REPORT OF THE DEPOSITOR COMPENSATION SCHEME FOR 2005

INTRODUCTION

In terms of regulation 8 of LN 369 of 2003, the Compensation Schemes Management Committee of the Depositor Compensation Scheme (hereinafter referred to as "the Scheme") is pleased to present its report on the discharge of its functions and its operations during 2005.

The Scheme's audited financial statements for 2005 are also attached.

MANAGEMENT COMMITTEE

In accordance with regulation 3 of the Regulations, the Scheme is managed and administered by a Management Committee (hereinafter referred to as "the Committee") appointed by the Malta Financial Services Authority. In terms of article 12 of the Investment Services Act and regulations 3 and 5 of LN 368 of 2003 (the Investor Compensation Scheme Regulations, 2003), the Malta Financial Services Authority appointed the Compensation Schemes Management Committee for a period of three years commencing on 1 January 2004. The following persons have served on the Management Committee during 2005:

Chairman
Dr Anton Felice

Members
Mr Charles Borg (*resigned on 21 January 2005*)
Prof Andrew Muscat
Mr Benny Borg Bonello
Mr George F Farrugia
Mr Kenneth Farrugia (*appointed as of 6 September 2005*)
Mr Rene Saliba
Dr Massimo Vella

Mr Geoffrey Bezzina has served as Secretary of the Committee.

The Management Committee held 4 meetings during 2005.

FINANCIAL STATEMENTS AS AT 31 DECEMBER 2005

The Scheme registered a surplus of Lm31,469 in 2005 compared to Lm10,928 in the previous year. Investment income amounted to Lm37,907, from which Lm6,438 have been spent in management and administration expenses. Accumulated capital and reserves amounted to Lm1,298,995.

FUNCTIONS OF THE SCHEME

In terms of regulation 4, the functions of the Scheme are:

(a) To maintain a fund for the payment of claims for compensation by depositors;

(b) To place contributions to the fund on deposit or to invest such funds;

(c) To establish procedures and arrangements for the payment of claims for compensation by depositors;

(d) To handle and pay claims for compensation by depositors;

(e) To advise the Malta Financial Services Authority on matters relating to compensation of depositors.

BUILDING THE FUND

The first function of the Scheme is to build and maintain a fund for the payment of claims to depositors.

The Regulations provide that a minimum amount of Lm1 million is to be contributed proportionately over a period not exceeding five years in accordance with each participants' share of the total eligible deposits.

As at 31 December 2005 all participating licence holders had duly fulfilled their obligation in respect of 2005 to transfer their supplementary contribution to the Fund which, as at 31 December 2005, stood at Lm1,256,854. Moreover there was no special commitment of the Scheme for which it was necessary to raise a Special Contribution.

The Committee, the Malta Bankers' Association (MBA), the Central Bank of Malta (CBM) and the MFSA have discussed at length a number of proposals for the restructuring of contributions from participants. Within the ambit of these discussions, the Committee has raised the need for removing current capping on the financial contribution of participants in order to provide the fund with the financing which is necessary to satisfy additional benefits under EU requirements.

The MBA acknowledges the need for such a review. However, it has insisted that a solution to the current mismatch in the availability of funds should not be found by removing the current capping in the contributions of participants. Instead they have proposed a series of measures whereby the Scheme would enjoy prior ranking rights over a failed bank's assets, including those reserve deposits held with the Central Bank. The MBA has also proposed that Government should guarantee any further inflows of funds.

The Scheme Committee has not favoured the MBA's proposals as these are incongruent with the principle that the banking sector should exercise solidarity in the event of the failure of any one of their members. Indeed, their proposals shift the finance burden on other sectors. They do this by suggesting that the scheme should enjoy preferential rights over a failed bank's assets to the detriment of other creditors including CIR, employees and other privileged creditors. They moreover imply that Government should be the insurer of last resort for any shortfall of proceeds. The Committee has also considered that it would be unable to exercise any rights on a failed bank's reserve requirement with the CBM, since these balances will shortly fall under the jurisdiction of the European Central Bank as a tool of monetary policy.

The Committee has therefore advised MFSA of its position concerning the MBA's proposals and has sought the Authority's guidance on this matter.

As at year end, the matter was still being considered by the parties concerned..

PROTECTION OF FUNDS

The Committee is required to deposit or invest the contributions that are made to the fund, until such time as they are required for the payment of claims for compensation by depositors.

In the performance of this task and in accordance with regulation 7, the Committee appointed the Central Bank of Malta to provide investment management services including financial, accounting and other related support services. This appointment has been effected in terms of an agreement (which was signed in 2003), which established the parameters for the investment of funds of the Scheme.

These parameters apply prudent investment criteria that take account of both the short and long term liquidity requirements of the Scheme.

PROCEDURES FOR THE PAYMENT OF CLAIMS

The third function of the Scheme is to establish procedures for the payment of claims for compensation by depositors.

In this connection, the Committee is required to inform the general public about the procedures and arrangements for claiming against the Scheme. For this purpose it has set up a website (*www.compensationschemes.org.mt*), from where users can obtain information about the scheme. It envisages that an information booklet that describes how depositors may claim against the Scheme and in which circumstances will be published in 2006.

Regulation 11 and 34 require the Committee to consult the relevant compensation schemes in other countries for the purpose of facilitating the procedures by which depositors may claim against the respective Schemes. Claims against foreign schemes may follow defaults by branches of a credit institution, which are situated overseas. The EU Directive 94/19/EC sets out different procedures according to whether the defaulting institution is incorporated in a EU country or a third party state.

During the year, there were no participants with branches outside Malta.

DEPOSITORS' CLAIMS

The fourth function of the Scheme is to handle and pay claims to depositors.

The Committee is pleased to report that during 2005 there have been no defaults of payments by participating credit institutions, which give rise to a claim against the Scheme.

CONSULTATION

The fifth function of the Scheme is to advise the Malta Financial Services Authority on matters relating to depositors' compensation.

Proposed Changes to Regulations

At the time this report is being compiled, the Prime Minister and Minister of Finance, acting on the advice of the MFSA, published and put into force L.N. 35 of 2006 — Depositor Compensation Scheme (Amendment) Regulations, 2006 — which as the title suggests, amends L.N. 369 of 2003 - the Depositor Compensation Scheme Regulations, 2003 ("principal regulations").

Essentially, L.N. 35 of 2006 is intended to harmonise the primary regulations with Directive 94/19/EC on deposit guarantee schemes.

Towards this objective, there are a number of modifications which include the re-definition of "depositor" to include both individuals and small and medium sized companies (with the exception of those entities defined in the First Schedule). The alignment with the Directive has also led to the redrafting of the exclusions list in the First Schedule of the regulations.

As a result of these amendments, the compensation limit in the proviso to regulation 17 has been deleted and the Scheme now protects all deposits in every currency of the European Union (regulation 18).

The extension of protection to deposits in every currency of the EU and the re-definition of "depositors" will have these effects:

(a) current members will be required to contribute more to the Scheme as their deposit base will be greater; and
(b) a number of other banks (currently not members of the Scheme) will become participants and will be required to make similar annual contributions (based on their respective deposit base).

As stated earlier (see "Building the Fund" above), the Malta Bankers' Association has objected to further proposed amendments which would require additional commitment from participants. This aspect is still the subject of consultation.

In addition there are a number of minor amendments that improve the legislation.

FEEDBACK TO THE EUROPEAN COMMISSION

The Scheme put forward its comments to the European Commission following the publication of a consultation working paper on the review of the Deposit Guarantee Scheme Directive.

In its response, the Scheme expressed the view that an examination of the DGS Directive should form part of a broader review which involves other schemes — including the Investor Compensation Scheme Directive 97/9/EC — as well as the proposed insurance insolvency scheme. This approach is justified because of the overlap of financial products and the fact that many Member States have adopted a common structure for both the depositor and investor compensation schemes.

In the protection to be given to depositors, the Scheme was of the view that a balance should be struck between the level of coverage and the financial sustainability of a scheme. Because of economic and cost considerations, the Scheme does not believe that it is opportune at the present moment to expand the present level of protection of EUR20,000. Nor does it favour the removal of the present level of co-insurance since this can lever against moral hazard. The Scheme favours a *de minimis* clause because the economic cost for processing small deposits (say, less than EUR100) will exceed the economic gain derived from compensating a depositor who holds such an amount at a failed bank.

The Scheme was of the opinion that the method of financing depositor compensation schemes should continue to be governed by the Member State where the credit institution is established. Nevertheless the Scheme would agree with any initiative that encourages Member States to adopt a higher level of ex-ante contributions.

The Scheme put forward the suggestion that the Commission should consider the addition of a recital specifying the implications to a Member State which has opted for a low or unfunded ex-ante scheme. This should emphasise that in the event of a severe or medium sized failure, such schemes would be unable to respond without impacting adversely on the financial stability of other credit institutions, or alternatively, with transferring the liability to the State. For this reason, the Scheme supports a debate with stakeholders as to the most appropriate level of ex-ante funding, which would include a study on the appropriateness of risk-based criteria in the levying of ex-ante contributions.

EUROPEAN FORUM OF DEPOSIT INSURERS (EFDI)

The Scheme is a full member of the European Forum of Deposit Insurers. EFDI was launched in Vienna in October 2002 and has over 40 members representing 32 European countries. It was established with the aim of contributing to the stability of financial systems by promoting European co-operation in the field of deposit insurance. In furtherance of this aim, EFDI members facilitate discussion and exchange of expertise and information on issues that are of mutual interest and concern (e.g. protection of cross-border services, financial customers' protection in the single market etc.).

During 2005, the Secretary attended EFDI meetings in Berlin and Warsaw on behalf of the Management Committee.

EFDI does not charge a membership fee but it draws funds from sponsors to finance its activities.

LIST OF PARTICIPANTS

APS Bank Limited
Bank of Valletta plc
HSBC Bank Malta plc
Lombard Bank Malta plc
Volksbank Malta Limited
HSBC Home Loans Limited

Dr Anton Felice
Chairman – Depositor Compensation Scheme Management Committee

13 June 2006

Attachment: Audited Financial Statements of the Depositor Compensation Scheme for 2005

Depositor Compensation Scheme
Report and financial statements
For the year ended 31 December 2005

Table of contents

Statement of responsibilities of the Management Committee

The Management Committee consists of the Chairman and the Committee Members, who are to ensure that:

a. proper accounting records are kept of all transactions entered into by the Scheme and of its assets and liabilities

b. adequate controls and procedures are in place for safeguarding the assets of the Scheme and the prevention and detection of fraud and other irregularities.

The Depositor Compensation Scheme Regulations requires that financial statements are prepared for each financial year. In preparing those financial statements which give a true and fair view of its state of affairs as at the end of the financial year and of its surplus or deficit for that year, the Management Committee:

- adopts the going concern basis unless it is considered inappropriate;
- selects suitable accounting policies and then applies them consistently;
- makes judgements and estimates that are reasonable and prudent;
- accounts for income and charges relating to the accounting period on the accruals basis;
- values separately the components of asset and liability items; and
- reports comparative figures corresponding to those of the preceding accounting period.

Report of the auditors to the Committee

We have audited the financial statements on pages 3 to 10. These financial statements are the responsibility of the Management Committee. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements give a true and fair view of the state of affairs of the Scheme as at 31 December 2005 of its surplus, changes in equity and cash flows for the year then ended in accordance with International Financial Reporting Standards and have been properly prepared in accordance with the Depositor Compensation Scheme Regulations.

Austin Demajo
f/Grant Thornton

Certified Public Accountants

Grant Thornton House
Princess Elizabeth Street
Ta' Xbiex MSD 11
Malta

30 March 2006

Income and expenditure account

	Note	2005 Lm	2004 Lm
Income	3	**37,907**	17,657
Administrative expenses		**6,438**	6,729
Surplus for the year	4	**31,469**	10,928

Balance sheet at 31 December

	Note	2005 Lm	2004 Lm
Non-current assets			
Financial assets	6	1,294,167	865,871
Current assets			
Debtors	7	4,869	2,230
Cash at bank and in hand		3,125	(1,062)
		7,994	1,168
Creditors : amounts falling due within one year	8	3,166	427
Net current assets		4,828	741
Net assets		1,298,995	866,612
Capital and reserves			
Contributions fund		1,256,854	855,940
Income and expenditure account		42,141	10,672
		1,298,995	866,612

The financial statements on pages 3 to 10 were approved by the Management Committee on 30 March 2006 and were signed on their behalf by:

Dr. Anton Felice
Chairman

George Farrugia
Member

Statement of changes in net assets/equity

	Contributions fund Lm	Income and expenditure account Lm	Total Lm
At 31 December 2003	444,793	(256)	444,537
Contributions during the year	411,147	-	411,147
Surplus for the year	-	10,928	10,928
At 31 December 2004	855,940	10,672	866,612
Contributions during the year	400,914	-	400,914
Surplus for the year	-	31,469	31,469
At 31 December 2005	**1,256,854**	**42,141**	**1,298,995**

Cash flow statement

	Note	2005 Lm	2004 Lm
Operating activities			
Cash generated from operations	10(a)	**4,741**	4,415
Investing activities			
Payments to acquire financial assets		**(2,952,035)**	(815,475)
Proceeds on maturity of financial assets		**2,550,567**	-
Net cash used in investing activities		**(401,468)**	(815,475)
Financing activities			
Contributions received		**400,914**	411,147
Net increase/(decrease) in cash and cash equivalents		**4,187**	(399,913)
Cash and cash equivalents at beginning of year	10(b)	**(1,062)**	398,851
Cash and cash equivalents at end of year	10(b)	**3,125**	(1,062)

Notes to the financial statements

1 Presentation of financial statements

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS).

These financial statements are presented in Maltese Liri (Lm).

2 Summary of significant accounting policies

The financial statements have been prepared on the historical cost basis. The principal accounting policies are set out below.

Income recognition

The Scheme's income consists of earnings on investments. Income is recognised on the accruals basis.

Impairment

At each balance sheet date the Scheme reviews the carrying amounts of its assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any).

If the recoverable amount of an asset is estimated to be less than its carrying amount, the carrying amount of the asset is reduced to its recoverable amount. Impairment losses are recognised as an expense immediately.

Where an impairment loss subsequently reverses, the carrying amount of the asset is increased to the revised estimate of its recoverable amount, but so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognised for the asset in prior years. A reversal of an impairment loss is recognised as income immediately.

Financial instruments

Financial assets and financial liabilities are recognised on the Scheme's balance sheet when the Scheme has become a party to the contractual provisions of the instruments.

Notes to the financial statements (continued)

2 Summary of significant accounting policies (continued)

Investments in securities

Investments in securities are recognised on a settlement date basis and are initially measured at cost.

At subsequent reporting dates, loans and receivables and held-to-maturity investments are carried at amortised cost using the effective yield method, less any provision for impairment.

Investments in available-for-sale securities are measured at subsequent reporting dates at fair value. For available-for-sale securities, unrealised gains and losses are recognised directly in equity until the security is disposed of or is determined to be impaired, at which time the cumulative gain or loss previously recognised in equity is included in the net profit or loss for the period.

Debtors

Debtors are stated at their nominal value as reduced by appropriate allowances for estimated irrecoverable amounts.

Creditors

Creditors are stated at their nominal value.

3 Income

	2005	2004
	Lm	Lm
Earnings on investments	**11,079**	5,518
Amortisation of premium and discount	**26,828**	12,139
	37,907	17,657

4 Surplus for the year

	2005	2004
	Lm	Lm
The surplus for the year is stated after charging:		
Committee Members' honoraria	**5,240**	5,562
Auditors' remuneration	**177**	177

Notes to the financial statements (continued)

5 Taxation

The Depositor Compensation Scheme is exempt from taxation under section 28A of the Banking Act, Cap. 371.

6 Financial assets

	2005 Lm	2004 Lm
5.1% Malta Government Stocks 2014	**25,000**	25,000
5.1% Malta Government Stocks 2022	**40,900**	40,900
5.5% Malta Government Stocks 2023	**20,000**	20,000
3.8% EIB Bond 2009	**26,000**	26,000
5% Malta Government Stocks 2021 F1	**100,000**	-
5% Malta Government Stocks 2021 F1C	**50,000**	-
Treasury Bills	**1,032,267**	753,971
	1,294,167	865,871

Note -

The fair value of financial assets at 31 December 2005 amounted to Lm 1,313,510 (2004: Lm 867,649).

7 Debtors

	2005 Lm	2004 Lm
Amounts falling due within one year:		
Other debtor	**-**	10
Prepayments and accrued income	**4,869**	2,220
	4,869	2,230

8 Creditors: amounts falling due within one year

	2005 Lm	2004 Lm
Accruals	**3,166**	427

Notes to the financial statements (continued)

9 Financial instruments

Financial assets include securities, debtors and cash held at bank and in hand. Financial liabilities include creditors. At 31 December 2005 and 2004 the Scheme had no unrecognised financial instruments.

Risk management policies

(a) Credit risk on amounts receivable is limited through the systematic monitoring of outstanding balances and the presentation of debtors net of allowances for doubtful debts, where applicable. Cash is placed with reputable banks.

(b) Liquidity risk is limited as the Scheme has sufficient funding resources to meet its financial obligations as these arise.

Fair values

At 31 December 2005 and 2004 the fair values of financial assets, other than securities, and liabilities of the Scheme were not materially different from their carrying amounts except as disclosed in note 6.

10 Notes to the cash flow statement

(a) Cash generated from operations

	2005 Lm	2004 Lm
Surplus for the year	**31,469**	10,928
Adjustment for:		
Interest receivable	**(4,869)**	(2,220)
Amortisation of discount on Treasury Bills	**(26,828)**	(5,396)
Operating (deficit)/surplus before working capital changes	**(228)**	3,312
Increase in creditors	**2,739**	-
Decrease in debtors	**2,230**	1,103
	4,741	4,415

(b) Cash and cash equivalents

Cash and cash equivalents consist of cash in hand and balances with banks. Cash and cash equivalents included in the cash flow statement comprise the following balance sheet amount:

	2005 Lm	2004 Lm
Cash in hand and balances with banks	**3,125**	(1,062)

Income and expenditure account (detailed)

	2005 Lm	2004 Lm
Income		
Earnings on investments	**11,079**	5,518
Amortisation of premium and discount	**26,828**	12,139
	37,907	17,657
Administrative expenses		
Committee Members' honoraria	**5,240**	5,562
Management fees	**250**	250
Auditors' remuneration	**177**	177
Travelling expenses	**771**	730
Postage	**-**	10
	6,438	6,729
Surplus for the year	31,469	10,928