounted for 82.8 per cent of the total investment portfolio. The smaller debt security portfolio is made up of OECD government or government-guaranteed fixed income securities, representing the partial investment of the Bank's net free capital. This portfolio amounted to $285.1 million at the 1998 year end.

An analysis of the investment securities portfolio is contained in Note 6 to the Financial Statements. $587.0 million or 18.2 per cent of the portfolio at the 1998 year end represented AAA-rated securities. Based on the rating of the issuer a further $2,104.7 million or 65.2 per cent of the portfolio represented investment grade debt securities. Thus 83.4 per cent of the total portfolio comprised investment grade securities. Other Debt Securities at the end of 1998 amounted to $266.1 million. These securities are largely of a loan substitution nature and as such are not necessarily rated. The credit risk associated with these securities

Asset Mix By Category



Per cent	96	97	98
Other	2.1	2.8	**2.2**
Placements and Money Market Instruments	27.3	26.7	**25.6**
Securities	32.3	34.0	**33.0**
Loans and Advances	38.3	36.5	**39.2**
Total	**100.0**	**100.0**	**100.0**

is rigorously monitored within the overall credit risk management process. The securities are therefore subject to the same stringent credit requirements as standard lending and contingent transactions. Equities and Equity Funds at 31st December 1998 amounted to $271.8 million. The equity and equity fund portfolio is principally invested in equity investments of a structured finance nature and also a wide range of externally managed fund-type investments which provide a diversified exposure to equity, debt and real estate markets.

Total investment security provisions at 31st December 1998 amounted to $59.6 million. Specific provisions, which comprise provisions in respect of both permanent diminutions in value and also troubled sovereign exposures as determined with reference to regulatory authority matrices, amounted to $37.5 million while general provisions were $22.1 million. The charge for the year of $22.0 million comprised increases in the specific and general provisions of $21.6 million and $0.4 million respectively. The increase in specific provisions during

“I have a will stronger than the mighty rock, and firmer than the unshakeable mountains”

One of the Strongest Arab Banks

GIB’s strength lies in the high quality of its assets, its conservative policy and its more than adequate liquidity as well as its solid shareholder support.

the year almost entirely related to provisions determined with reference to regulatory authority matrices. The related securities were, however, current in respect of both principal and interest. At 31st December 1998 the market value of the investment security portfolio exceeded the book value by $19.5 million.

Other Interest-bearing Asset Categories

Placements with Banks totalled $2,306.4 million at the 1998 year end and were well diversified by geography as illustrated in Note 18 to the Financial Statements.

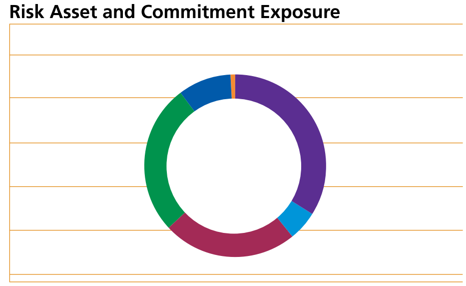
Money Market Instruments amounting to $310.6 million almost entirely comprised US government Treasury bills held for Balance Sheet management purposes.

Trading Securities at $139.6 million largely comprised listed debt securities. Trading Securities at the 1998 year end also included $69.9 million of managed funds. The funds, which are managed by international institutions with acknowledged expertise in their field, provide diversified exposure to foreign exchange and international debt markets. Trading Securities are accounted for at market value.

Risk Asset and Commitment Exposure

Risk assets and commitments at 31st December 1998 amounted to $12,843.8 million. Risk assets and commitments comprise all assets included in the balance sheet (with the exception of Fixed and Other Assets) and Credit-related Contingent Items. As alluded to earlier an analysis of risk asset and commitment exposure by category and geography is contained in Note 18 to the Financial Statements. An analysis of derivatives and foreign exchange products is set out in Note 21(a) while a further analysis of Credit-related Contingent Items together with their risk-weighted equivalents is contained in Note 21(b) to the Financial Statements.

Risk Asset and Commitment Exposure



	Per cent	US$ millions
GCC Countries	33.9	4,353.5
Other Middle East and North Africa	5.4	690.1
Europe	24.0	3,083.1
North America	26.7	3,429.7
Japan and Other Asia	9.3	1,196.6
Latin America	0.7	90.8
Total	**100.0**	**12,843.8**

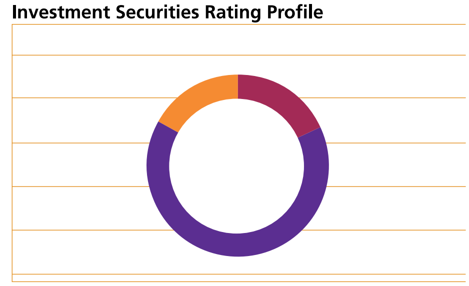
Credit Ratings

During the year under review the Bank's investment grade ratings were reaffirmed by Standard & Poor's, Moody's and BankWatch. Both Financial Strength and Global Issuer ratings, which are specific to Moody's and BankWatch respectively, are awarded on a scale from A to E. The Bank's credit ratings are as follows:

	BankWatch	Moody's	Standard & Poor's
Long-term	A-	Baa2	BBB+
Short-term	TBW-1	P3	A2
Financial Strength	–	D	–
Global Issuer	B/C	–	–

Standard & Poor's ratings reflect *'the bank's franchise in the Gulf region, its strong capitalisation at both the bank and shareholder level and good financial performance'*. According to BankWatch *'GIB is a well run bank with* *exceptional management reporting systems which enables proper enforcement of prudent lending, investing and asset and liability management policies*' while Moody's ratings '*are among the highest assigned to a bank in the Arabian Gulf*' and '*reflect its strong franchise in the six states of the GCC…and the bank's strong financial condition*'. It is an objective of GIB to manage itself in such a manner as to retain and enhance the assigned ratings.

Investment Securities Rating Profile



	Per cent	US$ millions
AAA/Aaa rated debt securities	18.2	587.0
Debt securities of other investment grade issuers	65.2	2,104.7
Other	16.6	537.9
Total	**100.0**	**3,229.6**

Risk Management

GIB maintains a prudent and professional approach to risk-taking. The Bank actively promotes a risk management culture that accords high value to disciplined and effective risk management and employs professionally qualified people with appropriate risk management skills. The Bank has developed comprehensive risk management processes which effectively identify, measure, monitor and control risk exposures and that are subject to oversight by senior management and the Board of Directors. The Bank is constantly seeking to strengthen these processes, particularly through investment in technology and training. Periodic review by internal and external auditors and regulators subject these processes to additional scrutiny and help to further strengthen risk management practices. GIB is also fully supportive of the risk management recommendations of the Basle Committee on Banking Supervision and the actions taken by national supervisory authorities with respect to the application of appropriate and adequate risk management principles.

The Bank's risk management process is based upon a detailed structure of policies, procedures and limits, a comprehensive risk measurement process and a strong management information system for the control, monitoring and reporting of risks. All significant policies are approved by the Board of Directors. Policies are consistent with corporate strategy, capital strength and management expertise. Both policies and procedures are reviewed regularly in order to ensure their continued appropriateness. Integrated bankwide limits are an essential component of the risk management process. This permits management to control exposures and to monitor the assumption of risk against predetermined approved tolerances. Global limits are established for each major type of risk. These are generally sub-allocated to individual business units.

A Risk Management Committee is the senior authority within the integrated risk management hierarchy and oversees the active management of all risks involved in the Bank's business. The committee comprises the Bank's most senior professionals and is chaired by the Group Chief Executive. The role of the committee includes the strategic management of the overall risk profile, ensuring the adequacy of the risk management infrastructure, the coordination of the various specialist risk control areas and assessing solutions for specific risk issues. The Risk Committee provides a forum for the discussion of risk issues by senior management as well as ensuring that the Bank is aware of the latest developments in risk management practice within the financial services industry.

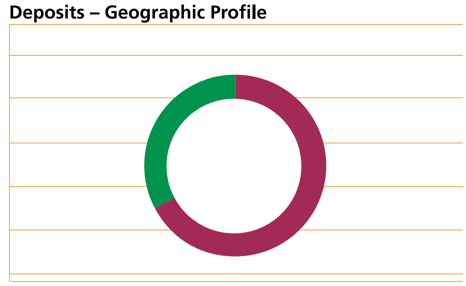
A fundamental risk management tenet within GIB is the clear segregation of duties and reporting lines between personnel transacting business and personnel processing that business. Key elements of the processing environment are clearly defined procedures, adequate systems infrastructure and a comprehensive system of internal controls.

A market risk management unit within the financial controls function possessing market risk management skills and capable of informative interpretation of management information contributes positively to the overall effectiveness of the risk management process. The Bank ensures that all risks associated with a product or line of business are clearly understood and are monitored and reported to senior management by professionally qualified and experienced personnel outside the business unit responsible for transacting that business.

A strong internal audit function is also of particular importance. The internal audit function conducts periodic reviews of the adequacy and integrity of the risk management process. Auditing procedures are designed to ensure the integrity of the measurement, control and reporting systems and compliance with approved policies and procedures. The Chief Auditor reports regularly to the Audit Committee of the Board of Directors. Recommendations from both the internal and external auditors are considered positively by senior management. In cases where remedial action is deemed appropriate, such action is undertaken promptly.

The Asset and Liability Committee ("ALCO"), which comprises members of senior management, provides a forum for treasury risk management.

Deposits – Geographic Profile



	Per cent	US$ millions
GCC Countries	67.3	5,387.8
Other Countries	32.7	2,616.4
Total	**100.0**	**8,004.2**

The ALCO meets on a weekly basis to review matters relating to both the asset and liability management function and trading strategies.

The Bank manages risks associated with off-balance sheet derivative instruments as part of its overall risk management function. Financial and risk management disclosures with respect to off-balance sheet financial instruments are set out in Note 21 to the Financial Statements. The disclosure provides details of derivative and foreign exchange transactions at 31st December 1998 analysed by type of product, counterparty and maturity.

The major risks associated with GIB's business are credit, market, liquidity and operational risks. These are discussed in more detail in the following sections.

Credit Risk

Credit risk represents the risk that a counterparty may fail to perform according to agreed terms and conditions, thus causing the bank to suffer a loss in terms of cash flow or market value. The Bank measures this risk in relation to banking and treasury products both on and off the balance sheet.

Credit risk is actively managed and rigorously monitored in accordance with well-defined credit policies and procedures. The creditworthiness of each counterparty is assessed, and appropriate credit limits are established within delegated authority by the Credit Committee. Credit limits are also established for countries, utilising a country risk review system. Overall industry and product exposures are also evaluated to ensure a broad diversification of credit risk. Established limits and actual levels of exposure are regularly reviewed by the Chief Credit Officer and senior management. Credit policies and procedures are designed to identify, at an early stage, exposures which require more detailed monitoring and review. The Bank has implemented a credit risk rating system and a watch list for this purpose. The Bank uses these together with the classification system in determining the appropriate level of specific and general provisions for credit losses.

The credit risk associated with foreign exchange and derivative products is assessed in a manner similar to that associated with on-balance sheet activities. However, unlike on-balance sheet products where the principal amount and interest generally represents the maximum credit exposure, the notional amount relating to a foreign exchange or derivative transaction typically exceeds the credit exposure by a substantial margin. The Bank's measure of credit exposure for foreign exchange and derivative contracts is therefore more appropriately considered to be their replacement cost at current market rates, should the counterparty default prior to the settlement date. The gross positive market values or credit risk amounts of foreign exchange and derivative transactions are set out in Note 21 to the Financial Statements. The total credit risk amount in respect of all such transactions outstanding at the 1998 year end amounted to only $75.4 million before taking account of the risk-reducing benefits of any collateral held or legally enforceable netting agreements. The note also highlights that 82.5 per cent of the total credit risk was concentrated on major OECD-based banks and was predominantly short-term in nature with 88.1 per cent of transactions outstanding at the end of 1998 due to mature within one year.

Market Risk

Market risk is the risk that the value of a financial instrument or a portfolio of financial instruments will change as a result of a change in market prices and rates. This risk arises from the Bank's trading, asset and liability management and investment activities in the interest rate, foreign exchange and, to a much less significant extent, equity markets. The Bank has a limit structure incorporating both VaR-based and non-VaR-based limits with respect to market risk. There are a variety of non-VaR-based constraints. These relate, inter alia, to positions, volumes, concentrations, maximum allowable losses and maturities. Exposures are monitored against the range of limits and regularly reported to, and reviewed by, senior management.

A key element in market risk management is the estimation of potential losses that may arise from adverse changes in market conditions. GIB utilises a Value-at-Risk system to estimate such losses. Value-at-Risk takes account of variables that may cause a change in portfolio value. These include interest rates, foreign exchange rates, securities prices, their respective volatilities and the correlations between these variables. GIB uses exponentially weighted historical one-day movements in these variables from the RiskMetrics™ data set in estimating potential future losses from its trading and asset and liability management activities as well as from its investment portfolios. These estimates assume normal market

"Deeds are as big as their doers, and generosity is as big as the philanthropist"

Recognised and Highly Regarded

GIB is not only respected and admired but it is also highly regarded as an authority in its field. GIB enjoys one of the highest credit ratings in the region and has won numerous awards among which the Euromoney Awards for the Best Bank in Bahrain for two consecutive years (1997 & 1998).

Financial Review

continued

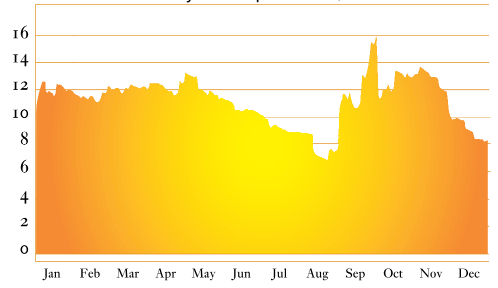
conditions and take account of potential diversification benefits of different positions both within each and across different portfolios.

For internal risk management purposes GIB measures losses that are anticipated to occur within a 95 per cent confidence level. This implies that there is a 5 per cent or 1 in 20 chance of a loss exceeding the VaR limit over the prescribed time horizon or holding period. A 1-day horizon is relevant for trading activities while a longer horizon is more appropriate for both asset and liability management and investment activities. Since the substantial majority of GIB's exposure to market risk resides within its investment rather than its trading activity, VaR at the total bank level is consolidated utilising a 25-business day rather than a 1-day holding period.

The graph opposite sets out the total Value-at-Risk of all activities at the close of business each day throughout the year. The figures are calculated at the 5 per cent risk level (1.65 standard deviations) and at the 25-business day horizon based on the RiskMetrics™ monthly data set. On this basis VaR over the period averaged $11.2 million and varied within the range of $7.0 million to $15.6 million. (At a 1-day rather than a 25-day horizon but at the same 5 per cent risk level average VaR was $2.2 million and varied between $1.4 million and $3.1 million.) At the 1998 year end VaR at the 25-day horizon amounted to $8.4 million. The market risk profile presented in the financial statements was therefore somewhat lower than the average prevailing during the year under review.

A major objective of asset and liability management is the maximisation of net interest income through the proactive management of the asset and liability profile based on anticipated movements in interest rates. Nominal gap and VaR-based limits are utilised to control fluctuations in interest earnings resulting

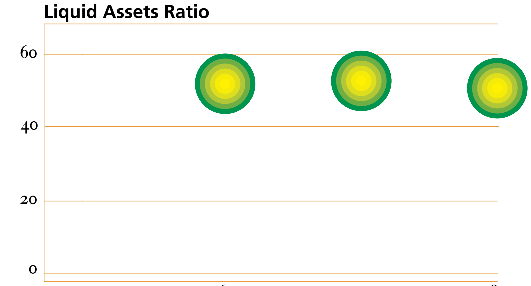
Value-at-Risk Daily Development US$ millions



from changes in interest rate levels. The asset and liability repricing profile and details of the effective interest rates prevailing at the year end on the various asset and liability categories are set out in Note 20 to the Financial Statements. The repricing profiles of securities and loans incorporate the effect of interest rate swaps used to modify the interest rate characteristics of specific transactions. By contrast interest rate swaps and forward rate agreements that have been used for asset and liability management purposes to hedge overall exposure to interest rate risk are included separately as Off-Balance Sheet Items. As illustrated in Note 20 the substantial majority of the Bank's assets and liabilities reprice within one year. The volume of net interest-bearing assets repricing over one year amounted to $491.0 million or 4.8 per cent of Total Assets. This largely represented the fixed rate investment securities portfolio which had a modified duration of 3.19 at the year end.

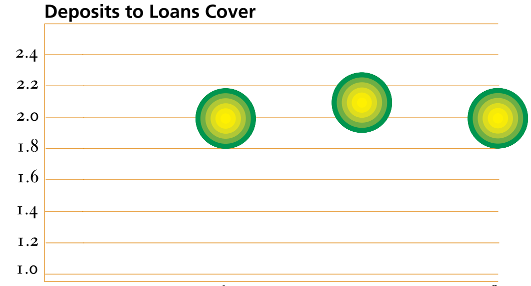
The Bank views VaR as an effective risk management tool and a valuable addition to the non-statistically based limit structure. It permits a consistent and uniform measure of market risk across all applicable products and activities based on the assumption of normal market conditions. The Bank therefore assumes market risk on a prudent basis

Liquid Assets Ratio



Per cent	96	97	98
Liquid Assets Ratio	60.2	61.6	59.1

Deposits to Loans Cover



Times	96	97	98
Deposits* to Loans Cover	2.19	2.29	2.19

* Includes Term Financing

in recognition of the fact that market shocks may result in losses in excess of those anticipated from VaR. A broad mix of limits are thus employed. This notwithstanding, GIB recognises limits in themselves as an aid to – rather than a substitute for – sound judgement. The Bank recognises sound judgement as the cornerstone of effective market risk management.

Liquidity Risk and Funding

Liquidity risk management ensures that funds are available at all times to meet the funding requirements of the Bank.

GIB's liquidity management policies are designed to ensure that under adverse conditions the Bank has access to adequate funds to meet its obligations. In normal conditions the objective is to ensure that there are sufficient funds available not only to meet current financial commitments but also to provide the flexibility to capitalise on opportunities for business expansion. These objectives are met through the application of a prudent mix of liquidity controls. These controls provide security of access to liquidity without undue exposure to increased costs from the liquidation of assets or the aggressive bidding for deposits. The liquidity controls ensure that over the short term the future profile of cash flows from maturing assets is adequately matched to the maturity of liabilities. Liquidity is monitored on a daily basis at both Head Office and Branch levels, enabling senior management to identify changes and to react accordingly to fluctuations in market conditions. Liquidity controls also provide for the maintenance of a stock of liquid and marketable assets and also an adequately diversified deposit base in terms of both maturities and range of counterparties. The Bank's funding base is enhanced through term financing of $750 million. Deposits from Customers provide a further stable source of funding. Contingency plans also exist and could be implemented on a timely basis to minimise the risk associated with dramatic changes in market conditions.

The asset and liability maturity profile by individual asset and liability category based on contractual repayment arrangements is set out in Note 19 to the Financial Statements. At the 1998 year end 37.7 per cent, or well over a third, of Total Assets were due to mature within three months. A significant portion of assets with longer term maturities were readily realisable securities. With regard to deposits the Bank's retention records demonstrate that there is considerable divergence between their contractual

Financial Review

continued

and effective maturities. By way of example average deposits in 1998 from those counterparties with deposits over $10 million each at the 1998 year end amounted to $6,423 million. Thus, these deposits of a core nature together with Shareholders' Equity and Term Financing were almost double and thus more than adequately funded the least liquid asset category, Loans and Advances. The loan portfolio is also comfortably exceeded by the more stable deposits from the GCC region. Deposits from GCC country governments and central banks and other institutions headquartered in the GCC states at 31st December 1998 amounted to $5,387.8 million (1997: $4,691.5 million). GCC deposits to total loans cover was therefore 1.3 times. Total deposits and term financing coverage to loans was 2.2 times compared to the previous year's level of 2.3 while the liquid assets ratio, which expresses bank balances, money market instruments, placements with banks and securities as a percentage of total assets, was 59.1 per cent compared to 61.6 per cent at the end of 1997.

Operational Risk

The Bank views operational risk as all risks not related to credit, market or liquidity risk which could adversely impact its financial performance and reputation. These include, inter alia, risks associated with the potential for loss caused by transaction processing errors, criminal acts, inadequate planning and reporting, systems failure or error and business interruptions.

To mitigate operational risk, the Bank has in place a series of comprehensive policies, procedures and controls, which are reviewed on a periodic basis by internal and external auditors. In addition, corporate planning is conducted annually and monitored closely by management committees, automated systems provide detailed management information reporting on a timely basis, and business recovery actions incorporate both in-country and out-of-country contingency plans including back-up computer systems. Focus on human resource planning and development ensures that the Bank maintains a solid core of dedicated professional staff who aim to provide a consistently high quality product delivery and customer service.

Of particular concern to the Bank at the present time in respect of systems risk are the technical challenges in processing date-related information beyond 1st January 2000. Following a review in 1997 of all its in-house and third party developed software, hardware, information delivery services, communication equipment and physical plant, the Bank acquired and implemented the required revisions to all non-compliant systems during 1998. Year 2000 compliance testing of mission critical systems is scheduled to be completed by 31st March 1999 with testing of other less critical components to be finalised by 30th June 1999.

Accounting Philosophy

Gulf International Bank is committed to the ongoing enhancement of its financial reporting. The Bank's objective is to provide clear, comprehensive and relevant disclosure in order to facilitate financial appraisal and risk assessment. Accounting and reporting policies comply with the requirements of International Accounting Standards and conform with best practice in the banking industry.

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Auditors' Report to the Shareholders

We have audited the financial statements of Gulf International Bank B.S.C. as at, and for the year ended, 31st December 1998 as set out on pages 31 to 47.

Respective responsibilities of directors and auditors

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.

Basis of opinion

We conducted our audit in compliance with the Bahrain Audit Law 26/1996 and 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.

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of Gulf International Bank B.S.C. as at 31st December 1998, and the results of its operations and its cash flows for the year then ended, in accordance with International Accounting Standards and comply with the Bahrain Commercial Companies Law 1975 (as amended) and the Bahrain Monetary Agency Law 1973 (as amended).

Other regulatory matters

In addition, in our opinion, the Bank has maintained proper accounting records and the financial statements are in agreement therewith. We have reviewed the accompanying Chairman's Statement and confirm that the information contained therein is consistent with the financial statements. To the best of our knowledge and belief, no violations of the Bahrain Commercial Companies Law 1975 (as amended), or the Bahrain Monetary Agency Law 1973 (as amended), or the terms of the Bank's licence or Agreement of Establishment and Articles of Association have occurred during the year that might have had a material adverse effect on the business of the Bank or on its financial position. Satisfactory explanations and information have been provided to us by management in response to all our requests.

KPMG

KPMG
Public Accountants
Manama, Bahrain
24th February 1999

Balance Sheet

	Note	At 31.12.98 US$ millions	At 31.12.97 US$ millions
Assets			
Cash and Balances with Banks		**51.0**	85.9
Money Market Instruments	3	**310.6**	260.7
Placements with Banks	4	**2,306.4**	2,281.4
Trading Securities	5	**139.6**	192.1
Investment Securities	6	**3,229.6**	3,047.0
Loans and Advances	7	**4,000.7**	3,478.7
Fixed Assets	8	**16.2**	13.6
Other Assets		**154.9**	164.5
Total Assets		**10,209.0**	9,523.9
Liabilities			
Deposits from Banks	9	**5,122.6**	4,456.8
Deposits from Customers	9	**2,881.6**	2,774.8
Securities Sold under Agreements to Repurchase		**486.9**	656.2
Proposed Dividend		**45.0**	45.0
Other Liabilities	10	**191.9**	147.2
Term Financing	11	**750.0**	750.0
Total Liabilities		**9,478.0**	8,830.0
Shareholders' Equity			
Share Capital	12	**450.0**	450.0
Reserves	13	**281.0**	243.9
Shareholders' Equity		**731.0**	693.9
Total Liabilities & Shareholders' Equity		**10,209.0**	9,523.9

Ibrahim Abdul-Karim
Chairman

Dr. Abdullah I. El-Kuwaiz
General Manager

The notes on pages 34 to 47 form part of these financial statements.

32 Statement of Income and Appropriations

	Note	Year Ended 31.12.98 US$ millions	Year Ended 31.12.97 US$ millions
Interest Revenue			
Interest and Fees on Loans	14	**287.6**	257.7
Interest on Placements and Money Market Instruments		**131.4**	133.2
Interest on Securities		**197.6**	169.0
		616.6	559.9
Interest Expense		**501.3**	450.3
Net Interest Revenue		**115.3**	109.6
Provision for Investment Securities	6	**(22.0)**	(7.0)
Provision for Loan Losses	7	**(8.0)**	(23.0)
Net Interest Revenue after Provisions		**85.3**	79.6
Other Income	15	**49.2**	54.0
Net Interest and Other Income		**134.5**	133.6
Operating Expenses			
Staff	16	**35.1**	30.3
Premises		**4.8**	4.3
Other		**13.0**	12.1
		52.9	46.7
Net Income before Tax		**81.6**	86.9
Overseas Tax	17	**0.5**	(0.5)
Net Income after Tax		**82.1**	86.4
Appropriations			
Compulsory Reserve	13	**8.2**	8.6
Voluntary Reserve	13	**8.2**	8.6
Proposed Dividend		**45.0**	45.0
Retained Earnings	13	**20.7**	24.2
		82.1	86.4

The notes on pages 34 to 47 form part of these financial statements.

Statement of Cash Flows

	Year Ended 31.12.98 US$ millions	Year Ended 31.12.97 US$ millions
Operating Activities		
Net Income	82.1	86.4
Adjustments to reconcile Net Income to Net Cash		
(Outflow)/Inflow from Operating Activities:		
Provision for Loan Losses	8.0	23.0
Provision for Investment Securities	22.0	7.0
Profit on Investment Securities	(25.1)	(9.4)
Profit on sale of Associated Company	–	(8.6)
Amortisation of Investment Securities	1.6	3.0
Depreciation of Fixed Assets	2.3	1.9
Decrease/(increase) in accrued interest receivable	4.1	(24.5)
Increase in accrued interest payable	2.4	9.5
Decrease/(increase) in other net assets	47.8	(36.3)
Net decrease/(increase) in Trading Securities	52.5	(105.9)
Net Cash Inflow/(Outflow) from Operating Activities	197.7	(53.9)
Investing Activities		
Net increase in Placements with Banks	(25.0)	(99.3)
Net increase in Loans and Advances	(530.0)	(65.2)
Purchase of Investment Securities	(1,625.6)	(1,259.4)
Sale and maturity of Investment Securities	1,444.5	1,010.3
Proceeds from sale of Associated Company	–	27.7
Purchase of Fixed Assets	(4.9)	(2.5)
Net Cash Outflow from Investing Activities	(741.0)	(388.4)
Financing Activities		
Net increase in Deposits from Banks	665.8	326.0
Net increase/(decrease) in Deposits from Customers	106.8	(61.7)
Net (decrease)/increase in Securities Sold under Agreements to Repurchase	(169.3)	49.9
Increase in Term Financing	–	200.0
Dividends paid	(45.0)	(45.0)
Net Cash Inflow from Financing Activities	558.3	469.2
Increase in Cash and Cash Equivalents	15.0	26.9
Cash and Cash Equivalents at 1st January	346.6	319.7
Cash and Cash Equivalents at 31st December	361.6	346.6

Cash and Cash Equivalents comprise Cash and Balances with Banks and Money Market Instruments. Movements in Trading Securities and Loans and Advances are stated net of transfers in respect of bonds received in settlement of sovereign debt principal claims.

The notes on pages 34 to 47 form part of these financial statements.

Notes to the Financial Statements

For the Year Ended 31st December 1998

1. Incorporation and Registration

Gulf International Bank B.S.C. ("the Bank") is a Bahraini Shareholding Company incorporated in the State of Bahrain by Amiri Decree Law No.30 dated 24th November 1975 and is registered as an offshore banking unit with the Bahrain Monetary Agency.

The Bank is wholly owned by Gulf Investment Corporation G.S.C. ("GIC"), an international investment company registered in the State of Kuwait and owned equally by the governments of the six member states of the Gulf Cooperation Council ("GCC") – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

The Bank is principally engaged in the provision of wholesale banking services.

2. Accounting Policies

The accounting and reporting policies of the Bank comply with International Accounting Standards and conform with prevailing practices within the banking industry.

The following is a description of the more significant accounting policies adopted by the Bank:

2.1 *Accounting Convention*

The financial statements have been prepared under the historical cost convention.

2.2 *Money Market Instruments*

Money Market Instruments are stated at cost, adjusted for the amortisation of premiums and accretion of discounts.

2.3 *Securities*

Trading Securities and Securities Sold but not yet Purchased are stated at market value. Realised and unrealised profits and losses are included in Other Income. Securities Sold but not yet Purchased are included in Other Liabilities.

Investment Securities are stated at cost, adjusted for the amortisation of premiums and accretion of discounts, less provisions for credit losses.

Bonds received in settlement of sovereign debt interest and principal claims are capitalised at the same net book value as other debt obligations of that country. The capitalised amount of bonds received in settlement of interest claims is credited to Interest and Fees on Loans.

2.4 *Securities Financing Arrangements*

Securities Purchased under Agreements to Resell (resale agreements) and Securities Sold under Agreements to Repurchase (repurchase agreements) are treated as collateralised lending and borrowing transactions and are stated at the amounts lent or borrowed. Securities Purchased under Agreements to Resell are included in Money Market Instruments.

2.5 *Subsidiaries and Associated Companies*

Investments in subsidiary companies are not material to the financial statements and are accordingly stated at cost less provision for permanent diminution in value. Investments in associated companies which are intended to be held for the long term are accounted for by the equity method. The Bank's share of the retained earnings of associated companies is determined with reference to the most recent audited financial statements and the latest unaudited financial information available to shareholders. Investments in associated companies which are not intended to be held for the long term are stated at cost less provision for permanent diminution in value.

2. Accounting Policies continued

2.6 *Loans and Advances*

Loans and Advances are stated net of provisions for credit losses.

Loans on which interest or principal is 90 days or more overdue are placed on a non-accrual basis and all unpaid and accrued interest is reversed from income. Interest on non-accrual loans is included in income only when received. Loans are restored to accrual status only after all delinquent interest and principal payments have been brought current, a regular payment performance has been established and future payments are reasonably assured.

Loans are written off after all restructuring and collection activities have taken place and the possibility of further recovery is considered to be remote.

2.7 *Provisions for Credit Losses*

Provisions for credit losses comprise both specific and general provisions. Specific provisions are maintained to cover identified potential losses and permanent diminution in the value of investments. Specific provisions in respect of troubled sovereign exposures are determined with reference to regulatory authority matrices. Specific provisions in respect of other credit exposures are made to the full extent of the estimated potential loss or permanent diminution in value. General provisions are maintained to cover possible losses which as yet have not been identified. Provisions for credit losses are deducted from the relevant asset category.

2.8 *Fixed Assets*

Land is stated at cost. Other fixed assets are stated at cost less accumulated depreciation. Depreciation is computed on a straight line basis over the estimated useful life of each asset category as follows:

Buildings	–	Ten years
Installations	–	Four years or period of lease if longer
Office Furniture	–	Six years
Office Equipment	–	Four years
Motor Vehicles	–	Three years

The costs incurred on modifying existing software systems in preparation for the introduction of the euro and to ensure Year 2000 compliance are recognised as an expense when incurred.

2.9 *Foreign Currency Conversion*

Assets and liabilities denominated in foreign currencies are converted into US Dollars at market rates of exchange prevailing on the balance sheet date. Realised and unrealised foreign exchange profits and losses are included in Other Income.

2.10 *Off-Balance Sheet Derivative and Foreign Exchange Instruments*

Off-balance sheet financial instruments include futures, forwards, swaps and options in the interest rate and foreign exchange markets. The Bank utilises these instruments to satisfy the requirements of its customers, for proprietary trading purposes and to hedge its own exposure to interest rate and currency risk.

Those instruments entered into for trading purposes or to hedge other trading positions are marked-to-market with associated profits and losses included in Other Income.

Profits and losses on instruments entered into for hedging purposes, other than those referred to above, are recognised in Interest Revenue or Interest Expense on an amortisation basis over the lives of the hedged assets or liabilities.

2.11 *Retirement and Other Terminal Benefits*

Retirement and other terminal benefits are accrued for during the employees' period of service in accordance with contractual obligations and regulations applicable in each location.

Notes to the Financial Statements

For the Year Ended 31st December 1998 continued

3. Money Market Instruments

Money Market Instruments at 31st December 1998 included US and German government Treasury bills and Securities Purchased under Agreements to Resell amounting to US$250.0 million and US$40.5 million respectively (1997: US$201.2 million and US$5.0 million respectively).

4. Placements with Banks

Placements with Banks at 31st December 1998 included placements with non-bank financial institutions amounting to US$106.7 million (1997: US$53.9 million).

5. Trading Securities

The classification of Trading Securities was as follows:

	31.12.98 US$ millions	31.12.97 US$ millions
Listed debt securities	**61.9**	110.2
Managed funds	**69.9**	75.7
Equities	**7.8**	6.2
	139.6	192.1

The externally managed funds provide a diversified exposure to foreign exchange and international debt markets.

6. Investment Securities

a) Classification of Investment Securities

	31.12.98		31.12.97	
	Book Value US$ millions	Market Value US$ millions	Book Value US$ millions	Market Value US$ millions
AAA/Aaa rated debt securities	**587.0**	**588.0**	858.8	866.0
Debt securities of other investment grade issuers	**2,104.7**	**2,104.0**	1,629.4	1,644.9
Other debt securities	**266.1**	**273.3**	349.5	358.0
Equities and equity funds	**271.8**	**283.8**	209.3	208.6
	3,229.6	**3,249.1**	3,047.0	3,077.5

The market value of Investment Securities at 31st December 1998 included net unrealised gains on securities of US$44.6 million (1997: US$39.3 million) and net unrealised losses of US$25.1 million (1997: US$8.8 million) on interest rate swaps used to convert fixed rate securities to a floating rate basis.

Equities and equity funds at 31st December 1998 included investments in subsidiaries and associated companies of US$5.0 million (1997: US$6.2 million).

b) Provisions for Investment Securities

The movements in the provisions for investment securities were as follows:

	1998			1997		
	Specific US$ millions	General US$ millions	Total US$ millions	Specific US$ millions	General US$ millions	Total US$ millions
At 1st January	**15.9**	**21.7**	**37.6**	9.6	21.0	30.6
Charge for the year	**21.6**	**0.4**	**22.0**	6.3	0.7	7.0
At 31st December	**37.5**	**22.1**	**59.6**	15.9	21.7	37.6

7. Loans and Advances

	31.12.98 US$ millions	31.12.97 US$ millions
Gross Loans and Advances	**4,780.1**	4,268.3
Provisions for Loan Losses	**(779.4)**	(789.6)
Net Loans and Advances	**4,000.7**	3,478.7

a) Concentrations of Loans and Advances

Net Loans and Advances at 31st December 1998 included exposure to GCC country governments of US$655.6 million (1997: US$465.4 million) and OECD country central government and agency risk of US$193.4 million (1997: US$258.7 million).

There were no significant concentrations by industrial sector at 31st December 1998 and at 31st December 1997.

b) Provisions for Loan Losses

The movements in the provisions for loan losses were as follows:

	1998 Specific US$ millions	1998 General US$ millions	1998 Total US$ millions	1997 Specific US$ millions	1997 General US$ millions	1997 Total US$ millions
At 1st January	**615.5**	**174.1**	**789.6**	623.2	169.1	792.3
Exchange rate movements	**12.9**	**(0.1)**	**12.8**	(16.3)	–	(16.3)
Amounts utilised	**(31.0)**	–	**(31.0)**	(9.4)	–	(9.4)
Charge for the year	**4.4**	**3.6**	**8.0**	18.0	5.0	23.0
At 31st December	**601.8**	**177.6**	**779.4**	615.5	174.1	789.6

c) Non-Performing Loans

The gross and net book values of loans on which interest was not being accrued were as follows:

	31.12.98 Gross US$ millions	31.12.98 Net Book Value US$ millions	31.12.97 Gross US$ millions	31.12.97 Net Book Value US$ millions
Sovereign	**474.2**	**15.5**	479.5	19.3
Corporate	**43.5**	**17.4**	32.1	4.7
Financial Institutions	**16.9**	**6.1**	4.7	–
	534.6	**39.0**	516.3	24.0

8. Fixed Assets

	Freehold Land US$ millions	Buildings US$ millions	Premises and Equipment US$ millions	Total US$ millions
At 31st December 1998				
Cost	**8.9**	**27.1**	**22.8**	**58.8**
Accumulated Depreciation	–	**26.4**	**16.2**	**42.6**
Net Book Value	**8.9**	**0.7**	**6.6**	**16.2**
At 31st December 1997				
Net Book Value	8.9	0.8	3.9	13.6

Notes to the Financial Statements

For the Year Ended 31st December 1998 continued

9. Deposits

Of total deposits at 31st December 1998 amounting to US$8,004.2 million (1997: US$7,231.6 million), US$5,387.8 million (1997: US$4,691.5 million) were from GCC country governments and central banks and other institutions headquartered in the GCC states. Deposits from central banks are included in Deposits from Customers.

10. Other Liabilities

Other Liabilities at 31st December 1998 included Securities Sold but not yet Purchased amounting to US$30.8 million (1997: US$2.1 million).

11. Term Financing

	31.12.98 US$ millions	31.12.97 US$ millions
US$ Floating rate loan due in 2000	**300.0**	300.0
US$ Floating rate loan due between 2001 and 2003	**250.0**	250.0
US$ Floating rate note due in 2002	**200.0**	200.0
	750.0	750.0

12. Share Capital

	31.12.98 US$ millions	31.12.97 US$ millions
Authorised, Issued and Fully Paid	**450.0**	450.0

The Issued Share Capital at 31st December 1998 and 31st December 1997 comprised 450 million shares of US$1 each.

13. Reserves

	1998				1997
	Compulsory Reserve US$ millions	Voluntary Reserve US$ millions	Retained Earnings US$ millions	Total US$ millions	Total US$ millions
At 1st January	**54.3**	**54.3**	**135.3**	**243.9**	202.5
Transfer from Statement of Income and Appropriations	**8.2**	**8.2**	**20.7**	**37.1**	41.4
At 31st December	**62.5**	**62.5**	**156.0**	**281.0**	243.9

Under the provisions of Article 52 of the Bank's Articles of Association 10 per cent of net profits are to be transferred to each of the Compulsory and Voluntary Reserves.

14. Interest and Fees on Loans

Interest and Fees on Loans included US$1.6 million (1997: US$2.9 million) representing the net book value of bonds received in settlement of sovereign debt interest claims.

15. Other Income

	1998 US$ millions	1997 US$ millions
Profit on Investment Securities	25.1	9.4
Dividend Income	23.3	8.5
Commissions on Letters of Credit and Guarantee	6.8	7.2
Profit on Foreign Exchange	3.9	5.3
Fee and Sundry Income	0.7	0.7
(Loss)/Profit on Trading Securities	(10.6)	14.3
Profit on sale of Associated Company	–	8.6
	49.2	54.0

16. Retirement and Other Terminal Benefits

The Bank has defined contribution pension plans which cover the majority of its employees. Contributions are based on a percentage of salary. The amounts to be paid as retirement benefits are determined by reference to the amounts of the contributions and investment earnings thereon. The Bank also pays contributions to Government defined contribution pension plans in accordance with the legal requirements in each location.

The total cost of retirement and other terminal benefits included in Staff Expenses for the year ended 31st December 1998 amounted to US$3.9 million (1997: US$3.7 million).

17. Overseas Tax

Overseas tax represents taxation relating to the overseas branch activities. Provision for overseas tax is included in Other Liabilities.

18. Geographic Distribution of Risk Assets

	31.12.98					31.12.97
	Placements & Balances with Banks US$ millions	Securities & Money Market Instruments US$ millions	Loans and Advances US$ millions	Credit-related Contingent Items US$ millions	Total US$ millions	Total US$ millions
GCC	903.8	308.4	2,263.8	877.5	4,353.5	3,510.2
Other Middle East & North Africa	90.5	74.8	348.2	176.6	690.1	533.1
Europe	773.7	1,308.3	482.9	518.2	3,083.1	3,310.4
North America	238.3	1,713.8	370.9	1,106.7	3,429.7	3,096.3
Japan & Other Asia	351.1	236.8	481.8	126.9	1,196.6	1,951.6
Latin America	–	37.7	53.1	–	90.8	116.8
Total	2,357.4	3,679.8	4,000.7	2,805.9	12,843.8	12,518.4

An analysis of derivatives and foreign exchange products is set out in Note 21(a).

Notes to the Financial Statements

For the Year Ended 31st December 1998 continued

19. Maturities of Assets and Liabilities

The asset and liability maturity profile was as follows:

	Within 3 months US$ millions	Month 4 to 1 year US$ millions	Years 2 and 3 US$ millions	Years 4 and 5 US$ millions	Over 5 years and other US$ millions	Total US$ millions
At 31st December 1998						
Money Market Instruments	**300.6**	**10.0**	–	–	–	**310.6**
Placements & Balances with Banks	**2,105.4**	**252.0**	–	–	–	**2,357.4**
Securities	**192.8**	**122.5**	**690.4**	**644.8**	**1,718.7**	**3,369.2**
Loans and Advances	**1,129.5**	**676.5**	**1,047.7**	**705.6**	**441.4**	**4,000.7**
Fixed & Other Assets	**119.5**	**35.4**	–	–	**16.2**	**171.1**
Total Assets	**3,847.8**	**1,096.4**	**1,738.1**	**1,350.4**	**2,176.3**	**10,209.0**
Deposits	**6,647.6**	**1,118.8**	**237.8**	–	–	**8,004.2**
Securities Sold under Agreements to Repurchase	**486.9**	–	–	–	–	**486.9**
Proposed Dividend & Other Liabilities	**168.1**	**68.8**	–	–	–	**236.9**
Term Financing	–	–	**400.0**	**350.0**	–	**750.0**
Shareholders' Equity	–	–	–	–	**731.0**	**731.0**
Liabilities & Shareholders' Equity	**7,302.6**	**1,187.6**	**637.8**	**350.0**	**731.0**	**10,209.0**
At 31st December 1997						
Total Assets	3,360.8	1,937.9	1,619.6	1,118.9	1,486.7	9,523.9
Liabilities & Shareholders' Equity	6,866.4	1,093.6	420.0	400.0	743.9	9,523.9

The asset and liability maturities are based on contractual repayment arrangements and as such do not take account of the effective maturities of deposits as indicated by the Bank's deposit retention records. Counterparties each with deposits over US$10 million at 31st December 1998 had average deposits throughout 1998 amounting to US$6,423 million (1997: US$6,104 million). Formal liquidity controls are nevertheless based on contractual asset and liability maturities.

20. Interest Rate Risk

The repricing profile and effective interest rates of the various asset and liability categories were as follows:

	Within 3 months US$ millions	Months 4 to 6 US$ millions	Months 7 to 12 US$ millions	Over 1 year US$ millions	Non-interest bearing items US$ millions	Total US$ millions	*Effective interest rates %*
At 31st December 1998							
Money Market Instruments	300.6	10.0	–	–	–	310.6	*4.15*
Placements & Balances with Banks	1,740.9	237.0	179.5	200.0	–	2,357.4	*6.21*
Trading Securities	61.9	–	–	–	77.7	139.6	*2.76*
Investment Securities:							
– Fixed Rate	–	–	–	285.1	–	285.1	*4.98*
– Floating Rate	2,218.9	437.9	38.0	–	(22.1)	2,672.7	*6.44*
– Equities & Equity Funds	–	–	–	–	271.8	271.8	–
Loans and Advances	2,923.1	1,125.5	123.7	5.9	(177.5)	4,000.7	*6.75*
Fixed & Other Assets	–	–	–	–	171.1	171.1	–
Total Assets	7,245.4	1,810.4	341.2	491.0	321.0	10,209.0	
Deposits	6,845.8	655.1	503.3	–	–	8,004.2	*5.61*
Securities Sold under Agreements to Repurchase	486.9	–	–	–	–	486.9	*5.42*
Proposed Dividend & Other Liabilities	–	–	–	–	236.9	236.9	–
Term Financing	750.0	–	–	–	–	750.0	*5.54*
Shareholders' Equity	–	–	–	–	731.0	731.0	–
Liabilities & Shareholders' Equity	8,082.7	655.1	503.3	–	967.9	10,209.0	
Balance Sheet Items	(837.3)	1,155.3	(162.1)	491.0	(646.9)	–	
Off-Balance Sheet Items	(319.3)	(81.8)	401.1	–	–	–	
Interest Rate Sensitivity Gap	(1,156.6)	1,073.5	239.0	491.0	(646.9)	–	
Cumulative Interest Rate Sensitivity Gap	(1,156.6)	(83.1)	155.9	646.9	–	–	
At 31st December 1997							
Cumulative Interest Rate Sensitivity Gap	(1,087.2)	(323.2)	142.6	612.6	–	–	

The repricing profile is based on the remaining period to the next interest repricing date. The repricing profiles of securities and loans incorporate the effect of interest rate swaps used to modify the interest rate characteristics of specific transactions. The repricing profile of Placements incorporates the effect of interest rate swaps used to lock-in a return on the Bank's net free capital funds. Interest rate swaps and forward rate agreements that have been used for asset and liability management purposes to hedge overall exposure to interest rate risk are included separately as Off-Balance Sheet Items. Their impact on effective interest rates is reflected in Deposits. The general provisions for securities and loan losses are deducted from non-interest bearing assets.

The substantial majority of the Bank's assets and liabilities reprice within one year. Accordingly there is a limited exposure to interest rate risk. The fixed rate investment securities portfolio is the principal asset or liability category to reprice over one year. At 31st December 1998 the modified duration of this portfolio was 3.19 (1997: 2.25). Modified duration represents the approximate percentage change in the portfolio value resulting from a 100 basis point change in yield. More precisely in dollar terms the price value of a basis point of the portfolio was US$93,000 (1997: US$149,000).

Notes to the Financial Statements

For the Year Ended 31st December 1998 continued

21. Off-Balance Sheet Financial Instruments

a) Derivatives and Foreign Exchange Products

The Bank utilises derivatives and foreign exchange instruments to meet the needs of its customers, to generate trading revenues and as part of its asset and liability management (ALM) activity to hedge its own exposure to interest rate and currency risk. The Bank has appropriate Board-approved procedures for the control of exposure to both market and credit risk from its derivatives and foreign exchange activities.

In the case of derivative transactions the notional principal typically does not change hands. It is simply a quantity which is used to calculate payments. While notional principal is a volume measure used in the derivatives and foreign exchange markets, it is neither a measure of market nor credit risk. The Bank's measure of credit exposure is the cost of replacing contracts at current market rates should the counterparty default prior to the settlement date. Credit risk amounts represent the gross unrealised gains on non-margined transactions before taking account of any collateral held or any master netting agreements in place.

The table below summarises the aggregate notional and credit risk amounts of foreign exchange and interest rate contracts.

Product Analysis

	Notional Amounts			Credit Risk
	Trading US$ millions	ALM US$ millions	Total US$ millions	Amounts US$ millions
At 31st December 1998				
Foreign Exchange Contracts:				
Unmatured Spot, Forward and Futures contracts	**4,572.0**	**1,362.4**	**5,934.4**	**56.3**
Options purchased	**113.7**	**–**	**113.7**	**0.1**
Options written	**107.3**	**–**	**107.3**	**–**
Total	**4,793.0**	**1,362.4**	**6,155.4**	**56.4**
Interest Rate Contracts:				
Futures and Forward Rate Agreements	**238.5**	**416.6**	**655.1**	**–**
Interest Rate Swaps	**628.0**	**1,604.9**	**2,232.9**	**19.0**
Options, Caps and Floors purchased	**2,405.0**	**5.0**	**2,410.0**	**–**
Options, Caps and Floors written	**2,589.1**	**5.0**	**2,594.1**	**–**
Total	**5,860.6**	**2,031.5**	**7,892.1**	**19.0**
Total	**10,653.6**	**3,393.9**	**14,047.5**	**75.4**
At 31st December 1997				
Total	6,924.5	3,405.4	10,329.9	66.5

Interest rate options purchased are exchange traded and therefore not subject to credit risk. There is no credit risk in respect of options, caps and floors written as they represent obligations of the Bank.

Counterparty Analysis

		31.12.98		31.12.97
Credit Risk Amounts	Banks US$ millions	Other US$ millions	Total US$ millions	Total US$ millions
OECD countries	**62.2**	**5.9**	**68.1**	49.0
GCC countries	**4.6**	**2.7**	**7.3**	17.3
Other countries	**–**	**–**	**–**	0.2
Total	**66.8**	**8.6**	**75.4**	66.5

Credit risk is concentrated on major OECD-based banks.

21. Off-Balance Sheet Financial Instruments continued

Maturity Analysis

Notional Amounts	Year 1 US$ millions	Years 2 and 3 US$ millions	Years 4 and 5 US$ millions	Over 5 years US$ millions	Total US$ millions
At 31st December 1998					
Foreign Exchange contracts	6,093.7	51.7	–	10.0	6,155.4
Interest Rate contracts	6,282.3	821.0	386.6	402.2	7,892.1
Total	12,376.0	872.7	386.6	412.2	14,047.5
At 31st December 1997					
Total	9,295.8	515.7	313.0	205.4	10,329.9

The Bank's derivatives and foreign exchange activities are predominantly short-term in nature. Transactions with maturities over one year either represent hedging transactions entered into for the Bank's own asset and liability management purposes or fully offset customer transactions.

Significant Net Open Positions

At 31st December 1998 the Bank had a US$26.5 million long (1997: US$25.4 million long) Omani Riyal net open currency position. This related to Omani Government investment security holdings.

There were no other significant derivative trading or foreign currency net open positions at 31st December 1998 and at 31st December 1997.

b) Credit-Related Financial Instruments

Credit-related financial instruments include commitments to extend credit, standby letters of credit and guarantees which are designed to meet the financing requirements of the Bank's customers. The credit risk on these transactions is generally less than the contractual amount. The table below sets out the notional principal amounts of outstanding credit-related contingent items and the risk-weighted exposure calculated in accordance with the capital adequacy guidelines of the Basle Committee on Banking Supervision.

	31.12.98		31.12.97	
	Notional Principal Amount US$ millions	Risk-Weighted Exposure US$ millions	Notional Principal Amount US$ millions	Risk-Weighted Exposure US$ millions
Direct credit substitutes	13.7	13.7	1.1	1.1
Transaction-related contingent items	923.7	429.7	1,146.5	493.7
Short-term self-liquidating trade-related contingent items	334.8	59.6	212.9	41.7
Undrawn loan commitments and underwriting commitments under note issuance and revolving facilities	1,533.7	510.6	1,812.1	507.8
Total	2,805.9	1,013.6	3,172.6	1,044.3

Notes to the Financial Statements

For the Year Ended 31st December 1998 continued

22. Capital Adequacy

The risk asset ratio calculated in accordance with the capital adequacy guidelines of the Basle Committee on Banking Supervision was as follows:

	31.12.98 US$ millions	31.12.97 US$ millions
Capital Base		
Tier I Capital		
Shareholders' Equity	**731.0**	693.9
Tier II Capital		
General provision subject to 1.25% risk-weighted exposure limitation	**90.7**	80.9
Total Capital Base	*(a)* **821.7**	774.8

Risk-Weighted Exposure

Credit Risk	Notional Principal Amount US$ millions	Risk-Weighted Exposure US$ millions	Notional Principal Amount US$ millions	Risk-Weighted Exposure US$ millions
Balance Sheet Items:				
Money Market Instruments	**310.6**	**12.1**	260.7	11.9
Placements & Balances with Banks	**2,357.4**	**534.9**	2,367.3	537.3
Securities	**3,369.2**	**2,120.9**	3,239.1	1,846.7
Loans and Advances	**4,000.7**	**3,057.3**	3,478.7	2,573.9
Fixed & Other Assets	**171.1**	**112.4**	178.1	109.9
	10,209.0	**5,837.6**	9,523.9	5,079.7
Off-Balance Sheet Items:				
Credit-related Contingent Items	**2,805.9**	**1,013.6**	3,172.6	1,044.3
Foreign Exchange Transactions	**6,155.4**	**13.6**	5,873.4	19.5
Interest Rate-related Items	**7,892.1**	**5.9**	4,456.5	5.9
	16,853.4	**1,033.1**	13,502.5	1,069.7
Credit Risk-weighted Exposure		**6,870.7**		6,149.4
Market Risk				
Market Risk-weighted Exposure		**388.9**		326.0
Total Risk-weighted Exposure		*(b)* **7,259.6**		6,475.4
Risk Asset Ratio [*(a)*/*(b)* x 100]		**11.3%**		12.0%

Exposure to market risk is computed utilising a Value-at-Risk model in accordance with the provisions of the Amendment to the Capital Accord to Incorporate Market Risks issued by the Basle Committee in January 1996. Value-at-Risk is calculated based on a 99 per cent confidence level, a ten-day holding period, a twelve-month historical observation period of unweighted data from the RiskMetrics™ regulatory data set and a multiplication factor of three. Correlations across broad risk categories are excluded. Prescribed additions in respect of specific risk are made to general market risk computed by the model. The measure of market risk so found is multiplied by 12.5, the reciprocal of the 8 per cent minimum capital ratio, to give Market Risk-weighted Exposure on a basis consistent with Credit Risk-weighted Exposure.

With regard to credit risk the risk-weighted exposures for foreign exchange transactions and interest rate-related items are determined using the current exposure method. A credit conversion factor as determined by the Basle Committee is applied to the replacement cost of these contracts. The resultant amounts are then risk-weighted according to the classification of the counterparty.

23. Related Party Transactions

During the year certain transactions were conducted with the Bank's parent company, Gulf Investment Corporation. These comprised standard wholesale money market and foreign exchange transactions that were conducted on an arm's length basis at open market prices.

	1998 US$ millions	1997 US$ millions
The following transactions were outstanding at 31st December of each year:		
Placements with GIC	**81.8**	28.0
Deposits from GIC	**71.6**	14.0
Floating rate notes held by GIC	**10.0**	10.0
Forward foreign exchange transactions	**10.6**	–
Interest on transactions during the year was as follows:		
Interest on Placements with GIC	**3.9**	2.6
Interest on Deposits from GIC	**0.8**	1.9
Interest on Floating rate notes held by GIC	**0.8**	0.3

24. Earnings Per Share

	1998	1997
Net Income after Tax (US$ millions)	**82.1**	86.4
Weighted average number of shares in issue (millions)	**450.0**	450.0
Earnings per share	US$**0.18**	US$0.19

Notes to the Financial Statements

For the Year Ended 31st December 1998 continued

25. Fair Value of Financial Instruments

The table set out below compares the estimated fair values of all on- and off-balance sheet financial instruments with their respective book values. The Bank's financial instruments are accounted for principally under the historical cost method. By contrast the fair value represents the amount at which an asset could be exchanged, or a liability settled, in a transaction between knowledgeable, willing parties in an arm's length transaction. Differences therefore can arise between book values under the historical cost method and fair value estimates. Underlying the definition of fair value is the presumption that the Bank is a going concern without any intention or requirement to curtail materially the scale of its operation or to undertake a transaction on adverse terms. Generally accepted methods of determining fair value include reference to quoted market prices or to the pricing prevailing for similar financial instruments and the use of estimation techniques such as discounted cash flow analysis.

	Book Value US$ millions	Fair Value US$ millions	Excess over Book Value US$ millions
At 31st December 1998			
Assets			
Cash and Balances with Banks	**51.0**	**51.0**	–
Money Market Instruments	**310.6**	**310.6**	–
Placements with Banks	**2,306.4**	**2,306.4**	–
Trading Securities	**139.6**	**139.6**	–
Investment Securities	**3,229.6**	**3,249.1**	**19.5**
Loans and Advances	**4,000.7**	**4,009.0**	**8.3**
Other Assets	**154.9**	**154.9**	–
Liabilities			
Deposits	**8,004.2**	**8,004.2**	–
Securities Sold under Agreements to Repurchase	**486.9**	**486.9**	–
Other Liabilities	**191.9**	**191.9**	–
Term Financing	**750.0**	**750.0**	–
Off-Balance Sheet Financial Instruments	–	–	–
Excess of Net Fair Values over Net Book Values			**27.8**
At 31st December 1997			
Excess of Net Fair Values over Net Book Values			99.6

Based on the valuation methodology outlined below, the net fair values of all on- and off-balance sheet financial instruments exceeded their net book values as at 31st December 1998 by US$27.8 million (1997: US$99.6 million).

a) Securities

The fair value of securities was based on quoted market prices with the exception of investments in subsidiaries and associated companies and unquoted equity investments, the fair values of which were estimated at attributable net asset value determined with reference to the most recent audited financial statements and latest unaudited financial information available to shareholders.

b) Loans and Advances

The fair value of floating rate loans was principally estimated at book value less attributable specific provisions and the general provision for loan losses. The fair value of troubled sovereign debt was based on market bid prices. The fair value of fixed rate loans was estimated on a discounted cash flow basis utilising discount rates equal to prevailing market rates of interest in the respective currencies for loans of similar residual maturity and credit quality. The repricing profile of Loans and Advances is set out in Note 20. All but US$5.9 million (1997: US$5.8 million) of Loans and Advances reprice within one year.

25. Fair Value of Financial Instruments continued

c) Term Financing

The fair value of term financing was based on book value as the financing is on a floating rate basis and as the applicable margins approximate the current spreads that would apply for borrowings with similar maturities. The term financing reprices at least semi-annually.

d) Other On-Balance Sheet Financial Instruments

The fair values of all other on-balance sheet financial instruments approximated their respective book values due to their short-term nature.

e) Off-Balance Sheet Financial Instruments

Derivative instruments utilised for asset and liability management (ALM) purposes were valued based on market prices and incorporated in the fair values of Placements, Securities, Loans and Advances and Deposits. The net unrealised loss on these contracts at 31st December 1998 amounted to US$30.3 million (1997: US$10.9 million).

The fair values of derivative trading and foreign exchange instruments were based on market prices. The market values of derivative trading and foreign exchange instruments are included in the book values of Other Assets and Other Liabilities.

No fair value adjustment was made with respect to credit-related off-balance sheet financial instruments, which include commitments to extend credit, standby letters of credit and guarantees, as the related future income streams materially reflect contractual fees and commissions actually charged at the balance sheet date for agreements of similar credit standing and maturity. Specific provisions have been made in respect of individual transactions, where a potential for loss has been identified. Such provisions are included in provisions for loan losses.

26. Event Subsequent to the Balance Sheet Date

On 18th December 1998 the Bank entered into a memorandum of understanding to acquire all the issued shares in Al-Bank Al-Saudi Al-Alami Limited (Saudi International Bank – “SIB”), a bank incorporated in the United Kingdom. Under the terms of the memorandum of understanding the 50 per cent and 20 per cent of SIB’s shares held by the Saudi Arabian Monetary Agency and Morgan Guaranty International Finance Corporation respectively are to be acquired in exchange for new shares to be issued by the Bank. The remaining 30 per cent of SIB’s shares are to be acquired for cash. The acquisition, which is subject to approval by the relevant regulatory authorities, is expected to be completed by the end of the first quarter of 1999.

27. Year 2000

The Bank, like other institutions, is exposed to potential risks arising from the Year 2000 issue. Accordingly a compliance project is being implemented to ensure that all computer systems and applications, as well as non-computer related equipment utilising date-dependent computer chips, are Year 2000 compliant. At 31st December 1998 the identification and assessment phases of the project had been completed. The Bank had commenced the remediation and testing phase of the project involving the modification, retirement or replacement of computer systems and applications which are identified as not being Year 2000 compliant. Procedures had also been initiated with respect to the evaluation of the Year 2000 readiness of service providers, customers and other third parties. It is not, however, possible for the Bank to determine with certainty whether a third party’s remediation efforts will be successful.

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Calligraphy by Mohammed Said Saggar.
Designed and produced by Coulton Design Consultancy, London.
Printed by White Dove Press.
Registration Number: FGIB 143