

# Chairman's Report



## Dear Shareholders,

With the world economy poised for its fastest five-year growth in the past three decades, global growth is expected to approach 5% this year. This spurt in growth provides policy makers with a chance to remove barriers to global trade and investments and help ensure the expansion continues. This has been clearly stated by the International Monetary Fund, which states that the favourable global environment 'provides a not-to-be-missed opportunity for all countries to advance structural reforms and fiscal consolidation, that would help sustain the underpinnings of continued growth and prosperity'.

## Oman's economy

The Oman economy also continued to prosper during 2006. GDP grew by 16.81%, as the realized oil price was USD 62/barrel against the budgeted oil price of USD 32/barrel. Oil GDP grew by 18% (RO 6642 million), while non-oil GDP grew by 15.6% (RO 1684 million). The two key non-oil sectors of natural gas and tourism grew by 60% and 22% respectively.

In keeping with the Government's continuing thrust on all round sustainable development, the state general budget for the year 2007 addresses all segments of the economy including oil and gas, infrastructure and social welfare, and stresses on the diversification drive of the Government in line with long-term goals of the Vision 2020. The budget for 2007 is expected to leave a lower deficit of RO 400 million, as against a deficit of RO 650 million estimated in the budget for 2006. The total aggregate expenditure for the year has been pegged at RO 4,890 million, as opposed to the budgeted expenditure of RO 4,237

million in 2006, and budgeted revenues receipts at RO 4,490 million, as against RO 3,587 million last year. Total oil, gas and non-oil revenues are estimated at RO 3,015 million, RO 550 million and RO 925 million respectively.

Budget estimates for 2007 have been made on an estimated average price of USD 40 per barrel of Oman crude.

## Capital Markets

Under the able guidance of Capital Markets Authority (CMA) of the Sultanate of Oman, the Muscat Securities Market (MSM) continued to register steady growth, reflecting the confidence of investors in the country's fundamentals. It was only in the last quarter that Sohar Bank came out with the lone IPO of the year. The Muscat Securities Market was the best performing market in the GCC region during 2006. The MSM Index concluded the year at 5,582 making a net gain of 14.5%. This gain, though modest compared to earlier years, was very encouraging in the context of the general weakness across the regional markets, during which the Bahrain stock market registered a modest gain of 1%. All other GCC markets closed in the red. The extent of decline ranging from 12% to 53%. The corporate sector in Oman, though marked by patches of over capacity in some industries, is expected to maintain a decent growth in 2007.

## Financial Overview

The Bank achieved a net profit of RO 60.4 million for the year ended 31 December 2006, as against a net profit of RO 45.4 million for the year ended 31 December 2005, an increase of 33.0%.

Net interest income increased by 27.5% from RO 78.1 million in 2005 to RO 99.5 million in 2006. Non-interest income grew from RO 23.3 million in 2005 to RO 31.1 million in 2006, an increase of 33.5%. Operating profit of RO 77.3 million in 2006 is 34.9% higher than the RO 57.3 million achieved in 2005. Operating expenses of RO 53.3 million in 2006 are higher by 21.1% than RO 44.0 million incurred in 2005. The Cost to Income ratio for the year was at 40.8% as compared to 43.5% in 2005.

The return on average assets improved from 2.3% in 2005 to 2.4% in 2006. The return on average equity improved from 20.2% in 2005 to 21.9% in 2006. The basic earnings per share increased from RO 0.058 in 2005 to RO 0.073 in 2006, which works to be a return of 73% on a nominal value of a share.

The Bank's net loans and advances portfolio grew by RO 463 million or 33.7% to RO 1,835 million as at 31 December 2006 compared to RO 1,372 million as at 31 December 2005. Customer deposits increased by RO 526 million or 40.7% to RO 1,817 million as at 31 December

2006 compared to RO 1,291 million as at 31 December 2005. Savings deposits increased by 26% from RO 338 million as at 31 December 2005 to RO 426 million as at 31 December 2006.

BankMuscat enjoys a market share of 42.0% in terms of total assets, 41.4% in terms of total credit and 39.2% in terms of total customer deposits as at 31 December 2006. The Bank's share of total savings deposits was 41.1% as at 31 December 2006.

The Bank made loan loss provisions of RO 18.4 million during the year compared to RO 24.4 million made during the year ended 31 December 2005. Loan loss provision charge of RO 18.4 million for the year 2006 includes RO 8.9 million towards general loan loss provision as per the requirement of Central Bank of Oman. As of 31 December 2006, the Bank has fully met the general loan loss provision requirement of Central Bank of Oman. The Bank holds a general loan loss provision of RO 31.1 million as at 31 December 2006. During the year 2006, the Bank recovered RO 7.3 million from provision for possible credit losses compared to RO 15.9 million in 2005.

The Bank's associates contributed RO 4.1 million as share of profits during the year 2006 as against a RO 3.7 million of 2005.

The Board of Directors is pleased to recommend a cash dividend of 35% and stock dividend of 10% for the year 2006, subject to due approval by the shareholders thus keeping up the practice of consistently providing good returns to shareholders.

### **The Year in Retrospect**

While the Bank continued on its path of measured growth during the year gone by, there were several measures taken to prepare it for sustained growth in the future. Perhaps, the most significant amongst these was the Bank's decision to implement the recommendations of global strategy firm, Booz Allen Hamilton on the re-organization of the Bank in line with emerging customer segments. We believe that, these changes will significantly help the Bank anticipate and capitalize on the opportunities that lie ahead. These changes also resulted in a number of senior management changes in the Bank with the aim to ensure the 'right people' are in the 'right places' as we plan for the future.

Also noteworthy in this regard was the Bank's decision to select and implement a new Core Banking System (CBS), replacing the existing MIE system. Assisted by Gartner Consulting, the Bank evaluated three leading CBS solutions before finally selecting Temenos T24 as the best fit for the Bank's business model. T24 is a web-based Universal Banking System that encompasses core functionalities such as retail banking, corporate banking, finance, branch operations and also a suite of

specialized business functions like as Treasury, Investments, Asset Management, Private Banking, Wealth Management etc. The Bank's main objective to implement a state-of-art CBS is to leverage technology to provide better and more efficient customer service and to tap more business from existing and new market segments by offering an enhanced range of products and services. In today's competitive banking environment, the new CBS would provide more flexibility and enable faster time-to-market to launch new products and services. The implementation of T24 is already in progress. The project is expected to be complete by March 2008.

During 2006, the Bank also continued to prosper, thanks to the tireless efforts of our people to enhance products, services and solutions standards across the Bank's operations. Inspired by the all around growth of the national economy, the Bank's Corporate Banking Group has had a stimulating and eventful year. The emphasis on customer relationships and providing 'comprehensive business solutions' continues to be the focus of the Group's business strategy. The Corporate Credit and Marketing unit's re-enforced approach directed at specific economic sectors enhanced customer confidence, leading to stronger relationships.

During the year, the Bank was associated with the financial closure of two large petrochemical projects as a Mandated Lead Arranger – Aromatics Oman in Sohar and Octal Petrochemicals in Salalah. Four major re-financing programmes were also undertaken by the Bank – two in the oil & gas sector, one for a power & water project and for another for an LNG tanker. The Bank also participated in structured transactions in the GCC, which saw several high profile financial closures for projects in the UAE, Qatar and Bahrain.

The Government has undertaken several steps to boost the tourism and real estate sectors in the country, including the conceptualization and development of 'integrated tourism complexes'. The Bank views this as an opportunity to support the Government's efforts and has been following these developments closely.

The Bank also recognized that it should encourage Small and Medium Enterprises (SMEs), which are the backbone of any economy. It is in keeping with this belief that the Bank has now upgraded its existing small business unit into a full-scale department (SME Credit & Marketing) with dedicated staff to look after the financial needs of the SME sector. The International Finance Corporation has also signed a technical agreement with the Bank to help it grow the small and medium enterprises (SME) finance segment in the Sultanate.

# Chairman's Report

Reflecting growing consumer demand, the Consumer Banking Group launched several key products during the year. The new al Mazyona saving's scheme has added on several new features including a special 'loyalty' prize to recognize and reward customers with a consistent savings habit. A special 'add-on' this year is a free personal accident insurance cover.

The most significant launch of the Consumer Banking Group was a suite of new product offerings in the rapidly growing 'home loans' market in the Sultanate. The importance of this product group gained new meaning during the year when the Bank became the recipient of the single largest investment of the International Financial Corporation (IFC) in the MENA region, with IFC extending a USD 100 million subordinated loan to the Bank to help enhance its capital adequacy and lend further momentum to its housing loan operations in the Sultanate.

Late in the year, the Cards Services unit also successfully upgraded their in-house software capabilities to the latest EMV technology-enabled solution, capable of issuing and supporting chip-based cards.

In line with its vision of moving even closer to people, the Bank strengthened its network of branches to reach a total of 97 branches nationwide, over 200 ATMs and 30 Cash Deposit Machines (CDMs). Staff assisted services at the Bank's call center were also made available 24x7.

The Corporate Finance & Advisory unit (CFA) continued its rapid progress during the year successfully making an impressive entry into the Global Advisory League Tables. The Unit has an otherwise impressive year as well as it closed its first regional transaction during the year. BankMuscat International, Bahrain's USD 35 million subordinated loan issuance was successfully placed in the international market. CFA also achieved an important milestone in winning the mandate to advise the Government-owned Botswana Power Corporation (BPC) for a 600 MW power project in Botswana against international competition. The size of the transaction is expected to be more than USD 800 million.

The Unit also played a pivotal role in the Bank's acquisition of a 43% stake in the Mangal Keshav Holding (MKH) in India. MKH ranks amongst one of the top 20 security houses in India and would provide an important platform for BankMuscat's entry into the Indian securities market.

During the year, CFA successfully completed the USD 147 million petrochemical project (Phase I), which is the first project in the Salalah Free Zone. As part of the mandate, the team worked as the exclusive financial advisor and raised both equity and debt for the project. CFA is also acting as

the Sole Financial Advisor to the Ministry of National Economy for the Solid Waste Management restructuring project in Oman. This involves the restructuring of the entire solid waste sector in the country. The Unit also won a mandate for privatization in the hospitality sector (Golden Tulip, Seeb) from the Ministry of National Economy.

CFA was the Sole Financial Advisor to Gulf Energy Corporation (GEC - a subsidiary of Oman Investment Corporation) for securing non-recourse financing for two of GEC's projects totaling USD 42 million. The Unit also won the mandate to act as the sole financial advisor to National Mineral Water Company, which is setting up a USD 20 million PET recycling project in Fujairah, United Arab Emirates.

Despite depressed regional bourses and a 30% drop in trading volumes on the Muscat Securities Market, the Bank's Brokerage unit had a very successful year and ended the year as the number one brokerage house in the country, with its highest ever market share of 19%. Sustained marketing efforts, especially focused on attracting foreign institutional investors, helped in protecting Brokerage revenues during the year.

All the major segments of the Bank's Treasury – Foreign Exchange, Money Markets and Structured Products – witnessed strong business growth during the year. The focus on offering structured derivative solutions, especially innovative currency and interest rate hedging products to corporations resulted in this portfolio growing significantly over the past year. This trend was also witnessed in the Interest Rate derivatives area, where Treasury was successful in structuring and completing the largest and most sophisticated transactions in Oman. These transactions are done for fulfilling the hedging requirements of customers and are completely hedged back to back by the Bank there by eliminating market risks from its balance sheet.

The Bank also became the first bank in the Sultanate of Oman to be granted approval for offering commodity-hedging products in the local market to local corporations. A dedicated Commodity Hedge desk, which acts as an intermediary between international institutions and local corporates, offers hedging products for base metals, precious metals and energy products to customers was launched during the year for this purpose.

To bolster long term funding the bank took USD 100 million subordinated debt from International Finance Corporation, Washington as well as borrowings through the reverse enquiry route of its EMTN program.

The focus on Money Market activities had increased Treasury's balance sheet size by over 60%. This is the result of a substantial number of new money market relationships to Treasury's already active counter-party list and by way of significantly strengthening existing relationships.

The funds and portfolios managed by the Bank's Asset Management unit turned in an excellent performance in 2006, outperforming the benchmark. The Muscat Fund, which invests in stocks listed on the Muscat Securities Market, was up 16.78%, as against the 14.09% for the MSM Index. The Fund was also able to attract significant investments from regional investors. The Oryx Fund, which invests in stocks listed on the GCC markets, recorded an excellent performance despite the downward trend in regional markets. The Fund's NAV moved up by 4.8% during 2006, as against a drop of 27.5% in the GCC Equally Weighted Index.

In the last quarter of 2006, the Asset Management unit launched the BankMuscat MSCI® Kuwait Fund – the first of its kind based on the MSCI® Kuwait Index – that allows investors to take exposure in blue-chip stocks in Kuwait. The Unit also launched BankMuscat Private Equity Fund II, which provides investors with the access to private equity managers with proven expertise in creating value through investments in a variety of stages, industries and geographic regions. Both Funds have received an excellent response from the local and regional investment community.

During the year, the Bank's Private Banking Unit also tied up with an international asset management firm to provide research and recommendations on mutual funds investing in global markets. Besides investment solutions, the Unit has also started offering Trust and other inheritance planning solutions to clients.

International Operations continues to form a priority focus at the Bank. During the year the Bank's international investments and operations continued to meet and exceed expectations.

BankMuscat's largest international investment is in its 21.95% stake in Centurion Bank of Punjab (CBoP). CBoP is today amongst the top 10 private sector banks in India – in terms of total assets. The Bank had a network of 256 branches and 402 ATMs across 128 locations in India as on 31 December 2006. During the year, Centurion Bank successfully completed its merger with Bank of Punjab and announced another merger with Lord Krishna Bank. Both mergers are expected to further consolidate the Bank's position in the high-growth Indian consumer banking market.

To gain entry into the Indian financial services sector, BankMuscat entered into an agreement with the Mangal Keshav Group (MK) to acquire 43% of its holding company in the last quarter of the year. MK is amongst the oldest and most respected security houses in India. BankMuscat is the first bank from the GCC region to take a stake in the

Indian financial services sector.

The Bank's subsidiary in Bahrain, BankMuscat International (BMI) also continued to turn in robust performances during the year. It is in view of BMI's consistent growth that the Bank was awarded 'investment grade' ratings from Standard & Poors', Moody's and Capital Intelligence at the beginning of 2006.

BMI was also successful in raising USD 35 million by way of subordinated loans from prime lenders in the GCC and beyond. The issue was over-subscribed several times – a reflection of the market confidence in BMI's capabilities.

BankMuscat's Representative Office in Dubai accelerated its business development initiatives amongst the non-resident Indian community during 2006 by capitalizing on the expertise and support of CBoP, its partner from India. With greater human resources at its disposal as a result of leveraging this relationship, the operations are expected to see considerable activity in the coming year.

Significant progress was also made to successfully start up the Bank's operations in Riyadh, Kingdom of Saudi Arabia. The branch office on King Fahd Road today houses a total of 45 employees, with the Bank's IT infrastructure all in place. The Bank is currently engaged in finalizing overall integrated operations testing and expects to commence business in the first half of 2007.

In an attempt to support the efforts made the by the Ministry of Social Development and the Central Bank of Oman to enhance the welfare of our society and promote long-term growth of the national economy, the Bank also launched a significant social awareness campaign during the year to address the dangers of excessive personal borrowing. Hinging on the philosophy that one needs to 'borrow sensibly, to live happily', the campaign was intended to recognize responsible consumer lending as a key value and crucial growth engine for our society. This is the first such programme to be endorsed by the Ministry of Social Development and the Central Bank of Oman.

It is also worth mentioning that the Bank launched a significant internal Quality Management initiative during the year: 'Committed to Quality'. This is meant to become a rallying cry within the organization, with the Bank attempting even more to strengthen its overall quality focus and orientation in everything it does. A new quality logo has been introduced as part of this initiative that will be reflected in a number of places and customer initiatives to be rolled out during the coming year.

# Chairman's Report

The Bank's performance, as a whole and across many of its business lines, were once again recognized and lauded by financial community during the year. Notable amongst the awards and recognitions gained during 2006 were:

- Euromoney: **Best Bank in Oman** (for the 5<sup>th</sup> time)
- Global Finance: **Best Bank, Oman** (6<sup>th</sup> year running); **Best Forex Bank and Provider, Oman** (3<sup>rd</sup> year running); **Best Trade Finance Bank and Provider, Oman** (3<sup>rd</sup> year running); **Best Internet Consumer Bank, Oman** (3<sup>rd</sup> year running)
- Lloyds List Middle East: **Trade Finance Award** (2<sup>nd</sup> year running)
- The Banker FT London: **Deals of the Year, Oman**
- Datamatrix: **Banking & Finance CEO of the Year**
- Middle East Institute: **Banking and Finance Personality of the Year, 3<sup>rd</sup> Middle East CEO Awards**
- JP Morgan Chase: **MT103 Quality Recognition Award** (6<sup>th</sup> time)
- Muscat Securities Market: **Best Brokerage Firm** (in terms of volume) and **2nd Best Services offered by a Brokerage House**
- Oman Awards for Excellence: **People Development Award** (3<sup>rd</sup> year running)
- **BS7799 certification:** for Best Practices in Information Security in the IT security function first organization in the Sultanate and the fourth bank from across the region to receive this certification.
- **Maiden entry into Global League Tables (mandates won) for Financial Advisors:** published by The Infrastructure Journal magazine. Ranked 11th in the Global Financial Advisors list (overall 3<sup>rd</sup> in the Africa and Middle East region) in terms of mandates won. Additionally, the Bank has been ranked 2<sup>nd</sup> globally in the Power Sector. The Bank's ranking has been based on winning four transactions amounting to USD 1.7 billion in the power, petrochemicals and waste sector.

## Risk Rating

During the year all key rating agencies reviewed and upwardly revised the bank's long-term and short-term financial ratings.

Commenting on its decision to upgrade the Bank's credit ratings to 'BBB+' from 'BBB' and affirm the 'A-2' short-term counter-party credit rating on the Bank, Standard & Poors said:

"The ratings reflect the bank's dominant commercial position in the Sultanate of Oman (A-/Stable/A-2), and its adequate financial performance and asset quality. They also take into account controlling ownership by the Government of Oman and our expectation that Government support would most likely be available in case of need. Therefore, the ratings on the bank (considered a Government-related

entity under our methodology) include a one-notch uplift from its stand-alone rating.

BankMuscat is strengthening its franchise through international expansion. It has a 49% stake in Bahrain-based BankMuscat International B.S.C. (BBB-/Stable/A-3); a 21.95% stake in Centurion Bank of Punjab (CBoP; not rated), a fast growing private bank in India; and is expected to take a 43% stake in India-based Mangal Keshav Holding (MKH; not rated). Total investment in India stands at about USD 110 million. Although this rapid expansion is contributing to increasingly diversified revenues, it is also raising the challenge of controlling risks outside Oman."

BankMuscat's ratings by the four international rating agencies, Fitch, Standard & Poor's, CI and Moody's are the highest to be awarded to any Omani bank.

## Corporate Governance in practice

I am happy to record that the best of good corporate governance practices have now been internalized in all the aspects of working of BankMuscat. The Bank had, in fact, set in place good governance practices even before the Capital Market Authority prescribed the 'Code of Corporate Governance'. The presence of the Code has further strengthened our implementation.

Fair practices, accountability and transparency are the pillars of good governance, which BankMuscat has set in place. Board, management, employee and stakeholder synergy and teamwork enable BankMuscat to stand out as an outstanding symbol of good governance in practice. Keeping in view the need for stakeholders to be kept informed about developments, information flow to the stakeholders is what the Bank ensures at all times. The annual report and other information, including beneficial ownership, is available on the investor's relations pages on the Bank's website and is also made available individually, to all shareholders and correspondent banks, containing the financial statements and notes to accounts duly certified by the Bank's external auditors, KPMG Oman. A detailed Corporate Governance report, duly certified by the external auditors is contained in the annual report as a separate section. Commitment to Corporate Social Responsibility (CSR) projects and sustainable development initiatives round off BankMuscat's corporate governance leadership and implementation. A comprehensive framework of policies across all the areas of the Bank's functions set in place the control framework.

We seek to assure our stakeholders, regulators in Oman and overseas, international agencies and the large network of banks and international

financial agencies we work with, that we shall endeavour to constantly inculcate the best of good governance practices in the years to come and shall be happy to share our experiences with them. We are also open to any suggestions to better ourselves in our mission towards the best of governance practices.

### **The Year Ahead**

The Banking landscape in the Sultanate is well poised for a sea change in 2007. With several new local and regional banks setting up or about to commence operations in the Sultanate, and many more waking up to the immense possibilities of the domestic market in Oman, the discerning consumer in the Sultanate will soon have more choice than he/she has ever had in terms of banking products, services and solutions. While this poses a major challenge to the domestic banking industry as a whole, at BankMuscat, we are fully confident that it will indeed spur us on to newer heights.

Competition, it has been proven the world over, is always healthy. And it is the consumer who always stands to benefit. As the market leader, we believe it is our to continue to lead from the front and provide an even broader, relevant and more technologically enabled suite of products, services and solutions to our customers. Our endeavour during the past few years has been to indeed gear up for this change.

The domestic economy is also showing signs of robust growth across industry sectors. And while global energy prices have somewhat softened in the past six months, the wise and visionary policies of His Majesty's Government are well placed to offset any price shocks that the energy prices are likely to witness. With the FTA with the United States of America also being successfully signed and with several more countries and large corporations looking at the Sultanate as a potential destination for FDI, things are only expected to auger well for the nation in the days to come.

The Bank plans to continue to build stronger ties with people across the country and across age-groups with a variety of value-added banking products, services and solutions. It is from here that our philosophy of 'With You Always' stems: building multiple, long-term, sustainable relationships with each of our target customers nationwide.

The Bank shall also continue to foray and emphasize the importance of fee based and commission based value-added services, which today contribute significantly to the bottom line. To this end, the Bank will continue pioneering initiatives that cut through the clutter and command a distinct premium in the days to come. It is only by achieving an ideal balance between its various revenue streams and by moving even closer to the customer with relevant products and superior services that the

Bank can strive to become future proof.

Today, we believe that we are not only ready to take on greater competition at home, but also take competition to our regional peers on their home markets. It is in this regard that the Bank's international operations will continue to gather importance in the days to come.

### **In conclusion**

On behalf of the Board of Directors, I would like to take this opportunity to thank the banking community, both in Oman and overseas, for the confidence reposed in the Bank. I would also like to thank the Management Team and all our employees for their dedication and commitment, without which, the Bank would not be able to continue to strive toward reaching even higher echelons of excellence.

The Board of Directors welcomes and supports the measures taken by the Central Bank of Oman and the Capital Markets Authority with a view to improving the financial markets in the Sultanate. The Bank's growth would not have been possible without the foresight and market-friendly policies adopted by His Majesty's Government.

The Board of Directors is also deeply thankful to His Majesty Sultan Qaboos bin Said for his vision and for ably steering the nation along its path of growth and prosperity.



**AbdulMalik bin Abdullah Al-Khalili**