



# MEDITERRANEAN BANK PLC ANNUAL REPORT 2013



# CHAIRMAN'S STATEMENT

During the past financial year, Eurozone countries continued to face important macro-economic challenges, with anaemic growth and ongoing strains in the financial sector. Notwithstanding these challenges, the 2012/13 financial year was a period of considerable growth and development for the Bank, which achieved strong financial results and a broader customer presence.

## BACKGROUND

During the early part of the financial year, many of the extreme stresses experienced during the previous year continued. As it emerged from the shadow of the Greek debt restructuring, the Eurozone was faced with questions and concerns regarding the broader implications of the Greek restructuring and the likelihood that it would be repeated in other jurisdictions. Markets remained highly fragile in early summer, with increasing focus on Spain and Italy amidst concerns about the health of their respective banking systems and the prospect of little or no economic growth. As policymakers scrambled for solutions, concerns regarding the future of the Eurozone intensified. Market respite finally came in the form of the Governor of the ECB, Mario Draghi, who pledged he would do "whatever it takes" to preserve the Eurozone. Together with accommodative policy actions, this pledge gave markets a significant confidence boost and led to the discounting by the markets of the possibility of a Eurozone break up. This in turn led to a sustained and powerful rally in Eurozone assets, underpinned by record low interest rates and excess liquidity in the financial system. The market rally had a particularly strong impact on peripheral Europe and brought a significant reduction in the trading spreads of government debt. The increase in market confidence enabled programme countries such as Ireland and Portugal to gain access to international funding markets and to provide a path for such countries to exit EU and IMF support.

Increasing optimism in European financial markets was supported by a recovery in the US economy, a strong performance by equity markets and a general sense that the broader global economy was finally turning a

corner, with vigorous policy actions being undertaken in countries such as Japan. The dark clouds of the Eurozone, however, never seemed to be too far away and returned with a vengeance in March 2013 in the guise of the Cypriot bailout. As a result of the unique peculiarities of the Cyprus situation, in order to address the sustainability of Cyprus's debt profile, it was proposed that a haircut in the form of a tax would be imposed on Bank depositors (a first for the Eurozone). Initially, the proposed package involved a tiered haircut on all depositors, including those with deposit balances of €100,000 or less which benefitted from the Cyprus deposit guarantee scheme. After a frantic second round of negotiations and following parliamentary rejection of the initial agreement, it was decided not to haircut deposits of €100,000 or less. The terms of the bailout

Francis J. Vassallo  
Chairman





of Cyprus may have profound implications on the future path of debt restructurings in Europe, potentially relieving governments of the burden of supporting over-stretched banking sectors but imposing far greater risks on bank investors and depositors. After an initial period of uncertainty, the markets appear to have taken these latest developments in stride and to be treating the Cypriot situation as unique. However, fundamental policy changes within Europe regarding bank resolution appear to be a part of a new paradigm and only time will tell how this affects the proposed European Banking Union.

The broader problems of the Eurozone seem to have affected Malta less than most Eurozone countries, with Malta experiencing relatively resilient economic activity and relatively low unemployment rates. However, following the Cyprus restructuring, there has been increasing market focus on the banking sectors of smaller economies, particularly Malta and Luxembourg, with comparative analyses relative to Cyprus being undertaken by various analysts and official bodies. Unquestionably, the situation that Malta faces is fundamentally different from that faced by Cyprus, in large part because of the domestic funding models of Maltese core banks and very different asset profiles.

The Bank has continued to grow its business in Malta geographically, through additional branch openings and more importantly by significantly increasing its product offering to both retail and corporate customers. We are committed to continuing to diversify our product offering in the Maltese market.

## DEVELOPMENTS

The financial year 2012/13 has been a significant one for the Bank, characterised by a growing equity base, customer base and product offering. This growth has been supported by continued investment in technology, people and capabilities.

I am pleased to report that during the past financial year, the Bank's Own Funds grew from €73.14 million to €123.70 million, a significant increase in its capital base. This increase demonstrates the commitment of the Bank and its shareholders to growth and investment which has been at the core of the Bank's philosophy since its purchase by AnaCap in 2009. In addition, building upon the success of its previous bond issues, we successfully

placed into the local market an over-subscribed €12.5 million Tier 2 subordinated bond in November 2012. This bond increased further the Bank's capital base, providing a solid platform from which to diversify the Bank's balance sheet and product offering.

Having successfully implemented a new core banking system in the prior year, the Bank carried out its plan to launch a highly innovative low cost execution platform for international and domestic investment products. The new platform brings to the Maltese market access to a one-stop-shop for a broad array of savings and investments products enhanced by free investment research and financial planning tools. We also rolled out a new corporate e-platform that enables our growing corporate customer base to access on a 24/7 basis a cost efficient payments platform and a highly competitive foreign exchange execution service. These capabilities underpin our future growth strategy and we are pleased to report their successful implementation and a very positive customer response.

The Bank also successfully executed its strategy to grow the branch network in Malta, with the opening of branches in Qormi in May 2012 and Gozo in August 2012. In addition, in March 2013 the Bank completed the relocation of its Sliema Branch to a new flagship site. This enhancement of the branch network underpinned the success of our Consumer Banking strategy. Although we have no plans to open additional branches, we continue to invest in the products and services offered through our existing branches which we believe will continue to be the cornerstone of our success in Malta.

## OUTLOOK

We expect that the macro-economic environment will continue to be challenging, particularly within the Eurozone where many hurdles and obstacles remain to be overcome. However, the economic environment remains fragile, there appears to be emerging is a broader sense of optimism that a corner has been turned and the worst of the crisis is behind us. Let us hope so.

We remain confident that the business strategy employed by the Bank is fundamentally sound and increasingly attractive. That strategy is characterised by a cost efficient, scalable customer platform that delivers to our retail customers consistent, transparent and competitive



solutions in the savings and wealth management arenas, whilst providing similar cost effective solutions to our growing corporate customer base. That strategy will be significantly enhanced during summer 2013 as we embark on our most exciting phase of growth to date with the launch of our internet-based Belgian branch. Building on the competitive foundations that we have established in Malta, we believe that we can deliver an attractive customer proposition to an international audience and are excited by the prospects that this brings..

## CONCLUSION

In what has been a period of remarkable growth, the Board has ensured that the Bank remains focused on a strategy which remains robust and sustainable. Paramount to this has been balance sheet discipline, which remains key to all current and future developments and is central to the way the Bank operates. This strategy continues to provide the appropriate path for all stakeholders of the Bank to follow.

**FRANCIS J. VASSALLO**  
**CHAIRMAN**

9 May 2013

Recommended asset mix for you is...



# CHIEF EXECUTIVE OFFICER'S REVIEW

As noted by the Chairman, the 2012/13 financial year has been a busy and productive period in the development of the Bank with the introduction of new products and services, the ongoing expansion of our branch network and continued investment in systems and capabilities that will underpin our future plans for expansion.

As has been done over the past three years, we continued to follow a policy of managing the Bank's balance sheet with a conservative approach to both its capital and liquidity ratios. While keeping to that policy, we have, over the past twelve months, undertaken a significant evolution of both our asset and liability profile. Deposit growth was consistently strong, ending the period at €566 million (an increase of 49%). This growth was driven by our efforts in both the consumer and corporate banking sectors and enabled us to build a longer term profile to the Bank's liability structure, with the average maturity of its deposit book being close to two years at 31 March 2013. Additionally, during the financial year, a large international financial institution extended to the Bank a three year bi-lateral term funding facility for corporate loans and bonds. Combined with the stability in the Bank's deposit base, this facility enabled us to build rapidly the Bank's international corporate lending and bond portfolio. At year end, the Bank's corporate lending portfolio stood at €460 million (including senior secured bonds of €55 million and high yield bonds of €5 million). The portfolio is diversified geographically and across industries, with most lending focused on core European countries and the UK. The portfolio consists principally of senior secured loans and bonds which benefit from structural protection. We continue to pursue further opportunities to develop our funding base which will allow us to continue to build our corporate lending profile. During the first half of the new financial year, we will endeavour to extend the Bank's corporate lending activities to the Maltese domestic market.

The Bank's core competency of treasury management operations continued to drive our ability to offer competitive savings products and reaped the ongoing benefits of the strategy put in place to mitigate the impact of the Euro crisis. Focus continued to be placed on extremely high

credit quality instruments, which performed extremely well through the period, benefitting from the ongoing low yield environment and market demand for the highest quality assets. The successful execution of this strategy has enabled the Bank to grow its capital base ahead of projections. As of the end of the 2012/13 financial year, Own Funds stood at €123.7 million (an increase of 69%). Contributing further to the growth of the Bank's capital base has been the highly successful issue of €12.5 million Tier 2 subordinated bonds, listed on the Malta Stock Exchange. This represents the Bank's first capital raise outside the original shareholder group and I would like to take this opportunity to thank our investors who subscribed to the issue, ensuring its success and allowing the Bank to develop further its balance sheet and product offering.

■ Mark A. Watson  
Chief Executive  
Officer





Financial performance for the year improved significantly from 2012 and reached record levels. Full year profit before tax was €31.5 million and we enter 2013/14 confident that our path to profitability is robust and sustainable. As a result of the evolution in the Bank's asset base, the Bank is now operating and expects in future to operate with a lower Tier 1 ratio than had historically been the case when capital principally supported the treasury portfolio. As of 31 March 2013, the Bank reported a Tier 1 ratio of 12.89% and a total capital ratio of 15.66%. The Tier 1 ratio is an international benchmark of balance sheet strength, with a current statutory minimum of 4%. The overall balance sheet size is now €2.1 billion, reducing overall leverage to 18 times [total equity]. Treasury management continues to focus on ensuring appropriate and adequate liquidity at all times. At year-end, the Bank's liquidity ratio was 90% (compared with a regulatory minimum of 30%).

The success of our deposit strategy has been bolstered by continued innovation in the development of attractive savings products. In that regard, I am pleased to report the highly successful launch of the "Me3" savings account, a savings account requiring three month notice of withdrawal that pays a competitive savings rate while providing Treasury with an excellent tool for liquidity management. For the first time, the Bank reduced interest rates on a number of its deposit products with no discernible impact on generation of deposits. We remain committed to providing overall consistency in the provision of competitive savings products but believe that going forward, the development of our brand and market presence will enable us to fine tune our offering and rates as we further develop our balance sheet and asset profile.

The 2012/13 financial year also witnessed the launch of several initiatives to enhance our customer offering. In the early part of the year, we launched our corporate internet banking platform which enables corporate customers to access and instruct multiple payment options and facilities. These include cost effective onward payment solutions and an innovative online foreign exchange facility, giving our customers instant access to international foreign exchange trading markets. In the last quarter of the year, we publicly launched our retail internet banking platform in conjunction with our Electronic Investment Platform. The Electronic Investment Platform provides our customers with access to multiple international stock markets, thousands of internationally-issued bonds and an extensive array of mutual funds from the world's leading fund managers, all supported by market research from Morningstar, one of

the world's leading investment research providers. This user friendly, integrated platform provides daily portfolio valuations with 24/7 access and has created a broader path from which to service our existing and future client base.

We look forward to the 2013/14 financial year with a good degree of optimism and are confident that we can continue on the path of focused expansion. Building on the myriad investments we have made over the last 24 months, we are about to embark on our most ambitious plan to date with the opening of our Belgian branch. Using the infrastructure we have created in Malta and supported by our efficient Maltese processing capability, we will launch in Belgium with a highly innovative, information rich but cost competitive offering directed toward the mass affluent audience. We will operate for the first time under a different brand, "Medirect", with a refreshed image in keeping with the internet-based offering that will be our principal channel for addressing the Belgian market.

As always, I would like to extend my thanks to our employees who have, in the face of many challenges, continued to deliver the high level of customer service with which we have become synonymous. Our staff numbers have grown significantly this year and we approach our new financial year with a full-time complement of close to 200 employees. The growth, in our employee base is expected to slow over the next 12 months as we have now achieved critical mass in many of our core functionalities and can now operate in a scalable manner and support our international operations.

We end the 2012/13 financial year with a larger capital base and a broader business model. We believe that the new financial year will undoubtedly bring with it another series of challenges. However, with continued focus and operational discipline, we are confident that our underlying business strategy will deliver broad based sustainable returns that create value for all of our stakeholders and most importantly, our customers and shareholders.



**MARK A. WATSON**  
**CHIEF EXECUTIVE OFFICER**

9 May 2013



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## Statement of Compliance with the Principles of Good Corporate Governance

### Introduction

Mediterranean Bank plc (the “Bank”) hereby reports on the extent to which the Code of Principles of Good Corporate Governance (the “Code”) have been adopted as required by the Listing Rules of the Malta Listing Authority as amended on 12 December 2012.

### Compliance with the Code

#### *Principles 1 and 3: Board of Directors and composition of the Board*

The Board of Directors (the “Board”) is composed of persons with a diverse range of skills and experience acquired in senior roles with international banks and financial organisations, professional firms and governmental entities. At 31 March 2013, the Board consisted of three non-executive members and four executive members. Taking into account certain factors such as the size of the Bank, the size of the Board and the balance of skills and experience represented by its members these are considered to be appropriate for the requirements of the business of the Bank.

In line with the Bank’s Articles of Association, the Chairman of the Board and Board directors resign and seek re-election at each Annual General Meeting of the Bank. All directors are required to be fit and proper to direct the business of the Bank.

#### *Principle 2: Chairman and Chief Executive*

The positions of Chairman and Chief Executive are held by different individuals, which avoids concentration of authority and power in one individual and differentiates the leadership of the Board from that of the running of the business of the Bank.

#### *Principles 4 and 5: Responsibilities of the Board and Board meetings*

The Board has the first level responsibility for executing the four basic roles of corporate governance namely: accountability, monitoring, strategy formulation and policy development.

### Functioning of the Board

The Board of Directors reviews and evaluates corporate strategy, major operational and financial plans, risk policy and performance objectives. The Board monitors implementation of its decisions and corporate performance, taking into account the requirements of all relevant laws, regulations and codes of best business practice. In particular, the Board:

- defines the Bank’s strategy, policies, management performance criteria and business policies;
- establishes a clear internal and external reporting system so that the Board has continuous access to accurate, relevant and timely information;
- assesses and monitors the Bank’s present and future operations, opportunities, threats and risks in the external environment and current and future strengths and weaknesses;
- evaluates management’s implementation of the Bank’s corporate strategy and financial objectives using key performance indicators;
- ensures that the Bank has appropriate policies and procedures in place to enable the Bank and its staff to comply with the highest standards of corporate conduct, including compliance with applicable laws, regulations and business and ethical standards; and
- ensures that the financial statements of the Bank and the annual audit of such statements are completed within the stipulated time periods.

## Statement of Compliance with the Principles of Good Corporate Governance

Notices of the dates of scheduled meetings of the Board together with supporting materials are circulated to the directors well in advance of such meetings. Advance notice is also given of ad hoc meetings of the Board to allow directors sufficient time to re-arrange their commitments in order to be able to participate. After each Board meeting and before the next meeting, minutes that faithfully record attendance, deliberations and decisions of the Board are prepared and circulated to all directors.

The following list details the members of the Board of directors of the Bank and the members of each of the committees of the Board:

### Board of directors

Since the date of the previous annual general meeting of the Bank, 17 Board meetings were held, including regularly scheduled meetings and telephone conference calls.

		Meetings attended
• Francis J. Vassallo	Chairman & Non-Executive Independent Director	14
• Finlay S. McFadyen	Non-Executive Independent Director	14
• Peter B. Cartwright	Non-Executive Director	14
• Mark A. Watson	Executive Director - Chief Executive Officer	17
• Henry C. Schmeltzer	Executive Director - Legal and Regulatory	16
• Joaquin Vicent	Executive Director - Credit and Investments	15
• Vincent Chatard	Executive Director - Chief Operating Officer	17

### Committees of the Board

Certain responsibilities of the Board of directors are delegated to Board committees. The Board committees play an essential role in supporting the Board in fulfilling its responsibilities and ensuring that the highest standards of corporate governance are maintained. Each Board committee reports to the Board following each of its meetings and the minutes of meetings of each Board committee meeting are available to the full Board.

#### Board committees

##### A. Audit and Risk Committee

The Audit and Risk Committee is primarily responsible for reviewing and approving specific matters relating to the audit of the Bank, internal control and risk management systems. In particular, the Audit and Risk Committee:

- reviews and approves the annual internal audit plan and subsequent revisions and monitors progress against the annual audit plan;
- ensures that the scope of work performed in accordance with the audit plan is adequate and appropriate;
- vets and approves related party transactions in accordance with Listing Rule 5.138;
- reviews work performed on all audit engagements through presentations made by the Chief Risk Officer; and



## Statement of Compliance with the Principles of Good Corporate Governance

- reviews and interacts with external auditors on the annual statutory audit to obtain feedback on the internal control framework and financial reporting of the Bank.

The members of the Audit & Risk Committee are:

- Finlay S. McFadyen                      Committee Chairman and Independent Non-Executive Director
- Peter B. Cartwright                      Member and Non-Executive Director
- Francis J. Vassallo                      Member and Independent Non-Executive Director / Chairman of the Board

Mr Francis J. Vassallo was appointed by the Board as the independent director who is competent in accounting and/or auditing in terms of listing rules 5.117 and 5.118. Mr Vassallo occupied various senior positions with Chase Manhattan Bank, is ex-Governor of the Central Bank of Malta, ex-Chairman of the Malta Development Corporation and presently a member of numerous boards of directors of entities operating in the financial services industry. Mr Vassallo is deemed independent because he is free from any business, family or other relationship with the Bank or its management that may create a conflict of interest such as to impair his judgment.

During the year ended 31 March 2013, four quarterly meetings of the Bank's Audit and Risk Committee were held. In addition, the chairman of the committee held regular discussions with the Bank's internal auditors without the presence of an executive director.

As a result of the increased size of the Bank's product base and range of operations, it is the Bank's intention to replace the Audit and Risk Committee with an Audit Committee and a separate Risk Committee.

### ***B. Nomination and Remuneration Committee***

The Nomination and Remuneration Committee is described in the Remuneration Report.

The Nomination and Remuneration Committee is composed only of non-executive directors with no personal financial interest. The Chairman is an independent non-executive director.

### ***C. Board Executive Committee***

The Board Executive Committee was established in order to facilitate the day to day activities of the Bank including approval of asset purchases, approval of the establishment and modification of bank accounts and banking relationships, waiver of specific provisions of compliance requirements, limitation of signatory authorisation, dealing with investment portfolio/trading/operational matters and issuance of certified extracts of Board resolutions.

The members of the committee are:

- Mark A. Watson                      Committee Chairman & Executive Director
- Henry Schmeltzer                      Member & Executive Director
- Vincent Chatard                      Member & Executive Director

This committee operated throughout the reporting period and met on an ad hoc basis when specific issues were to be considered.

## Statement of Compliance with the Principles of Good Corporate Governance

### Principal Management committees

#### A. *Executive Management Committee (EXCO)*

The EXCO takes day to day responsibility for the efficient operation of the Bank. In addition, the EXCO is responsible for the formulation and implementation of Board-approved strategies and plans and for ensuring that the Bank's business is operated in accordance with such strategies and plans.

The members of the EXCO include the Bank's Chief Executive Officer, Head of Legal and Regulatory Affairs, Head of Credit and Investment, Chief Operating Officer, Chief Financial Officer and Head of Personnel and Administration. The EXCO meets three times each month.

#### B. *Management Credit Committee*

The Management Credit Committee is responsible for approving credit recommendations and making other credit decisions under its delegated authority - this includes decisions on individual credits; reviewing and recommending credit to the Board; monitoring adherence to large exposure limits; consideration of credit hedging strategies; and recommending other concentration limits for Board approval. It also establishes transactional authority for members of the Credit and Investment Department. In addition, the Management Credit Committee reviews provisioning and lending policies; monitors the Bank's investment portfolios and reviews Management Information reports.

The members of the Management Credit Committee include the Bank's Chief Executive Officer, Head of Credit and Investment, Head of International Investment Strategy and Chief Risk Officer. The committee meets regularly on an ad hoc basis.

#### C. *Asset & Liability Committee (ALCO)*

ALCO sets and reviews overall policies and objectives for asset and liability management, capital management and allocation; capital usage and efficiency; transfer pricing; risk management; and underwriting, dealing and trading activities according to the risk appetite set by the Board.

The members of ALCO include the Bank's Head of Treasury, Chief Executive Officer, Head of Credit and Investment, Chief Financial Officer and Chief Risk Officer. ALCO has scheduled meetings monthly but also holds additional ad hoc meetings.

### Code Provision 4.2.7 - Succession Planning

The Bank has established a list of Key Personnel Substitutes to cover instances in which executive directors or other key personnel are temporarily incapacitated or otherwise unable to complete their duties for a significant period of time.

If such directors or key personnel are permanently unable to re-assume their duties, the Bank's management, in consultation with the Board, will designate permanent successors, either from the Bank's existing management team or, if appropriate, by selecting an outside candidate.

## Statement of Compliance with the Principles of Good Corporate Governance

### ***Principle 6: Information and professional development***

In addition to the responsibilities of the Board listed above, in line with Principle 6, the Board actively participates in the appointment of senior management. Board members receive regular updates on the Bank's strategic, operational, corporate governance, compliance, risk management and financial plans and objectives.

### ***Principle 7: Evaluation of the Board's performance***

During the year, the Board carried out an evaluation procedure whereby Board members were requested to complete a questionnaire of the Board's performance and that of its committees. The evaluation was co-ordinated by the Board's Chairman, a non-executive director and all directors participated in the process as a sub-committee of the Board. Feedback from the evaluation was presented to the Board for analysis. It was concluded that no material changes to the Bank's Board governance and procedures were necessary.

### ***Principles 9 and 10: Relations with Shareholders and with the market and institutional Shareholders***

Through public announcements, the Bank's website, financial reports and interaction with the general media in Malta, the Bank provides the market with regular, timely, accurate, comprehensive and comparable information in sufficient detail to enable investors to make informed investment decisions in respect of the Bank's listed securities.

The Bank's controlling institutional shareholder is represented on its Board of directors and actively monitors its investment in the Bank.

### ***Principle 11: Conflicts of interest***

The Bank's Articles of Association provide that any director who is in any way, whether directly or indirectly, interested in a transaction or proposed transaction with the Bank must (i) declare to the other directors the nature of such interest, (ii) not participate in or be present for any discussion relative to any such transaction or proposed transaction, and (iii) not vote in respect of any such transaction or proposed transaction.

On joining the Board and regularly thereafter, directors are informed and reminded of their obligations in respect of dealing in securities of the Bank within the parameters of law and the Listing Rules.

### ***Principle 12: Corporate social responsibility***

As a Maltese bank, Mediterranean Bank is proud to play its part in contributing to the community by supporting and promoting culture, sport, heritage and charitable causes. The Bank's commitment to these initiatives was demonstrated during the year ended 31 March 2013 by its sponsorship and support of a number of important organisations serving Malta.

The Bank supported the Maltese sporting community through its patronage of the Malta Rugby Football Union during the 2012-2013 season. The Bank's sponsorship assists the Union's development on an international level, supports the local game and also the Union's participation in the European Sevens competition.

## Statement of Compliance with the Principles of Good Corporate Governance

Encouraging Maltese youth and elderly to participate in activities is another major area of the Bank's efforts in the area of social responsibility. The Bank supported a range of activities including, amongst others, Id-Dar tal-Providenza, an Easter tournament organised by San Gwann Youth Nursery, a Lejla Maltija organised in collaboration with the Qormi Local Council and the Anici Band Club, Qormi, the Marsacala Water Sports Club, Otters Water Polo Club in Gozo, Oasi Foundation in Gozo, the Salesian Brigade, Nadur Football Club and Fondazzjoni Dun Nerik.

In November 2012, the Bank launched an art competition called ATM - Art That Matters - for emerging artists in Malta and abroad. The competition was organised by the Bank in collaboration with So Galerie to encourage emerging artists of any age to interpret the spirit of Mediterranean Bank through their art, utilising different media including photography, painting and sculpture. Twenty-five works were chosen as part of an exhibition that was organised by the Bank to provide exposure to the participating artists.

As part of the Bank's corporate social responsibility programme, it also continues to support and promote the performing arts. The Bank will once again be the principal benefactor of The Manoel Theatre during its 2012 / 2013 season. It also provides significant support to The Malta Philharmonic Orchestra, supporting its Baroque Concert series. The Bank was also the main sponsor of the 2013 Malta Eurovision Song Festival.

Finally, the Bank also made a donation to The Malta Community Chest Fund during L-Istrina and The Ladybird Foundation benefitted from the Bank's Medbank-4-Charity Christmas campaign and its support of Run 51.

### Listing Rules

At each meeting, the Audit and Risk Committee, which is responsible for the vetting and approving of related party transactions in accordance with the listing rule 5.138, receives notices of all the related party transactions and balances.



## **Statement of Compliance with the Principles of Good Corporate Governance**

### **Other Disclosures**

Francis J. Vassallo, who is the non-executive Chairman and independent director of the Bank, retired on 10 May 2012 as a member of the Board of directors of FIMBank plc, a credit institution licensed in terms of the Banking Act, Cap. 371 of the Laws of Malta.

### **Licence and hosting agreement**

On 1 September 2011, the Bank entered into a computer software licence and maintenance agreement with Intelligent Environments Europe Ltd (IE), pursuant to which IE licensed to the Bank in perpetuity its Netfinance e-banking application and related software and to provide maintenance services in respect of such applications for a minimum term of three years.

On 24 October 2011, the Bank entered into a hosting services agreement with IE, pursuant to which IE agreed to host the Bank's website and related back end connectors. The term of the hosting services agreement is three years.

### **Licence and hosting agreement**

On 9th December 2011, the Bank entered into a computer software license and hosting agreement with MBA Systems Limited (MBA), pursuant to which MBA licensed to the Bank for use in Malta its Internet Broker IB.Net application and related software and to provide maintenance and hosting services in respect of such applications for the three-year term of the agreement.

On 19th March 2013, the Bank entered into a further contract with MBA extending the licence and hosting agreement to the Bank's Belgian operations and extending both contracts to 26th November 2015.

### **Professional services agreement and software licence agreement**

On 10 August 2010, Infosys Technologies Limited (Infosys) and the Bank entered into agreements pursuant to which Infosys (a) granted the Bank a perpetual, irrevocable, non-exclusive, non-transferable, limited licence to use its proprietary software Finacle (a banking software product) in accordance with the terms of the software licence agreement and to provide maintenance services in relation thereto; and (b) agreed to provide the Bank with professional services in relation to the installation, customisation, development, parameterisation, training, testing and implementation of the licensed software, subject to the terms and conditions contained in the said agreement.

Effective 30 November 2011, the Bank's contracts with Infosys were assigned to its affiliate, Medifin Leasing Limited.

### **Software licence agreement**

On 14 August 2009, SunGard Front Arena AB (SunGard) and the Bank entered into an agreement pursuant to which SunGard provided a personal, non-transferable, non-exclusive, limited-scope, term licence in favour of the Bank, subject to the payment of a license fee, yearly support fees, as well as professional services fees, expense reimbursements and taxes, all as specified in the agreement. The licence provided to the Bank relates to the Front Arena trading and risk management system under which the Bank can enter and execute new trades, manage asset and liability risk and perform risk and portfolio management. The initial licence term duration is five years from the specified date, after which the renewed licence term will continue unless terminated by either party giving the other party not less than six months prior notice. The Bank or

## Statement of Compliance with the Principles of Good Corporate Governance

SunGard may immediately terminate the agreement by giving a written notice of termination, upon the occurrence of certain events set forth in the agreement.

### Consulting and information services

On 1 June 2011, the Bank entered into an agreement with Morningstar Associates Europe Limited (Morningstar) whereby Morningstar provides consulting services to the Bank in respect of the Bank's wealth management and portfolio planning services. The initial term of the agreement is three years.

On 1 June 2011, the Bank entered into an agreement with Morningstar UK Ltd. to license certain Morningstar analytical tools for use by the Bank in Malta.

On 30 March 2012, the Bank entered into agreements with Morningstar UK Ltd. to license the Morningstar Document Library and certain Morningstar Data Packages.

On 21 May 2012, the Bank entered into an agreement with Morningstar UK Ltd. to license certain Morningstar data feed information for use by the Bank in Malta.

## Statement of Compliance with the Principles of Good Corporate Governance

### Management's internal controls over financial reporting

The Board is responsible for ensuring that the Bank's senior management develops and implements a sound system of internal controls and for reviewing its effectiveness. Such a system is designed to manage, rather than eliminate, the risk of failure to achieve business objectives and can only provide reasonable and not absolute, assurance against material misstatement or loss. The Bank operates a system of internal control which provides reasonable assurance of effective and efficient operations covering all controls, including financial and operational controls and compliance with laws and regulations. Processes are in place for identifying, evaluating and managing the significant risks facing the Bank.

The management of the Bank is responsible for instituting and preserving sufficient internal control over financial reporting. Internal control over financial reporting is a process designed under the supervision of the Chief Financial Officer to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with International Financial Reporting Standards as adopted by the European Union ("IFRS").

Internal control over financial reporting includes policies and procedures that pertain:

- to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets;
- to providing reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with IFRS;
- to ensuring that receipts and expenditures are made only in accordance with authorisations of management and the respective directors; and
- to providing reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use or disposition of assets that could have a material effect on the financial statements.



Francis J. Vassallo  
Chairman



Mark A. Watson  
Director and Chief Executive Officer

9 May 2013

## **Directors' Report**

### **For the Year Ended 31 March 2013**

The directors present their annual report, together with the financial statements of Mediterranean Bank plc (the "Bank") for the year ended 31 March 2013. This report is prepared in terms of the Companies Act, 1995 (Chapter 386, Laws of Malta) and complies with the disclosure requirements of the Sixth Schedule to the same Act.

#### **Board of Directors**

In accordance with the Bank's Articles of Association, during the Annual General Meeting to be held on 9 May 2013, all the directors serving at that time will retire and offer themselves for reappointment.

The directors of the Bank who held office throughout the year ended 31 March 2013 were:

Mr. Francis J. Vassallo - Chairman  
Mr. Mark Alexander Watson - Chief Executive Officer  
Mr. Peter Bramwell Cartwright  
Mr. Finlay Stuart McFadyen  
Mr. Henry C. Schmeltzer  
Mr. Joaquin Vicent  
Mr. Vincent Chatard

#### **Presentational changes in Financial Statements**

- During the comparative period presented, the Bank changed its accounting reference period from 31 December 2011 to 31 March 2012. Accordingly, the comparative figures presented cover a fifteen-month period from 1 January 2011 to 31 March 2012. Subsequent accounting periods are twelve-month periods ending 31 March. Consequently, the current period presented and related financial information will cover the period from 1 April 2012 to 31 March 2013.
- The Bank's two subsidiaries (Mediterranean Research Limited and Mediterranean Global Advisory SA) are dormant and have been placed into liquidation. The subsidiaries are deemed to be immaterial and not relevant to the operations of the Bank. On 5 June 2012, the Bank established a partnership (Medifin Estates) to enter into property leases on the Bank's branches and to lease them back to the Bank. Medifin Estates is also deemed to be immaterial. Consequently, only the financial statements of the Bank are presented.

#### **Principal activities**

The Bank was granted a licence by the Malta Financial Services Authority (MFSA) in terms of the Banking Act, Chapter 371 of the laws of Malta, on 14 July 2005. The Bank is licensed amongst other things, to carry out the business of banking, to undertake money transmission services, to issue and administer means of payment, to issue guarantees and commitments, to trade on own account and/or for the account of customers in a number of instruments, to provide portfolio management and advice and to provide safe keeping services. The Bank also holds a category 2 and category 4 license issued by the MFSA which authorises the Bank to provide investment services, to hold or control clients' money and to act as trustee or custodian of collective investment schemes.

Profitability has been achieved through the creation of diversified investment portfolio comprising a treasury book consisting of high quality, liquid securities, including senior financial instruments, bank covered bonds, public sector bonds and mortgage bonds and a corporate lending portfolio consisting primarily of senior secured loans and bonds. The corporate lending portfolio largely consists of Western European credits and all loans and bonds in the portfolio are denominated in euro or pounds sterling. All of the loans are floating rate instruments and do not bear material interest rate risk.



## Directors' Report

### For the Year Ended 31 March 2013

The Bank's principal customer focus is on savings, investments and wealth management products. The principal customer-related activities of the Bank include the following:

- The provision of term savings and wealth management products;
- The receipt and acceptance of customers' monies for deposit in savings and fixed term deposit accounts denominated in euro and other major currencies;
- Trading for the account of customers in foreign exchange;
- The provision of money transmission services;
- The provision of safe custody services with a wide range of custom-tailored solutions as well as administration and safekeeping of securities;
- The provision of investment advice to customers of the Bank;
- The provision of portfolio management services; and
- The provision of senior secured loans.

### Review of business development and financial position

During the financial year ended 31 March 2013, the Bank continued to implement its business plan with the aim of sustaining the Bank's long-term profitability by building its customer base in the mass affluent market both in Malta and internationally and also through a selected corporate sector in Malta. The Bank also intends to continue to improve its banking, investment and wealth management services in Malta and internationally.

During the year ended 31 March 2013, the Bank made significant investments in technology that have allowed it to introduce new online banking and investment services, together with systems to support such services. The Bank has implemented (i) an e-banking system that enables the Bank's customers to execute banking transactions online, and (ii) an e-brokerage system that enables the Bank's wealth management customers to execute online brokerage transactions in respect of equities, bonds and funds. The Bank offers online goal planning, research and market data as well as analytical tools and capabilities for customers through its wealth management platform.

The Bank's Total Operating Income for the year ended 31 March 2013 was €54.252 million (15 months ended 31 March 2012: €80.299 million). This was created through the Bank's treasury operations and its corporate lending platform. The Bank's treasury management and its investment capabilities have, combined with its low cost base and superior customer service, enabled it to position itself as a market leading provider of savings and term deposit products, primarily in the Maltese market. In addition, during the 2012/13 financial year, the Bank underwrote two major local market debt issues earning fees of €300,000.

The Bank recorded a Profit after Tax for year ended 31 March 2013 of €20.483 million (15 months ended 31 March 2012: €0.708 million).

As of 31 March 2013, the Bank's investment securities stood at €1.564 billion (2012: €1.415 billion) consisting of held-to-maturity securities amounting to €357 million and available-for-sale (AFS) securities amounting to €1.207 billion. The fair value of the AFS book was risk managed through interest rate derivatives such as interest rate swaps where the hedge accounting methodology under IAS 39 was adopted over the last six months.

The Bank's loans and advances to customers stood at €402.174 million as of 31 March 2013 (2012: €27.666 million), net of impairment loss allowances of €0.676 million. At year end, all of the loans were performing and no specific provisions were required.

After gaining membership to the Eurex electronic repo platform during the 2011/12 financial year, the Bank continued to develop its institutional funding base by entering into a three-year loan funding facility with a large international financial institution.

## **Directors' Report**

### **For the Year Ended 31 March 2013**

On 21 November 2012, the Bank successfully issued the euro equivalent of €12,500,000 of 7.50% subordinated bonds due 2019. The issue were oversubscribed and were admitted to the Malta Stock Exchange Official List on Thursday 27 December 2012. During the year, the Bank bought back €4.1 million nominal value of its 6.25% Bonds due 2015 through market operations.

Shareholders' equity at the reporting date amounted to €115.083 million (2012: €75.386 million).

At an extraordinary shareholders general meeting held on 15 March 2013, a resolution was approved for the issuance and allotment to Medifin Holding Limited of 6,320,000 (six million three hundred and twenty thousand) ordinary A shares of €1.00 each that were fully paid in cash.

Also, during the year ended 31 March 2013, by an extraordinary resolution dated 27 March 2013, it was resolved to provide the Bank a shareholders' contribution of €8,500,000.

#### **Dividends and reserves**

A net interim dividend of €7.146 million (17 cents per ordinary share) was paid in cash on 15 March 2013. An amount of €6.320 million has been re-invested in the Bank in the form of a fresh issue of ordinary A shares.

Retained earnings as at 31 March 2013 amounted to €21,191 million (2012: €7.029 million). The directors have proposed to distribute €21 million as a final dividend by way of a bonus share issue. The final dividend will be executed 10 May 2013.

#### **Standard licence conditions and regulatory sanctions**

In accordance with the Investment Services Rules for Investment Services providers regulated by the MFSA, licence holders are required to include in the Directors' Report breaches of standard licence conditions or other regulatory requirements. Accordingly, the directors confirm that no breaches of standard licence conditions or other breach of regulatory requirements were reported which were subject to administrative penalty or regulatory sanction.

#### **Future business developments**

The Bank maintains its prime strategic objective as being a leading provider of savings, investment and wealth management products to the mass affluent market, both in Malta and internationally.

The Bank intends to continue to develop its new online banking, investment and wealth management systems in order to create a seamless, easy to use platform that delivers to customers cost efficient and transparent execution capabilities. The Bank aims to create systems and processes that are scalable and can be deployed to new markets and products at relatively low incremental cost.

The principal market in which the Bank currently operates is the Maltese market. During the financial year, the Bank was approved the establishment of a branch in Belgium. Through the Belgian branch, the Bank will broaden the range of markets in which it operates and competes. Expansion of the Bank's operations to international markets has the goal of gaining access to a broader customer base and enabling the Bank to offer its products and services, particularly investment services, to a larger pool of potential customers. This strategy is also intended to allow the Bank to deliver cost effective investment solutions to a wider range of customers and to take advantage of the Bank's relatively cost efficient existing back office and systems infrastructure located in Malta.

## **Directors' Report**

### **For the Year Ended 31 March 2013**

In Malta, the Bank continues to develop its customer base. Since setting up its first local branch in Sliema in August 2010, the Bank has established a further six branch offices throughout Malta. The Bank is also building its corporate banking business by expanding the range of payment, custody and foreign exchange services that it offers to its corporate customers.

In respect of its investment activities, the Bank has maintained and intends to continue its policy of investing its treasury portfolio in highly-rated investment securities. The Bank plans to grow its portfolio of senior secured loans and bonds as a percentage of its overall asset base. The Bank also intends to increase its corporate lending activities in the domestic market during the first half of the next financial year.

In order to support the growth of its senior secured loan and bond portfolios, the Bank continues to pursue further opportunities to build its funding base.

As corporate loans typically attract higher risk weightings than the highly-rated investment securities in which the Bank has historically invested, it is expected that the Bank's capital adequacy ratio will decrease over time, although it is the Bank's intention to continue to operate with a capital adequacy ratio significantly in excess of the MFSA's minimum capital requirements.

The Bank remains committed to operating with strong regulatory ratios in terms of capital and liquidity and to continue to import market leading risk management practices for the benefit of its customers, shareholders and all stakeholders.

#### **Outlook**

The Bank foresees continued difficulties for the Eurozone in the near term, but ultimately expects that a stronger monetary union will strengthen Eurozone markets and institutions. The Bank is confident that as it grows its customer base, it can broaden its relationship with customers, which should lead to consistently growing revenues over the course of time.

#### **Related parties**

During the year ended 31 March 2013, other than the transactions described under note 35 to the financial statements, there were no material changes in related party transactions as compared with those detailed within the financial statements for the period ended 31 March 2012. During this financial year, no related party transactions materially affected the financial position or performance of the Bank, with the exception of dividend payment, increase in share capital and shareholders' contribution, as described in note 25.

#### **Events after the reporting date**

As described above, €21.000 million will be distributed from the retained earnings as a final dividend by way of a bonus share issue. This will transfer all retained earnings as bonus shares. Apart from the bonus share issue, there were no events after the reporting date that would have a material effect on the financial statements.

#### **Going concern**

After due consideration of the Bank's profitability, financial position, capital adequacy and solvency, the directors declare, pursuant to MFSA Listing Rule 5.62, that the Bank is in a position to continue operating as a going concern for the foreseeable future.

## **Directors' Report**

### **For the Year Ended 31 March 2013**


#### **Auditors**

A resolution to re-appoint KPMG as auditors of the Bank will be proposed at the forthcoming annual general meeting.

#### **Statement by the directors pursuant to Listing Rule 5.68**

We, the undersigned, declare that to the best of our knowledge, the financial statements were prepared in accordance with the applicable accounting standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Bank and that this report includes a fair review of the performance of the business and the position of the Bank, together with a description of the principal risks and uncertainties that it faces.

Approved by the Board of directors on 9 May 2013 and signed on its behalf by:



Francis J. Vassallo  
Chairman



Mark A. Watson  
Director and Chief Executive Officer

**Registered Office**  
10, St. Barbara Bastion,  
Valletta, VLT 1961  
Malta

## Directors' Responsibility for the Financial Statements

The Companies Act, 1995 (Chapter 386, Laws of Malta) (the "Act") requires the directors of Mediterranean Bank plc (the "Bank") to prepare financial statements for each financial year which give a true and fair view of the financial position of the Bank as at the end of the financial year and of the profit or loss of the Bank for that year in accordance with the requirements of International Financial Reporting Standards as adopted by the European Union.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy, at any time, the financial position of the Bank and to enable them to ensure that the financial statements have been properly prepared in accordance with the provisions of the Act and the Banking Act, 1994.

The directors are also responsible for safeguarding the assets of the Bank and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors, through oversight of management, are responsible for ensuring that the Bank establishes and maintains internal control to provide reasonable assurance with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

Management is responsible, with oversight from the directors, to establish a control environment and to maintain policies and procedures to assist in achieving the objective of ensuring, as far as possible, the orderly and efficient conduct of the Bank's business. This responsibility includes establishing and maintaining controls pertaining to the Bank's objective of preparing financial statements as required by the Act and managing risks that may give rise to material misstatements in those financial statements. In determining which controls should be implemented to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud.

Signed on behalf of the Board of directors by:



Francis J. Vassallo  
Chairman



Mark A. Watson  
Director and Chief Executive Officer

9 May 2013



## Remuneration Report

### Remuneration governance

The primary purpose of the Nomination and Remuneration Committee (NRC) is to review remuneration levels in the Bank and to consider whether to approve performance-related bonus awards and long-term incentive plan awards.

The NRC receives recommendations from the management of the Bank regarding remuneration levels and the awarding of bonuses. It may request market-related information from time to time to verify the recommendations made by management.

One of the NRC's primary functions is to ensure that the Bank is able to attract and retain suitable employees at all levels at an acceptable cost.

### Membership and meetings

The members of the NRC are:

- Finlay S. McFadyen Independent Non-Executive Director (Committee Chairman)
- Francis J. Vassallo Independent Non-Executive Director / Chairman of the Board
- Peter B. Cartwright Non-Executive Director

On 30 January 2013, Finlay S. McFadyen, an independent non-executive director of the Bank, was elected to the NRC and appointed as its Chairman, replacing Peter B. Cartwright in that capacity. In accordance with the NRC's terms of reference, Mr. McFadyen's appointment was approved by the Bank's Board of directors. In addition, on 30 January 2013, Mark A. Watson, an executive director and the Chief Executive Officer of the Bank, resigned from the NRC.

During the year ended 31 March 2013, the NRC met once and this meeting was attended by all members of the NRC.

### Remuneration policy statement

The Board is responsible for ensuring that this statement and its contents adhere to all laws, rules and regulations issued by the Malta Financial Services Authority. The Board, directly and through the NRC, carries out effective monitoring and evaluation of the Bank's remuneration system on an ongoing basis. The NRC and the Board monitor the ongoing performance by management of its supervisory function in respect of design and implementation of a remuneration system.

The NRC is charged with aligning the Bank's remuneration policy and in particular performance-related elements of remuneration, with the best interests of the stakeholders and with the Bank's business strategy and risk tolerance, objectives, values and long-term interests.

Remuneration consists of base salary and, where applicable, performance based bonus awards. Performance-related compensation shall be determined both on (i) a bank wide basis, and (ii) an individual employee basis.

Compliance with the Bank's rules and requirements and involvement on a continuing basis in risk management are taken into account when determining performance-based remuneration for all employees. Other non-financial factors shall also be considered such as skills acquired, personal development, commitment to the Bank's business strategies and policies and contribution to the performance of the team. Performance shall be measured in relation to non-financial and financial goals and, where appropriate, failure to perform in non-financial areas of responsibility shall outweigh success in profit generation in determining compensation. Control functions shall be adequately rewarded in order to ensure that the Bank is able to attract skilled individuals for such roles.

## Remuneration Report

The Bank's remuneration policy has not been changed since its adoption in March 2011. The Bank has no present intention to effect changes in its remuneration policy during the following financial year.

### (a) Measures of performance as basis for awarding of pay

Base pay is expected to comprise the majority of the Bank's overall compensation cost.

#### i. All staff

The NRC considers a variety of factors in determining compensation tailored to the role of the individual concerned and takes into account factors such as risk management, development of systems, monitoring of risk and creation of long-term value for the Bank.

#### ii. Members of management and control functions

Recommendations by management as to remuneration of members of control functions are made by the Chief Executive Officer. Such recommendations are reviewed and approved or rejected by the NRC.

Compensation for employees serving in control functions takes into account broadly based performance measurements, including evaluation of achievements in respect of control function responsibilities. Control function employees are compensated in accordance with their own performance and not in accordance with the performance of the business units they control.

Senior members of management may be eligible to participate in the Bank's Long-term Incentive Plan, enabling such managers to participate in the long-term profitability of the Bank. In addition, the Bank has established an employee benefit trust enabling employees other than senior members of management to participate in this incentive.

#### iii. Non executive directors

The remuneration of non-executive directors is not performance based and is not linked to the Bank's short term results. It is determined based on remuneration levels for directors of similar financial companies and takes into account factors such as time invested and responsibilities.

### (b) Measures of performance as basis for awarding of bonuses

A bonus pool is established for the Bank as a whole and is calculated at Bank level based on the success of the Bank in meeting its business objectives. These objectives relate, amongst other things, to profitability, sustainability of performance, risk management, building of business lines and creation of long-term shareholder value.

Individuals are compensated out of that bonus pool based on their contribution to the achievement of the Bank's business objectives. Such individual criteria depend on the role of the individual in the Bank.

Control functions are judged on success in developing appropriate policies, developing effective risk management controls and procedures, monitoring risk and building control systems. Whilst the general bonus pool of the Bank will be based on the Bank's financial results, compensation of control functions is not directly tied to the results of any business unit.

## Remuneration Report

### Staff savings account

All of the Bank's staff are entitled to make monthly deposits of specified amounts direct from after tax payroll into an employee savings account. At the end of each calendar year, the Bank will pay 5% interest on the accumulated savings remaining in the account in December. On such date, amounts remaining in such savings accounts may be withdrawn and the terms of such accounts may be reset.

### Long-term incentive plan (LTIP)

The Bank's immediate parent company has established a LTIP for the benefit of senior management and other employees of the Bank. The LTIP enables senior managers and other employees to participate in the long-term value and profitability of the Bank.

### Remuneration policy - directors

Based on the recommendations of the NRC, the directors' fees earned by the directors for the year ended 31 March 2013 amounted to €110,150.

Total emoluments earned by the directors of the Bank during the year ended 31 March 2013, are reported below pursuant to Code Provision 8.A.5:

Fixed Remuneration	Variable Remuneration	Shares	Non-Cash Benefits
€935,969	€1,050,000	None	€189,507

### Termination payments

During the year ended 31 March 2013, there were no termination payments made either to directors or members of senior management.

### Employment contracts - executive directors

All the executive directors as of 31 March 2013 were engaged under indefinite employment contracts.

### Remuneration policy - senior management

Total emoluments received by senior management (excluding directors) during the year ended are reported below:

Fixed Remuneration	Variable Remuneration	Shares	Non-Cash Benefits
€871,112	€587,236	None	€26,578



Francis J. Vassallo  
Chairman

9 May 2013



Mark A. Watson  
Director and Chief Executive Officer

## Statement of Financial Position

As at 31 March 2013

		31 Mar 2013	31 Mar 2012
	Notes	€000	€000
<b>ASSETS</b>			
Balances with Central Bank of Malta, treasury bills and cash	14	70,055	63,656
Loans and advances to financial institutions	15	20,131	27,804
Loans and advances to customers	16	402,174	27,666
Investment securities	17	1,564,034	1,415,493
Derivative assets held for risk management	18	279	2,572
Investment in subsidiaries	19	65	63
Property and equipment	20	2,485	2,880
Intangible assets	21	228	351
Other assets	22	14,471	15,649
Prepayments and accrued income	23	27,996	19,442
Deferred tax assets	24	-	244
<b>Total assets</b>		<b>2,101,918</b>	<b>1,575,820</b>
=====			

*The notes on pages 30 to 97 are an integral part of these financial statements.*

## Statement of Financial Position

As at 31 March 2013

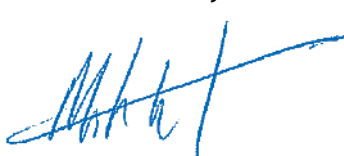
		31 Mar 2013	31 Mar 2012
	Notes	€000	€000
<b>EQUITY</b>			
Share capital	25	62,350	56,030
Share premium	25	13,464	13,464
Retained earnings	25	21,191	7,029
Shareholders' contribution	25	8,500	-
Other reserves	25	9,578	(1,137)
<b>Total equity</b>		<b>115,083</b>	<b>75,386</b>
<b>LIABILITIES</b>			
Amounts owed to financial institutions	26	1,368,995	1,093,753
Amounts owed to customers	27	566,047	379,555
Debt securities in issue	28	15,664	19,672
Subordinated liabilities	29	12,341	-
Current tax		7,660	166
Other liabilities	30	1,100	682
Accruals	31	9,966	6,606
Deferred tax liability	24	5,062	-
<b>Total liabilities</b>		<b>1,986,835</b>	<b>1,500,434</b>
<b>Total equity and liabilities</b>		<b>2,101,918</b>	<b>1,575,820</b>
=====			
<b>Contingent assets</b>	16/17	<b>76,000</b>	<b>70,612</b>
=====			
<b>Contingencies and commitments</b>	16/34	<b>12,285</b>	<b>1,454</b>
=====			

*The notes on pages 30 to 97 are an integral part of these financial statements.*

The financial statements on pages 24 to 97 were approved and authorised for issue by the Board of directors on 9 May 2013 and signed on its behalf by:



Francis J. Vassallo  
Chairman



Mark A. Watson  
Director and Chief Executive Officer



Edward Jaccarini  
Chief Financial Officer



## Statement of Comprehensive Income

For the Year Ended 31 March 2013

		1 Apr 2012 to 31 Mar 2013	1 Jan 2011 to 31 Mar 2012
	Notes	€000	€000
Interest income		50,945	64,067
Interest expense		(27,668)	(34,327)
<b>Net interest income</b>	7	<b>23,277</b>	<b>29,740</b>
Fee and commission income		951	253
Fee and commission expense		(2,777)	(424)
<b>Net fee and commission expense</b>	8	<b>(1,826)</b>	<b>(171)</b>
<b>Net trading income</b>	9.1	<b>5,267</b>	<b>1,799</b>
<b>Other operating income</b>	9.2	<b>27,534</b>	<b>48,931</b>
<b>Total operating income</b>		<b>54,252</b>	<b>80,299</b>
Net impairment	4/16/17	(676)	(62,885)
Administrative and other expenses	10	(10,183)	(9,020)
Personnel expenses	11	(10,902)	(6,461)
Depreciation and amortisation	20/21	(944)	(772)
<b>Operating expenses</b>		<b>(22,705)</b>	<b>(79,138)</b>
<b>Profit before income tax</b>		<b>31,547</b>	<b>1,161</b>
Income tax expense	12	(11,064)	(453)
<b>Profit for the year/period</b>		<b>20,483</b>	<b>708</b>
<b>Other comprehensive income</b>			
Fair value reserve - available-for-sale assets			
Net change in fair value		44,505	37,103
Net amount transferred to profit or loss		(28,020)	(36,977)
Income taxes		(5,770)	147
<b>Other comprehensive income for the year/period</b>		<b>10,715</b>	<b>273</b>
<b>Total comprehensive income for the year/period</b>		<b>31,198</b>	<b>981</b>
<b>Earnings per share (cents)</b>	13	<b>36c</b>	<b>1c</b>

The notes on pages 30 to 97 are an integral part of these financial statements.

## Statement of Changes in Equity

For the Year Ended 31 March 2013

	Share capital €000	Share premium €000	Retained earnings €000	Fair value reserve €000	Total €000
Balance as at 1 January 2011	41,030	13,464	6,321	(1,410)	59,405
Total comprehensive income for the period:					
Profit for the period	-	-	708	-	708
Other comprehensive income for the period:					
Available-for-sale assets:					
- Net change in fair value	-	-	-	24,308	24,308
- Net amount transferred to profit or loss	-	-	-	(24,035)	(24,035)
Total comprehensive income for the period, net of tax	-	-	708	273	981
Transactions with owners, recorded directly in equity					
Contributions by owners:					
Issue of share capital (note 25)	15,000	-	-	-	15,000
Total contributions by owners	15,000	-	-	-	15,000
Balance at 31 March 2012	56,030	13,464	7,029	(1,137)	75,386

The notes on pages 30 to 97 are an integral part of these financial statements.

## Statement of Changes in Equity

For the Year Ended 31 March 2013

	Share capital €000	Share premium €000	Shareholders' contribution €000	Retained earnings €000	Fair value reserve €000	Total €000
Balance as at 1 April 2012	56,030	13,464	-	7,029	(1,137)	75,386
Total comprehensive income for the year:						
Profit for the year	-	-	-	20,483	-	20,483
Other comprehensive income for the year:						
Available-for-sale assets:						
- Net change in fair value	-	-	-	-	28,928	28,928
- Net amount transferred to profit or loss	-	-	-	-	(18,213)	(18,213)
Total comprehensive income for the year, net of tax	-	-	-	20,483	10,715	31,198
Transactions with owners, recorded directly in equity						
Contributions by owners:						
Issue of share capital (note 25)	6,320	-	-	-	-	6,320
Shareholders' contribution (note 25)	-	-	9,325	-	-	9,325
Dividends to equity holders (note 32)	-	-	(825)	(6,321)	-	(7,146)
Total contributions by owners	6,320	-	8,500	(6,321)	-	8,499
Balance at 31 March 2013	62,350	13,464	8,500	21,191	9,578	115,083

The notes on pages 30 to 97 are an integral part of these financial statements.

## Statement of Cash Flows

For the Year Ended 31 March 2013

	1 Apr 2012 to 31 Mar 2013	1 Jan 2011 to 31 Mar 2012
Note	€000	€000
<b>Cash flows from operating activities</b>		
Interest and commission receipts	52,741	60,158
Interest payments and commission expense	(30,128)	(30,287)
Payments to employees and suppliers	(15,715)	(26,984)
<b>Operating profit before changes in operating assets/liabilities</b>	<b>6,898</b>	<b>2,887</b>
(Increase)/decrease in operating assets:		
- reserve deposits with Central Bank of Malta	(1,360)	(68)
- loans advanced to customers and financial institutions	(297,583)	(27,250)
- investment securities	91,657	1,091,620
Increase in operating liabilities:		
- amounts owed to customers and financial institutions	474,850	(171,114)
Tax paid	(4,038)	(3,847)
<b>Net cash from operating activities</b>	<b>270,424</b>	<b>892,228</b>
<b>Cash flows from investing activities</b>		
Acquisition of property and equipment	(431)	(1,026)
Disposal of property and equipment	-	109
Acquisition of intangible assets	-	(4,517)
Disposal of intangible assets	-	5,401
Acquisition of available-for-sale assets	(1,170,867)	(3,184,077)
Disposal of available-for-sale assets	941,592	1,987,289
Acquisition of derivative assets held for risk management	(13,749)	(4,728)
Advances to parent	(200)	(1,273)
Advances to group companies	(2,071)	(3,575)
<b>Net cash used in investing activities</b>	<b>(245,726)</b>	<b>(1,206,397)</b>
<b>Cash flows from financing activities</b>		
Proceeds from the issue of share capital	6,320	15,000
Proceeds from shareholders' contribution	9,325	-
Proceeds from the issue of debt securities	-	4,937
Re-purchase of debt securities	(4,095)	-
Net proceeds from the issue of subordinated debt securities	12,341	-
Dividends paid	(7,143)	-
<b>Net cash from financing activities</b>	<b>16,748</b>	<b>19,937</b>
<b>Net decrease in cash and cash equivalents</b>	<b>41,446</b>	<b>(294,232)</b>
Cash and cash equivalents at beginning of year/period	(617,268)	(323,036)
<b>Cash and cash equivalents at year/period end</b>	<b>(575,822)</b>	<b>(617,268)</b>

The notes on pages 30 to 97 are an integral part of these financial statements.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 1 Reporting entity

Mediterranean Bank plc (the “Bank”) is domiciled and incorporated in Malta. The address of the Bank’s registered office is 10, St. Barbara Bastion, Valletta, VLT 1961, Malta. As described in note 2.5, during 2012, the Bank changed its financial period-end from 31 December to 31 March.

The Bank is principally involved in the provision of term savings and wealth management products which is supported by the acquisition of a high quality investment portfolio comprising EU sovereign and sovereign related credits, covered bonds and other similar credit quality instruments.

These financial statements present only the Bank’s separate financial statements since the subsidiaries are deemed to be immaterial and not relevant for the operations of the Bank. Furthermore, two subsidiaries are dormant and have been placed into liquidation.

On 5 June 2012, the Bank established a partnership (Medifin Estates) to enter into property leases on the Bank’s branches and to lease them back to the Bank. Medifin Estates is also deemed to be immaterial. Consequently, only the financial statements of the Bank are presented.

### 2 Basis of preparation

#### 2.1 Statement of compliance

These financial statements have been drawn up in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (the “applicable framework”).

All references in these financial statements to IAS, IFRS or SIC/IFRIC interpretations refer to those adopted by the European Union. The principal accounting policies applied in the preparation of these financial statements are set out below and in the relevant notes to the financial statements.

The financial statements have also been drawn up in accordance with the provisions of the Banking Act, 1994 (Chapter 371, Laws of Malta) and the Companies Act, 1995 (Chapter 386, Laws of Malta).

#### 2.2 Basis of measurement

The financial statements have been prepared on the historical cost basis except that

- available-for-sale financial instruments are measured at fair value;
- derivative financial instruments are measured at fair value; and
- recognised financial assets and financial liabilities designated as hedged items in qualifying fair value hedge relationships are adjusted for changes in fair value attributable to the risk being hedged.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 2 Basis of preparation (continued)

#### 2.3 Functional and presentation currency

These financial statements are presented in euro (€), which is the Bank's functional currency. Except as otherwise indicated, financial information presented in euro has been rounded to the nearest thousand.

#### 2.4 Use of estimates and judgements

The preparation of the financial statements in conformity with IFRS requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an on-going basis. Revisions to accounting estimates are recognised in the period in which the estimates are revised and in any future periods affected.

Information about significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amounts recognised in the financial statements are described in note 5.

#### 2.5 Comparative information

During the comparative period presented, the Bank changed its accounting reference period from 31 December 2011 to 31 March 2012. Accordingly, the comparative figures presented are a fifteen-month period covering the period from 1 January 2011 to 31 March 2012. Subsequent accounting periods are twelve-month periods ending 31 March. Consequently, the current period presented and related financial information cover the period from 1 April 2012 to 31 March 2013.

For this reason, the comparative amounts for the statement of comprehensive income, statement of changes in equity, statement of cash flows and related notes are not entirely comparable to the amounts disclosed for the period ended on 31 March 2012.

### 3 Significant accounting policies

The accounting policies set out below have been applied consistently to all periods presented in these financial statements and have been applied consistently by Bank.

#### 3.1 Basis for non-consolidation

Subsidiaries are entities controlled by the Bank. These are accounted for, at cost. All the subsidiaries are deemed to be immaterial and not relevant for the operations of the Bank. Furthermore, two subsidiaries are dormant and have been placed into liquidation.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 3 Significant accounting policies (continued)

#### 3.2 Foreign currency

Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated into the functional currency at the spot exchange rate at that date.

The foreign currency gain or loss on monetary items is the difference between amortised cost in the functional currency at the beginning of the period, adjusted for effective interest and payments during the period and the amortised cost in foreign currency translated at the spot exchange rate at the end of the period.

Foreign currency differences arising on retranslation are recognised in profit or loss. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction.

#### 3.3 Interest

Interest income and expense, including interest received on financial assets measured at amortised cost, are recognised in profit or loss using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or liability. When calculating the effective interest rate, the Bank estimates future cash flows considering all contractual terms of the financial instrument, but not future credit losses.

The calculation of the effective interest rate includes transaction costs that are incremental and are directly attributable to the acquisition or issue of a financial asset or liability.

Interest income and expense presented in the statement of comprehensive income include:

- coupon received and amortisation of discount and/or premium on:
  - i. financial assets and financial liabilities measured at amortised cost calculated on an effective interest basis;
  - ii. available-for-sale investment securities calculated on an effective interest basis; and
- net cash settlement on interest rate swaps designated in a fair value hedge to hedge fair value changes in available-for-sale investment securities.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 3 Significant accounting policies (continued)

#### 3.4 Fees and commission

Fees and commission income and expenses that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate.

Other fees and commission income, including servicing fees, underwriting fees and other investment management fees are recognised as the related services are performed. Other fees and commission expense relate mainly to transaction and service fees, which are expensed as the services are received.

#### 3.5 Net trading income

Net trading income includes:

- foreign exchange differences;
- fair value changes on derivatives held for risk management purposes that are not designated as qualifying hedging instruments; and
- the effective and ineffective portion of fair value changes in the available-for-sale investment securities and qualifying hedging derivatives which are designated in fair value hedges on interest rate risk.

#### 3.6 Other operating income

Other operating income mainly comprises of realised gains on disposal of available-for-sale, held-to-maturity investments and redemptions of loans and receivables. Dividend income, which is recognised when the right to receive income is established, is reflected as a component of other operating income.

#### 3.7 Lease payments made

Payments made under operating leases are recognised in profit or loss on a straight-line basis over the term of the lease. Lease incentives received are recognised as an integral part of the total lease expense, over the term of the lease.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 3 Significant accounting policies (continued)

#### 3.8 Taxation

Tax expense comprises current and deferred tax. Current tax and deferred tax are recognised in profit or loss except to the extent that they relate to items recognised directly in equity or in other comprehensive income.

Current tax is the expected tax payable or receivable on the taxable income or loss for the period, using tax rates enacted or substantively enacted at the reporting date and any adjustment to tax payable in respect of previous periods. Current tax payable also includes any tax liability arising from the declaration of dividends.

Deferred tax is recognised in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities against current tax assets and they relate to taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

A deferred tax asset is recognised for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which they can be utilised. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

In determining the amount of current and deferred tax, the Bank takes into account the impact of uncertain tax positions and whether additional taxes and interest may be due. This assessment relies on estimates and assumptions and may involve a series of judgements about future events. New information may become available that causes the Bank to change its judgement regarding the adequacy of existing tax liabilities; such changes to tax liabilities will impact tax expense in the period that such a determination is changed.



## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 3 Significant accounting policies (continued)

#### 3.9 Financial assets and financial liabilities

##### 3.9.1 *Recognition and initial recognition*

The Bank initially recognises loans and advances at the date at which they are originated, except for corporate loans and advances which are initially recognised on the date of transfer of beneficial ownership. Amounts due to customers, debt securities and subordinated liabilities are also recognised on the date which they are originated. All other financial assets and liabilities are initially recognised on the trade date at which the Bank becomes part to the contractual provisions of the instrument, except for investments and derivative assets and liabilities held for risk management which are recognised on date of settlement.

A financial asset or liability is measured initially at fair value plus or minus, in the case of instruments not classified as at fair value through profit or loss, transaction costs that are directly attributable to its acquisition of the asset or issue of the liability.

##### 3.9.2 *Classification*

###### *Financial assets*

The Bank classifies its financial assets in one of the following categories:

- Loans and receivables;
- Held-to-maturity;
- Available-for-sale; or
- At fair value through profit or loss and within the category as:
  - Held-for-trading; or
  - Designated at fair value through profit or loss

See accounting policies 3.10, 3.12, 3.13, 3.14 and 3.15.

###### *Financial liabilities*

The Bank classifies its non-derivative financial liabilities as measured at amortised cost and classifies its derivative liabilities at fair value through profit or loss.

See accounting policy 3.14 and 3.20.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 3 Significant accounting policies (continued)

#### 3.9 Financial assets and financial liabilities (continued)

##### 3.9.3 *Derecognition*

The Bank derecognises a financial asset when the contractual rights to the cash flows from the financial asset expire, or when it transfers the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial assets are transferred or in which the Bank neither transfers nor retains substantially all the risks and rewards of ownership and it does not retain control of the financial asset.

Any interest in transferred financial assets that qualify for derecognition that is created or retained by the Bank is recognised as a separate asset or liability in the statement of financial position. On derecognition of a financial asset, the difference between the carrying amount of the asset (or the carrying amount allocated to the portion of the asset transferred) and the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised in other comprehensive income, is recognised in profit or loss.

The Bank enters into transactions whereby it transfers assets recognised on its statement of financial position, but retains either all or substantially all of the risks and rewards of the transferred assets or a portion of them. If all or substantially all risks and rewards are retained, then the transferred assets are not derecognised. Transfers of assets with retention of all or substantially all risks and rewards include, for example, securities lending and repurchase transactions.

The Bank derecognises a financial liability when its contractual obligations are discharged, cancelled or expire.

When assets are sold to a third party with a concurrent total rate of return swap on the transferred assets, the transaction is accounted for as a secured financing transaction similar to repurchase transactions as the Bank retains all or substantially all the risks and rewards of ownership of such assets.

##### 3.9.4 *Offsetting*

Financial assets and liabilities are offset and the net amount presented in the statement of financial position when and only when, the Bank has a legal right to set off the recognised amounts and it intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis only when permitted under IFRSs, or for gains and losses arising from a group of similar transactions.

##### 3.9.5 *Amortised cost measurement*

The amortised cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initial amount recognised and the maturity amount, minus any reduction for impairment.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 3 Significant accounting policies (continued)

#### 3.9 Financial assets and financial liabilities (continued)

##### 3.9.6 Fair value measurement

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction on the measurement date.

When available, the Bank measures the fair value of an instrument using quoted prices in an active market for that instrument. A market is regarded as active if quoted prices are readily and regularly available and represent actual and regularly occurring market transactions on an arm's length basis.

If a market for a financial instrument is not active, then the Bank establishes fair value using a valuation technique. Valuation techniques include using recent arm's length transactions between knowledgeable, willing parties (if available), reference to the current fair value of other instruments that are substantially the same, discounted cash flow analysis and option pricing models. The chosen valuation technique makes maximum use of market inputs, relies as little as possible on estimates specific to the Bank, incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments. Inputs to valuation techniques reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument. The Bank calibrates valuation techniques and tests them for validity using prices from observable current market transactions in the same instrument or based on other available observable market data.

Fair value reflects the credit risk of the instrument and includes adjustments to take account of the credit risk of the Bank entity and the counterparty where appropriate. For subsequent measurement, assets are measured at a bid price.

The best evidence of the fair value of a financial instrument at initial recognition is the transaction price, i.e. the fair value of the consideration given or received.

##### 3.9.7 Identification and measurement of impairment of financial assets

At each reporting date the Bank assesses whether there is objective evidence that financial assets are impaired. A financial asset or a group of financial assets is/are impaired when objective evidence demonstrates that a loss event has occurred after the initial recognition of the asset(s) and that the loss event has an impact on the future cash flows of the asset(s) that can be estimated reliably.

Objective evidence that financial assets are impaired can include significant financial difficulty of the borrower or issuer, default or delinquency by a borrower, restructuring of a loan or advance by the Bank on terms that the Bank would not otherwise consider, indications that a borrower or issuer will enter bankruptcy, the disappearance of an active market for a security, or other observable data relating to a Bank of assets such as adverse changes in the payment status of borrowers or issuers in the Bank, or economic conditions that correlate with defaults in the Bank.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 3 Significant accounting policies (continued)

#### 3.9 Financial assets and financial liabilities (continued)

##### 3.9.7 *Identification and measurement of impairment of financial assets (continued)*

The Bank considers evidence of impairment for loans and advances at both a specific asset and collective level and investment securities at a specific asset level. All individually significant loans and advances and investment securities are assessed for specific impairment. All individually significant loans and advances found not to be specifically impaired are then collectively assessed for any impairment that has been incurred but not yet identified. Loans and advances that are not individually significant are collectively assessed for impairment by grouping together loans and advances with similar risk characteristics.

In assessing collective impairment on loans and advances to customers, the Bank uses published historical default rates relative to the credit quality of the issuer and the duration of the instrument, timing of recoveries and the amount of loss incurred, adjusted for management's judgement as to whether current economic and credit conditions are such that the actual losses are likely to be greater or less than suggested by historical default rates.

Impairment losses on assets carried at amortised cost are measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the asset's original effective interest rate. Impairment losses are recognised in profit or loss and reflected in an allowance account against loans and advances and investment securities as appropriate. Interest on impaired assets continues to be recognised through the unwinding of the discount. When a subsequent event causes the amount of impairment loss to decrease, the decrease in impairment loss is reversed through profit or loss.

Impairment losses on available-for-sale investment securities are recognised by transferring the cumulative loss that has been recognised in other comprehensive income to profit or loss as a reclassification adjustment. The cumulative loss that is reclassified from other comprehensive income to profit or loss is the difference between the acquisition cost, net of any principal repayment and amortisation and the current fair value, less any impairment loss previously recognised in profit or loss. Changes in impairment provisions attributable to time value are reflected as a component of interest income.

If, in a subsequent period, the fair value of an impaired available-for-sale investment security increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss is reversed, with the amount of the reversal recognised in profit or loss.

The Bank writes off loans and advances and investment securities when these are determined to be uncollectible (see note 4).

The Bank evaluates whether a loss event, including financial difficulties, has an impact on the estimated future cash flows of the financial asset. Accordingly, future estimated cash flows may need to be reduced or delayed, normally implying a decrease of their estimated present value and thus giving rise to an impairment loss which must be recognised.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### **3 Significant accounting policies (continued)**

#### **3.9 Financial assets and financial liabilities (continued)**

##### **3.9.7 *Identification and measurement of impairment of financial assets (continued)***

The Bank measures the amount of the impairment loss as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred), discounted at the original effective interest rate (i.e. the effective interest rate before modification of the terms of the contract).

##### **3.9.8 *Sale of a financial asset with a total return swap***

The Bank sells financial assets that are subject to a concurrent total return swap. In all cases, the Bank retains substantially all the risks and rewards of ownership. Therefore, the Bank continues to recognise the transferred assets in its statement of financial position. The cash received is recognised as a financial asset and a corresponding liability is recognised. The Bank does not separately recognise the total return swap that prevents derecognition of the assets as a derivative because doing so would result in recognising the same rights and obligations twice. Because the Bank sells the contractual rights to the cash flows of the assets it does not have the ability to use the transferred assets during the term of the arrangement.

#### **3.10 Cash and cash equivalents**

Cash and cash equivalents include notes and coins on hand, unrestricted balances held with central banks and highly liquid financial assets, including treasury bills, with original maturities of less than three months, which are subject to insignificant risk of changes in their fair value and are used by the Bank in the management of its short-term commitments.

Cash and cash equivalents are measured at amortised cost in the statement of financial position.

#### **3.11 Investment in subsidiaries**

Investment in subsidiaries is accounted for in these separate financial statements of the Bank at cost less any impairment.

#### **3.12 Loans and advances to customers**

Loans and advances to customers are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and that the Bank does not intend to sell immediately or in the near term.

When the Bank purchases a financial asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date ("reverse repo"), the arrangement is accounted for as a loan or advance and the underlying asset is not recognised in the Bank's financial statements.



## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 3 Significant accounting policies (continued)

#### 3.12 Loans and advances to customers (continued)

Loans and advances to customers are accounted for on settlement date and are initially measured at fair value plus incremental direct transaction costs and subsequently measured at their amortised cost using the effective interest method.

The Bank participates in syndicated lending. Such loans and advances are accounted for on the agreement date, being the date of transfer of beneficial ownership.

#### 3.13 Investment securities

The Bank's investment securities primarily represent assets classified as held-to-maturity and available-for-sale.

##### 3.13.1 Held-to-maturity

Held-to-maturity investments are non-derivative assets with fixed or determinable payments and fixed maturity that the Bank has the positive intent and ability to hold to maturity and which are not designated as fair value through profit or loss or as available-for-sale.

Held-to-maturity investments are measured at amortised cost using the effective interest method. A sale or reclassification of a more than insignificant amount of held-to-maturity investments would result in the reclassification of all held-to-maturity investments as available-for-sale and would prevent the Bank from classifying investment securities as held-to-maturity for the current and the following two financial years. However, sales and reclassifications in any of the following circumstances would not trigger a reclassification:

- sales or reclassifications that are so close to maturity that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;
- sales or reclassifications after the Bank has collected substantially all of the asset's original principal; and
- sales or reclassifications attributable to non-recurring isolated events beyond the Bank's control that could not have been reasonably anticipated.

##### 3.13.2 Available-for-sale

Available-for-sale investments are non-derivative investments that are designated as available for sale or are not classified as another category of financial assets. Available-for-sale investments are measured at fair value.

Any foreign exchange gains or losses on available-for-sale investment securities are recognised in profit or loss. Interest income is recognised in profit or loss using the effective interest method. Other fair value changes are recognised in other comprehensive income until the investment is sold or impaired, whereupon the cumulative gains and losses previously recognised in other comprehensive income are reclassified to profit or loss as a reclassification adjustment. A non-derivative financial asset may be reclassified from the available-for sale category to the loans and receivables category if it otherwise would have met the definition of loans and receivables and if the Bank has the intention and ability to hold the financial asset for the foreseeable future or until maturity.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 3 Significant accounting policies (continued)

#### 3.14 Derivatives held for risk management purposes

Derivatives held for risk management purposes include all derivative financial assets and liabilities that are not classified as trading assets or liabilities. Derivatives held for risk management purposes include:

- Derivatives which are designated as hedging instruments; and
- Derivatives used for risk management purposes but which do not qualify for hedge accounting.

Derivatives held for risk management purposes are measured at fair value in the statement of financial position. All changes in its fair value are recognised immediately in profit or loss as a component of net trading income.

#### 3.15 Hedge Accounting

For accounting purposes there are three possible types of hedges:

- (1) Fair Value Hedges: hedges of changes in the fair value of assets, liabilities or unrecognised firm commitments;
- (2) Cash Flow Hedges: hedges of the variability of future cash flows from highly probable forecast transactions and floating rate assets and liabilities; and
- (3) Hedges of net investments in foreign operations: hedges of the translation adjustments resulting from translating the functional currency financial statements of foreign operations into the presentation currency of the parent.

The Bank makes use of Fair Value Hedge accounting.

IAS 39 prescribes the use of hedge accounting for derivatives which serve to hedge the fair value of assets or liabilities against one or more defined risks. Interest rate swaps are primarily used to hedge fixed rate available-for-sale securities that are subject to interest rate risk. Any changes in the fair value of the hedged asset or hedged liability resulting from an opposite move in the hedged risk are also recognised in profit or loss under 'net trading income'. Any portion of the changes in fair value that are not attributable to the hedged risk are accounted for in accordance with the rules of the valuation category to which the hedged asset or liability belongs.

In fair value hedge accounting an underlying transaction is linked with one or more hedging transactions in a hedging relationship. The carrying amounts of the hedged transactions are adjusted through profit or loss in the event of changes in fair value attributable to the hedged risk.

The application of hedge accounting rules is tied to a number of conditions. These relate above all to the documentation of the hedging relationship and also to its effectiveness. Documentation must include, in particular, the identification of the hedging instrument, the related hedged item or transaction, the nature of the risk being hedged and how effectiveness of the hedge is assessed.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 3 Significant accounting policies (continued)

#### 3.15 Hedge Accounting (continued)

IAS 39 requires the effectiveness of a hedge to be demonstrated during the entire term of the hedge in order for hedge accounting rules to be applied. Effectiveness in this context means the relationship between the change in fair value of the hedged item and the change in fair value of the hedging instrument attributable to the risk being hedged.

If these changes offset each other almost fully, a high degree of effectiveness exists. Proof of effectiveness requires, firstly, that a high degree of effectiveness can be expected from a hedge in the future (prospective effectiveness); secondly, when a hedge exists, it must be regularly demonstrated that it was highly effective during the period under review (retrospective effectiveness). Both the retrospective and prospective effectiveness must be within a range of between 80% and 125%.

Hedge effectiveness is assessed at inception and throughout the term of each hedging relationship. Hedge effectiveness is always assessed, even when the terms of the derivative and hedged item are matched.

Hedging derivatives are reported as “Derivative financial instruments designated as fair value hedges” within ‘Derivative assets held for risk management’ or ‘Derivative liabilities held for risk management’. In the event that a derivative is subsequently de-designated from a hedging relationship, it is transferred to financial assets/liabilities at fair value through profit or loss and reported as ‘Derivative assets held for risk management’ or ‘Derivative liabilities held for risk management’. Subsequent changes in fair value are recognised in net trading income.

Hedge ineffectiveness is reported in net trading income and is measured as the net effect of changes in the fair value of the hedging instrument and changes in the fair value of the hedged item arising from changes in the market rates that correspond to the hedged risk.

If a fair value hedge of a debt instrument is discontinued prior to the instrument’s maturity (i.e.: the derivative is terminated, expired or the relationship is de-designated), any remaining fair value adjustments relating to the hedged risk is made to the carrying amount of the debt instrument which is amortised to interest income or expense over the remaining life of the instrument. For other types of fair value adjustments, and whenever a fair value hedged asset or liability is sold or otherwise derecognised, any such adjustments are included in the calculation of the gain or loss on de-recognition.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 3 Significant accounting policies (continued)

#### 3.16 Property and equipment

##### 3.16.1 Recognition and measurement

Items of property and equipment are measured at cost less accumulated depreciation and any accumulated impairment losses.

Cost includes expenditures that are directly attributable to the acquisition of the asset. Purchased software that is integral to the functionality of the related equipment is capitalised as part of that equipment.

When parts of an item of property and equipment have different useful lives, the major components are accounted for as separate items of property and equipment.

The gain or loss on disposal of an item of property and equipment is determined by comparing the proceeds from disposal with the carrying amount of the item of property and equipment and are recognised net within other operating income in profit or loss.

##### 3.16.2 Subsequent costs

The cost of replacing a component of an item of property or equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the Bank and its cost can be measured reliably. The carrying amount of the replaced component is derecognised. Ongoing repairs and maintenance property and equipment are recognised in profit or loss as incurred.

##### 3.16.3 Depreciation

Depreciation is recognised in profit or loss on a straight-line basis over the estimated useful lives of each component of an item of property and equipment since this most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. Leased assets under finance leases are depreciated over the shorter of the lease term and their useful lives.

The estimated useful lives for the current and comparative periods are as follows:

- |                            |             |
|----------------------------|-------------|
| • improvements to premises | 4 -10 years |
| • computer equipment       | 3 - 5 years |
| • other equipment          | 4 years     |
| • fixtures and fittings    | 10 years    |
| • motor vehicles           | 5 years     |

Depreciation methods, useful lives and residual values are reassessed at each financial period-end and adjusted if appropriate.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 3 Significant accounting policies (continued)

#### 3.17 Intangible assets

The Bank's intangible assets represent software. Software acquired by the Bank is stated at cost less accumulated amortisation and any accumulated impairment losses.

Subsequent expenditure on software assets is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

Amortisation is recognised in profit or loss on a straight-line basis over the estimated useful life of the software, from the date that it is available for use since this most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. The estimated useful life of the software is 3 to 5 years.

Amortisation methods, useful lives and residual values are reviewed at each financial period-end and adjusted if appropriate.

#### 3.18 Leased assets - lessee

Leases in terms of which the Bank assumes substantially all the risks and rewards of ownership are classified as finance leases. Upon initial recognition the leased asset is measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. Subsequent to initial recognition, the asset is accounted for in accordance with the accounting policy applicable to that asset.

Other leases are operating leases and the leased assets are not recognised on the Bank's statement of financial position.



## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 3 Significant accounting policies (continued)

#### 3.19 Impairment of non-financial assets

The carrying amounts of the Bank's non-financial assets, other than deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists then the asset's recoverable amount is estimated. For intangible assets that are not yet available for use, the recoverable amount is estimated each year at the same time.

The recoverable amount of an asset or cash-generating unit is the greater of its value in use and its fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

For the purpose of impairment testing, assets that cannot be tested individually are grouped together into the smallest group of assets that generate cash inflows from continuing use that are largely independent of the cash inflows of other assets or groups of assets (the "cash-generating unit" or "CGU").

The Bank's corporate assets do not generate separate cash inflows. If there is an indication that a corporate asset may be impaired, then the recoverable amount is determined for the CGU to which the corporate asset belongs.

An impairment loss is recognised if the carrying amount of an asset or a CGU exceeds its estimated recoverable amount. Impairment losses are recognised in profit or loss.

Impairment losses recognised in prior periods are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 3 Significant accounting policies (continued)

#### 3.20 Amounts owed to financial institutions, amounts owed to customers, debt securities issued and subordinated liabilities

Amounts owed to financial institutions and customers, debt securities issued and subordinated liabilities are the Bank's principal sources of debt funding.

When the Bank sells a financial asset and simultaneously enters into an agreement to repurchase the asset (or a similar asset) at a fixed price on a future date ("repo"), the arrangement is accounted for as a secured loan and the underlying asset continues to be recognised in the Bank's financial statements.

Amounts owed to financial institutions, amounts owed to customers, debt securities and subordinated liabilities are initially measured at fair value less incremental direct transaction costs and subsequently measured at their amortised cost using the effective interest method.

#### 3.21 Provisions

A provision is recognised if, as a result of a past event, the Bank has a present legal or constructive obligation that can be estimated reliably and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.

#### 3.22 Employee benefits

The Bank contributes towards the State Pension Defined Contribution plan in accordance with legislation and to which it has no commitment beyond the payment of fixed contributions. Obligations for this defined contribution plan are recognised as an employee benefit expense in profit or loss in the years during which services are rendered by employees.

#### 3.23 Earnings per share

The Bank presents basic earnings per share (EPS) data for its ordinary shares. Basic EPS is calculated by dividing the profit or loss attributable to ordinary shareholders of the Bank by the weighted average number of ordinary shares outstanding during the year. The Bank does not have any dilutive potential ordinary shares that would otherwise require the presentation of diluted earnings per share. Bonus shares declared and approved after year end are added to the weighted average number of ordinary with no time weighting applied.

#### 3.24 New standards and interpretations not yet adopted

A number of new standards, amendments to standards and interpretations are effective for annual periods beginning on or after 1 April 2013 and have not been applied in preparing these financial statements. None of these are expected to have a significant effect on the financial statements of the Bank.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 4 Financial risk management

#### 4.1 Introduction and overview

The Bank has exposure to the following risks from its use of financial instruments:

- credit risk
- liquidity risk
- market risk
- operational risk

This note presents information about the Bank's exposure to each of the above risks, the Bank's objectives, policies and processes for measuring and managing risks and the Bank's management of capital.

#### 4.2 Risk management framework

The Bank recognises the need to have an effective and efficient risk management function and therefore it has adopted a comprehensive process that provides an appropriate balance between the fast growth of the Bank, maximising its profitability and managing the associated risks.

The Bank's objective is to deploy an integrated risk management approach that ensures an awareness of, and accountability for, the risks taken throughout the Bank and also to develop the tools needed to address those risks. This integrated approach is realised through the governance structure of the Bank and relies on three lines of defence - business units management, an independent risk management function, and independent on-going reviews by internal audit.

#### 4.3 Credit risk

Credit risk is the risk of financial loss to the Bank if a customer or counterparty to a financial instrument fails to meet its contractual obligations and arises principally from the Bank's loans and advances to customers and other banks and investment debt securities. For risk management reporting purposes, the Bank considers and consolidates all elements of credit risk exposure (such as individual obligor default risk, country and sector risk).

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 4 Financial risk management (continued)

#### 4.3 Credit risk (continued)

##### 4.3.1 *Management of credit risk*

The Bank's objective is to maximise its investment returns while maintaining a sound and prudent investment profile. To facilitate achieving this target, the Bank invests in a diversified portfolio including both high-quality assets with strong ratings stability and a highly granular portfolio of loans to corporations and securities issued by corporations, whose higher returns are viewed as justifying a greater level of risk.

Specifically, the Bank focuses on secured and unsecured debt securities issued by financial institutions (some of which may carry a government guarantee) and on debt securities issued by supranational agencies and governments, emphasising Eurozone issuers. The Bank also provides lending to corporate borrowers, either by subscribing to debt securities or by providing senior loans. The Bank's Credit and Investment Policy permits it, subject to the prior approval of the Board, to manage its credit risk through credit hedges, although to date it has not done so.

The Bank's investments are managed on a portfolio basis, taking into account correlations between asset classes. The Bank diversifies its financial and government exposures to avoid excessive concentration in particular countries or types of financial institutions and by including lending to corporate borrowers in the Bank's portfolio. In building and managing a portfolio of financial assets, the Bank's Credit and Investment department takes into account correlation between government and financial system risk in view of the financial system's dependence on government support.

The Management Credit Committee is responsible for approving credit recommendations and making other credit decisions under its authority delegated by the Board. This includes decisions on individual credits, reviewing and recommending credit and large exposures to the Board, consideration of credit hedging strategies and recommending other concentration limits for Board approval. It is also responsible for delegating transactional responsibility to the Credit and Investment department and within the parameters that the Management Credit Committee sets out, the Bank's investment portfolio is managed on a day to day basis by the Head of Credit and Investment.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 4 Financial risk management (continued)

#### 4.3 Credit risk (continued)

##### 4.3.1 Management of credit risk (continued)

Set out below is an analysis of the gross and net of impairment of the Bank's financial assets:

	31 March 2013		31 March 2012	
	Gross Exposure	Net Exposure	Gross Exposure	Net Exposure
	€000	€000	€000	€000
Balances with Central Bank of Malta and treasury bills	69,848	69,848	63,572	63,572
Loans and advances to financial institutions	20,131	20,131	27,804	27,804
Loans and advances to customers: corporate	400,276	399,600	27,081	27,081
Retail secured lending	2,574	2,574	585	585
Investment securities	1,564,034	1,564,034	1,478,378	1,415,493
Derivative assets held for risk management	279	279	2,572	2,572
	2,057,142	2,056,466	1,599,992	1,537,107

##### 4.3.2 Impaired loans and advances and investment securities

The Management Credit Committee has reviewed all credit exposures on a case by case and collective basis (see accounting policy 3.9.7) in the light of current economic conditions and considered the likelihood that the Bank may be exposed to losses on loans and advances and investment securities. Impaired investment securities and loans are those where a loss event has occurred and the Bank establishes that it is unlikely that it will collect the full principal and/or interest due in accordance with the contractual terms of the underlying agreement(s).

##### 4.3.3 Allowances for impairment

The Bank established a collective allowance for impairment losses on its loans and advances to customers that represents losses incurred but not yet identified. For the year ended 31 March 2013, such an allowance amounted to €0.676 million (2012: nil).

During the financial year ended 31 March 2013, there were no forbearance activities (2012: nil).

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 4 Financial risk management (continued)

#### 4.3 Credit risk (continued)

##### 4.3.4 Write-off policy

The Bank writes off a loan or an investment debt security balance and any related allowances for impairment losses, when the Bank determines that the balance is uncollectible. This determination is made after considering information such as the occurrence of significant changes in the borrower's/issuer's financial position such that the borrower/issuer can no longer pay the obligation, or that proceeds from collateral will not be sufficient to pay back the entire exposure.

##### 4.3.5 Exposure to sovereign debt of selected Eurozone countries

During the year ended 31 March 2013 significant concerns about the creditworthiness of certain Eurozone countries persisted. The Bank managed its exposure to the affected Eurozone markets very closely during the year ended 31 March 2013, adjusting the relevant limits where necessary.

The Bank's exposure to sovereign Eurozone government bonds is as follows:

	% of Total Investment Securities	
	31 Mar 2013	31 Mar 2012
Greece	0.96%	1.5%
Portugal	2.18%	3.7%
Malta	1.97%	0.6%
	-----	
	5.11%	5.8%
	=====	

On 25 April 2012, the Bank participated in the final phase of the Private Sector Involvement (PSI) covered by the provisions under the second support plan for Greece. The settlement terms consisted of the exchange of foreign-law governed bonds into new Greek sovereign bonds, European Financial Stability Facility notes and detachable GDP-linked securities issued by Greece. An impairment charge of €31.4 million in respect of foreign-law governed bonds was charged during the period ending 31 March 2012.

No impairment provisions in respect of these positions were required during the year ending 31 March 2013.



## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 4 Financial risk management (continued)

#### 4.3 Credit risk (continued)

##### 4.3.6 Concentration of loans and advances and investment securities

The Bank monitors concentrations of credit risk by sector and by geographical location. An analysis of concentrations of credit risk (net) at the reporting date is shown below.

	Loans and advances to financial institutions		Loans and advances to customers		Investment securities	
	31 Mar 2013	31 Mar 2012	31 Mar 2013	31 Mar 2012	31 Mar 2013	31 Mar 2012
	€000	€000	€000	€000	€000	€000
<b>Concentration by type</b>						
Senior bank obligations	49,087	91,377	-	-	104,477	154,145
Covered bonds	-	-	-	-	1,000,290	910,317
Government securities	-	-	-	-	130,365	132,949
Sovereign agencies and supranationals	-	-	-	-	151,500	62,656
Pooled securities	-	-	-	-	117,433	155,426
Secured corporate lending	-	-	399,600	27,081	54,964	-
Unsecured corporate lending	-	-	-	-	5,005	-
Retail secured lending	-	-	2,574	585	-	-
	49,087	91,377	402,174	27,666	1,564,034	1,415,493
<b>Concentration by location</b>						
Europe	49,087	91,377	385,161	27,666	1,530,868	1,324,928
North America	-	-	17,013	-	33,166	90,565
	49,087	91,377	402,174	27,666	1,564,034	1,415,493

Concentration by location for investment securities is measured based on the location of issuer of the security. Concentration by location for loans and advances is based on the borrower's country of domicile. Government and government guaranteed securities include securities issued or guaranteed by regional governments, supranationals and sovereign agencies as well as sovereign governments themselves.

All securities in the portfolio are accepted by the European Central Bank (ECB) as collateral except for the pooled securities with an aggregate carry value of €40.608 million and the corporate lending portfolio. Either the securities themselves or the issuers of the securities are rated by at least two of Fitch, Standard & Poor's and Moody's.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 4 Financial risk management (continued)

#### 4.3 Credit risk (continued)

##### 4.3.6 Concentration of loans and advances and investment securities (continued)

The Bank held investment securities of €1,564 million as at 31 March 2013 (2012: €1,415 million) net of impairment, an analysis of the credit quality based on rating agency ratings is as follows:

	31 Mar 2013 Net carrying amount €000	31 Mar 2012 Net carrying amount €000
Government securities		
A+ or lower	130,365	132,949
Other securities		
AA- and higher	1,111,924	926,158
A+ or lower	321,745	356,386
<b>Total</b>	<b>1,564,034</b>	<b>1,415,493</b>

##### 4.3.7 Settlement risk

The Bank's activities may give rise to risk at the time of settlement of transactions and trades. Settlement risk is the risk of loss due to the failure of an entity to honour its obligations to deliver cash, securities or other assets as contractually agreed.

For all types of investment transactions the Bank mitigates this risk by conducting settlements through a settlement / clearing agent to ensure that a trade is settled only when both parties have fulfilled their contractual settlement obligations. Settlement limits form part of the credit approval / limit monitoring process described earlier. Furthermore, the Bank has a number of master netting agreements covering repurchase transactions and securities with its counterparties.

#### 4.4 Liquidity risk

Liquidity risk is the risk that the Bank will encounter difficulty in meeting obligations associated with its financial liabilities that are settled by delivering cash or another financial asset.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 4 Financial risk management (continued)

#### 4.4 Liquidity risk (continued)

##### 4.4.1 *Management of liquidity risk*

The Bank's approach to managing liquidity is to ensure that, as far as possible, it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Bank's reputation.

Treasury maintains a portfolio of short-term liquid assets to ensure that there is sufficient unencumbered liquidity within the Bank. The liquidity requirements of the Bank are met through the international repo market, the Eurex repo market and also through ECB secured funding to cover any short-term fluctuations. Longer bi-lateral term funding (for example in the form of total return swaps) is also in place to address any structural liquidity requirements. In addition, deposits and issuance of debt securities provides further support to the Bank's liquidity requirements.

The Bank has designed its liquidity risk management processes and systems to ensure that at all times the Bank maintains a sufficient stock of cash and liquid assets to meet all of its liquidity requirements in the short term and over time. The Bank will at all times ensure that it is in full compliance with all applicable regulatory requirements, including and not limited to, the Minimum Liquid-Asset Requirement and MFSA Banking Rule BR/05/2007 ("Rule BR/05").

In order to ensure that the Bank has adequate liquidity to meet its obligations, the Bank analyses its liquidity using four key approaches:

1. Liquidity Ladder Analysis
2. Scenario Analysis: a forward-looking liquidity risk framework based on projected prices and credit ratings of assets in the Bank's base case scenario and a number of stress scenarios
3. Maximum Cumulative Outflow (MCO) Analysis
4. Key metrics including Net Cash and the Net Cash to Wholesale Funding Ratio

Inputs to these analyses and the analyses themselves, are provided by the Treasury and Risk Management groups, based both on expected and stressed cash flow profiles. Potential material changes in future liquidity requirements are discussed in ALCO.

The Bank actively manages the risk from short-term tenor of deposits through maintaining competitive pricing and constant monitoring of market trends. The majority of the Bank's customer deposit portfolio comprises term deposits rather than deposits that can be withdrawn at short notice and the Bank continues to develop new deposit products that will improve its liquidity risk position.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 4 Financial risk management (continued)

#### 4.4 Liquidity risk (continued)

##### 4.4.2 Exposure to liquidity risk

The key measure used by the Bank for managing liquidity risk is the ratio of the net liquid assets to wholesale funding. For this purpose net liquid assets are considered as including cash and cash equivalents and investment grade debt securities for which there is an active and liquid market as a percentage to the actual wholesale funding of the Bank. A similar, but not identical, calculation is the liquidity ratio as reported in line with MFSA Banking Rule BR/05, which at the reporting date and during the reporting year/period was as follows:

	2013	2012
At 31 March	<b>90.13%</b>	134.59%
Average for the year/period	<b>128.76%</b>	86.73%
Maximum for the year/period	<b>162.05%</b>	134.59%
Minimum for the year/period	<b>90.05%</b>	60.38%

##### 4.4.3 Residual contractual maturities of financial liabilities

###### 31 March 2013

	Carrying amount €000	Gross nominal outflow €000	Less than 1 month €000	1 to 3 months €000	3 months to 1 year €000	1 year to 5 years €000	Over 5 years €000
<i>Non-derivative liabilities</i>							
Amount owed to financial institutions:							
- Due to Central Bank of Malta	107,000	107,016	107,016	-	-	-	-
- Due to clearing houses	695,000	696,669	164,269	181,232	205,159	146,009	-
- Due to other banks	566,995	567,467	175,259	299,499	9,789	82,920	-
Amounts owed to customers	566,047	618,039	170,303	15,583	97,703	334,450	-
Debt securities in issue	15,664	18,887	-	-	994	17,893	-
Subordinated liabilities	12,341	18,936	-	-	931	3,725	14,280
	<b>1,963,047</b>	<b>2,027,014</b>	<b>616,847</b>	<b>496,314</b>	<b>314,576</b>	<b>584,997</b>	<b>14,280</b>

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 4 Financial risk management (continued)

#### 4.4 Liquidity risk (continued)

##### 4.4.3 Residual contractual maturities of financial liabilities (continued)

31 March 2012	Carrying amount €000	Gross nominal outflow €000	Less than 1 month €000	1 to 3 months €000	3 months to 1 year €000	1 year to 5 years €000	Over 5 years €000
Non-derivative liabilities							
Amount owed to financial institutions:							
- Due to Central Bank of Malta	70,000	70,014	70,014	-	-	-	-
- Due to clearing houses	468,000	470,455	52,033	125,486	292,936	-	-
- Due to other banks	555,753	556,293	261,753	196,618	97,922	-	-
Amounts owed to customers	379,555	410,200	147,434	9,276	58,614	194,876	-
Debt securities in issue	19,672	25,274	-	-	1,336	23,938	-
	<b>1,492,980</b>	<b>1,532,236</b>	<b>531,234</b>	<b>331,380</b>	<b>450,808</b>	<b>218,814</b>	<b>-</b>

The table above shows the potential undiscounted cash flows on the Bank's non-derivative financial liabilities assuming that all liabilities are crystallised into cash at the earliest contractually permitted date. The Bank's cash flows on these instruments may vary significantly from this analysis. For example, demand deposits from customers are expected to maintain a stable or increasing balance.

To manage the liquidity risk arising from financial liabilities, the Bank holds liquid assets comprising cash and cash equivalents and investment grade debt securities for which there is an active and liquid market. The Bank does not expect that the disposal of such securities to cover possible liquidity gaps would result in material losses.

#### 4.5 Market risks

Market risk is the risk that changes in market prices, such as interest rate, foreign exchange rates and credit spreads (not relating to changes in the obligor's / issuer's credit standing) which will affect the Bank's income or the value of its holdings of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimising the return on risk.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 4 Financial risk management (continued)

#### 4.5 Market risks (continued)

##### 4.5.1 *Management of market risks*

All foreign exchange risk within the Bank is managed and hedged by the Treasury department. Accordingly, the foreign exchange position is treated as part of the Bank's investment portfolios for risk management purposes.

The overall authority for market risk is vested in ALCO which is responsible for the development of detailed risk management policies and for the day-to-day review of their implementation.

The Bank's Treasury Management Policy (TMP) provides the framework within which treasury prudently manages interest rate, foreign exchange, funding, liquidity, counterparty and investment risk and any other associated risks related to managing the assets and liabilities presented on the statement of financial position. Regular reviews of the TMP are conducted to test robustness of the policy's risk control limits within both normalised and stressed environments.

The Bank's Asset-Liability Management Policy establishes the standards, internal controls, reporting requirements and approval processes that govern the ongoing management of (i) the liquidity and asset-liability mix of the Bank, and (ii) the Bank's market, interest rate and currency risk.

##### 4.5.2 *Currency risk*

Currency risk is the risk that the value of a financial instrument will fluctuate due to the changes in foreign exchange rates. The Bank is exposed to currency risk on foreign exchange along with the parameters set by the TMP. In the majority of cases the Bank covers this risk by ensuring that its foreign currency denominated liabilities are matched with corresponding assets in the same currency. Any mismatches that can arise are monitored accordingly.

The Bank focuses its activities largely on euro denominated assets and liabilities, thus it runs a limited foreign exchange risk. The Bank seeks to minimise foreign exchange risk and thus seeks to hedge all major exposures in this area in accordance with the prevailing ALCO strategy. All foreign currency forward contracts, option contracts or foreign exchange spot deals are executed only with banks on the approved foreign exchange counterparty list set by ALCO.

The following table provides an analysis of the financial assets and financial liabilities of the bank into relevant currency groupings.



## Notes to the Financial Statements

For the Year Ended 31 March 2013

	31 March 2013			31 March 2012		
	Euro Currency €'000	Other Currencies €'000 equivalent	Total €'000 equivalent	Euro Currency €'000	Other Currencies €'000 equivalent	Total €'000 equivalent
<b>Financial assets</b>						
Balances with Central Bank of Malta, treasury bills	69,957	98	70,055	63,640	16	63,656
Loans and advances to financial institutions	13,538	6,593	20,131	19,955	7,849	27,804
Loans and advances to customers	346,726	55,448	402,174	27,141	525	27,666
Investment securities	1, 559,301	4,733	1,564,034	1,415,493	-	1,415,493
Derivative assets	279	-	279	2,572	-	2,572
	<b>1,989,801</b>	<b>66,872</b>	<b>2,056,673</b>	<b>1,528,801</b>	<b>8,390</b>	<b>1,537,191</b>
<b>Financial liabilities</b>						
Amounts owed to financial institutions	1,329,240	37,754	1,368,995	1,093,753	-	1,093,753
Amounts owed to customers	469,132	96,915	566,047	269,284	110,271	379,555
Debt securities in issue	15,664	-	15,664	19,672	-	19,672
Subordinated liabilities	10,079	2,262	12,341	-	-	-
	<b>1,824,116</b>	<b>136,931</b>	<b>1,963,047</b>	<b>1,382,709</b>	<b>110,271</b>	<b>1,492,980</b>
 Net financial position	 163,685	 (70,059)	 93,626	 146,092	 (101,881)	 44,211
Derivative instruments held for risk management	(69,756)	69,756		(101,973)	101,973	
Exposure		(303)			92	

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 4 Financial risk management (continued)

#### 4.5 Market risks (continued)

##### 4.5.3 *Exposure to interest rate risk - non-trading portfolios*

The principal risk to which non-trading portfolios are exposed is the risk of loss from fluctuations in the future cash flows or fair values of financial instruments because of a change in market interest rates. Interest rate risk is managed principally through monitoring exposure to moves in market interest rates, both through their effect on future cash flows and through their effect on the current economic values of financial instruments and by having pre-approved limits on these exposures. ALCO is the monitoring body for compliance with these limits and is assisted by Risk Management in its monitoring activities.

In order to evaluate the risk arising through fluctuations in future cash flows, such flows are projected for both assets and liabilities on a base case and stressed scenarios of the relevant yield curves. A comparison report demonstrates the effects of interest rate stresses on Net Interest Margin (NIM) over a number of years. The risk arising from fluctuations in fair value is calculated for each section of the Bank's portfolio, showing exposure to individual market rates to a high degree of granularity. It is then expressed both as a risk to reported income and capital and as an economic measure that can be compared to the risk reported using a cash flow approach.

The outputs from the interest rate reports are used by ALCO to determine the appropriateness of the Bank's interest rate risk exposure and manage the assets and liabilities accordingly.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 4 Financial risk management (continued)

#### 4.5 Market risks (continued)

##### 4.5.3 Exposure to interest rate risk - non-trading portfolios (continued)

A summary of the Bank's interest rate gap position on non-trading portfolios is as follows:

31 March 2013	Re-pricing in:			
	Carrying amount €000	Less than 3 months €000	3 months to 1 year €000	More than 1 year €000
Balances with Central Bank of Malta and treasury bills	69,848	45,975	19,941	3,932
Investment securities	1,564,034	401,626	3,699	1,158,709
Loans and advances to financial Institutions	20,131	20,131	-	-
Loans and advances to customers	402,174	385,871	13,834	2,469
	<b>2,056,187</b>	<b>853,603</b>	<b>37,474</b>	<b>1,165,110</b>
Amounts owed to financial institutions:				
- Due to Central Bank of Malta	107,000	107,000	-	-
- Due to clearing houses	695,000	345,000	205,000	145,000
- Due to other banks	566,995	551,609	14,649	737
Amounts owed to customers	566,047	185,465	94,932	285,650
Debt securities issued	15,664	-	-	15,664
Subordinated liabilities	12,341	-	-	12,341
	<b>1,963,047</b>	<b>1,189,074</b>	<b>314,581</b>	<b>459,392</b>
Interest rate gap	<b>93,140</b>	<b>(335,471)</b>	<b>(277,107)</b>	<b>705,718</b>

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 4 Financial risk management (continued)

#### 4.5 Market risks (continued)

##### 4.5.3 Exposure to interest rate risk - non-trading portfolios (continued)

31 March 2012	Re-pricing in:			
	Carrying amount €000	Less than 3 months €000	3 months to 1 year €000	More than 1 year €000
Balances with Central Bank of Malta and treasury bills	63,572	61,001	-	2,571
Loans and advances to financial institutions	27,804	27,804	-	-
Loans and advances to customers	27,666	27,081	25	560
Investment securities	1,415,493	423,433	57,830	934,230
	1,534,535	539,319	57,855	937,361
Amounts owed to financial institutions:				
- Due to Central Bank of Malta	70,000	70,000	-	-
- Due to clearing houses	470,455	177,519	292,936	-
- Due to other banks	553,298	457,555	95,743	-
Amounts owed to customers	379,555	156,742	57,155	165,658
Debt securities issued	19,672	-	-	19,672
	1,492,980	861,816	445,834	185,330
Interest rate gap	41,555	(322,497)	(387,979)	752,031

Interest rate risk positions are managed by Treasury and Credit and Investment departments, in conjunction with Risk Management, by strategically positioning the asset and liability interest rate re-pricing profiles as well as by purchases of interest rate derivatives, primarily swaps. The use of derivatives to manage interest rate risk is described in note 18.

In addition, Treasury uses advances to financial institutions and deposits from financial institutions to manage the overall position arising from the Bank's non-trading activities.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 4 Financial risk management (continued)

#### 4.5 Market risks (continued)

##### 4.5.3 Exposure to interest rate risk - non-trading portfolios (continued)

The management of interest rate risk against interest rate gap limits is supplemented by monitoring the sensitivity of the Bank's financial assets and liabilities to various interest rate scenarios. The estimated impact on NIM as a result of a 100 basis points (bps) movement and on Fair Value Reserve as a result of a 100 basis points (bps) parallel fall / rise in the yield curves would be as follows:

##### 31 March 2013

- Net profit would decrease by €7.91 million / increase by €8.96 million.
- Economic Value would decrease by €16.96 million / increase by €19.61 million.

These values are presented after taking into account the impact of hedge accounting and it has been assumed in this calculation that market interest rates do not become negative.

##### 31 March 2012

- Net profit would decrease by €0.872 million / €0.502 million.
- Economic Value would increase by €9.084 million / decrease by €8.153 million.

Interest rate movements affect reported equity in the following ways:

- Retained earnings arising from increases or decreases in net interest income after taking into consideration the net impact of interest rate hedging instruments; and
- Fair value reserves arising from increases or decreases in fair values of available-for-sale financial instruments reported directly in equity.

As the Bank's expectation is that it will increase its annual reserves by more than the calculated maximum loss under the most severe stress scenario of 100 bps noted above, the Bank should always generate a net positive increase of its reserves.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 4 Financial risk management (continued)

#### 4.6 Operational risks

Operational risk is the risk of direct or indirect loss arising from a wide variety of causes associated with the Bank's processes, personnel, technology and infrastructure and from external factors other than credit, market and liquidity risks such as those arising from legal and regulatory requirements and generally accepted standards of corporate behaviour. Operational risks arise from all of the Bank's operations and are faced by all business entities.

The Bank's objective is to manage operational risk so as to balance the avoidance of financial losses and damage to the Bank's reputation with overall cost effectiveness and to avoid control procedures that restrict initiative and creativity while maintaining risk taking within a tolerable limit.

The primary responsibility for the development and implementation of controls to address operational risk is assigned to senior management within each business unit. This responsibility is supported by the development of overall Bank standards for the management of operational risk in the following areas:

- requirements for appropriate segregation of duties, including the independent authorisation of transactions
- requirements for the reconciliation and monitoring of transactions
- compliance with regulatory and other legal requirements
- documentation of controls and procedures
- requirements for the periodic assessment of operational risks faced and the adequacy of controls and procedures to address the risks identified
- requirements for the reporting of operational losses and proposed remedial action
- development of contingency plans
- training and professional development
- ethical and business standards
- risk mitigation, including insurance where this is effective.

A financial measurement of this risk is calculated by the Bank for the purpose of allocating risk capital using the Basic Indicator Approach under the Banking Rule 4. The capital requirement for operational risk under this method was calculated at €4,387,500 (31 March 2012: €3,102,800).



## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 4 Financial risk management (continued)

#### 4.7 Capital management - regulatory capital

The Bank's regulator, the MFSA, sets and monitors capital requirements for the Bank.

In implementing current capital requirements, the MFSA requires the Bank to maintain a prescribed ratio of total capital to total risk-weighted assets.

The Bank does not engage in trading and is exempt from having a trading book. Risk-weighted assets on the banking book are determined according to specified requirements that seek to reflect the varying levels of risk attached to assets including balances with counterparties and other illiquid assets.

The Bank complies with the provisions of the Basel II framework in respect of regulatory capital and it applies the standardised approach.

The Bank's regulatory capital consists of:

- core tier 1 capital, which includes ordinary share capital, share premium, retained earnings, shareholders' contribution and other regulatory adjustments relating to items that are included in equity but are treated differently for capital adequacy purposes including and deductions relating to Reserve for Depositor Compensation Scheme ('Other reserves') and the carrying amounts of investment in subsidiaries that are not included in the regulatory consolidation and certain other regulatory items; and
- core tier 2 capital, consisting of subordinated liabilities in issue and fair value reserve.

The Bank's policy is to maintain a sufficient capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business. The impact of the level of capital on shareholders' return is also recognised and the Bank recognises the need to maintain a balance between the higher returns that might be possible with greater gearing and the advantages and security afforded by a sound capital position.

The Bank's regulatory Own Funds was increased through an increase in share capital of €6.320 million on 15 March 2013 and a further €8.500 million as shareholders' contribution on 27 March 2013.

The Bank has complied with all externally imposed capital requirements throughout the year.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 4 Financial risk management (continued)

#### 4.7 Capital management - regulatory capital (continued)

The Bank's regulatory capital position was as follows:

	31 Mar 2013	31 Mar 2012
<i>Own funds</i>	€000	€000
Share capital	62,350	56,030
Share premium	13,464	13,464
Retained earnings brought forward	708	6,321
Profit for the year/period	20,483	708
Other reserves	(3,429)	(1,836)
Intangible assets	(228)	(351)
Investment in subsidiaries	(65)	(63)
Fair value reserve	9,578	(1,137)
Shareholders' contribution	8,500	-
Subordinated liabilities	12,341	-
<b>Own funds</b>	<b>123,702</b>	<b>73,136</b>
=====		
<i>Capital ratio</i>		
Regulatory capital as a % of total risk-weighted assets	15.66%	24.53%
=====		

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 5 Use of estimates and judgements

The preparation of the financial statements requires the directors to make judgements, estimates and assumptions that affect the reported amounts of revenues, expenses, assets and liabilities and the disclosure of contingent liabilities, at the end of the reporting period. However, uncertainty about these assumptions and estimates could result in outcomes that require a material adjustment to the carrying amount of the asset or liability affected in future periods. These disclosures supplement the disclosures on the financial risk management (see note 4).

In the process of applying the Bank's accounting policies, the directors have made the following judgements, which have the most significant effect on the amounts recognised in the consolidated financial statements:

#### 5.1 Financial assets and liabilities classification

In classifying financial assets as held-to-maturity, the Bank has determined that it has both the positive intention and ability to hold the assets until their maturity date as required by accounting policy 3.13.1.

#### 5.2 Revision of estimated cash flows from investment securities

A substantial part of the investment securities has a pass-through principal repayment profile. This means that principal payments on the investment securities that are held by the Bank are driven by and dependent on, the receipts from the underlying collateral pool.

Inherently, projections on principal receipts from a collateral pool are uncertain and based on a number of assumptions. For this reason, the Bank considers different scenarios in analysing the investment securities portfolio. Three of the scenarios are similar to the rating agency stress scenarios (AAA, AA, A) and the fourth approximates a prudent estimate of cash flows based on historical observations.

As part of the monitoring of the Bank's investments, the Credit and Investment department, together with the Back Office, track actual receipts on the investment securities. As new observations occur on due dates of the securities, actual cash flow receipts are compared to the estimated cash flows for the same date. The latter is an estimate and thus differences from actual cash flows are expected.

If the cash flows received deviate from those expected by more than 50%, the assumptions underlying the measurement of the investment security are reassessed and adjusted, if required.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 5 Use of estimates and judgements (continued)

#### 5.3 Allowances for credit losses

Assets accounted for at amortised cost are evaluated for impairment on the basis described in accounting policy 3.9.7. The specific counterparty component of the total allowances for impairment applies to financial assets evaluated individually for impairment and is based upon management's best estimate of the present value of the cash flows that are expected to be received as described in 5.2. In estimating these cash flows, management also considers the net realisable value of any underlying collateral.

Collectively assessed impairment allowances cover credit losses inherent in portfolios of loans and advances with similar credit risk characteristics when there is objective evidence to suggest that they contain impaired loans and advances, but individually impaired items cannot yet be identified. In assessing the need for collective loss allowances, management considers factors such as credit quality, portfolio size, concentrations and economic factors. In order to estimate the required allowance, assumptions are made to define the way inherent losses are modelled and to determine the required input parameters, based on historical experience (including loss emergence periods) and current economic conditions. The accuracy of the allowances depends on the estimates of future cash flows for specific counterparty allowances and the model assumptions and parameters used in determining collective allowances.

#### 5.4 Effectiveness testing under Hedge Accounting

The following effectiveness tests are performed under Hedge Accounting:

- A prospective effectiveness test. This is a forward-looking test of whether a hedging relationship is expected to be highly effective against market moves.
- A retrospective effectiveness test. This is a backward-looking test of whether a hedging relationship has actually been highly effective over a period: this is specifically defined in terms of an effectiveness ratio between 80% and 125%.

The Bank assesses the effectiveness under the dollar offset methodology; this is a quantitative method that compares the change in fair value or cash flows of the hedging instrument with the change in fair value or cash flows of the hedged item attributable to the hedged risk. The dollar offset method is performed using different approaches, as follows:

- Prospective effectiveness testing uses the sensitivity analysis approach. This method consists of measuring the effect of a hypothetical shift in the underlying hedged risk (for example, a 1% shift in the yield curve of the interest rate being hedged) on both the hedging instrument and the hedged item. Interest rates used in the prospective effectiveness test represent a reasonable proxy for the cost of funding. Bonds were modelled with coupons adjusted down by their credit spreads consistent with the aim of hedging purely the interest rate component of their price risk.
- Retrospective effectiveness testing uses the hypothetical derivative approach, which compares the change in the fair value or cash flows of the hedging instrument with the change in the fair value or cash flows of a hypothetical derivative matching the terms of the hedged item. Valuations of both the hedging instruments themselves and the hypothetical derivatives, are calculated using a market-standard approach.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 6 Financial assets and liabilities

#### 6.1 Valuation

The Bank measures fair values using the following fair value hierarchy that reflects the significance of the inputs used in making the measurements.

- Level 1: Quoted market price (unadjusted) in an active market for an identical instrument.
- Level 2: Valuation techniques based on observable inputs, either directly (i.e. as prices) or indirectly (i.e. derived from prices). This category includes instruments valued using: quoted market prices in active markets for similar instruments; quoted prices for identical or similar instruments in markets that are considered less than active; or other valuation techniques where all significant inputs are directly or indirectly observable from market data.
- Level 3: Valuation techniques using significant unobservable inputs. This category includes all instruments where the valuation technique includes inputs not based on observable data and the unobservable inputs have a significant effect on the instrument's valuation. This category includes instruments that are valued based on quoted prices for similar instruments where significant unobservable adjustments or assumptions are required to reflect differences between the instruments.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 6 Financial assets and liabilities (continued)

#### 6.1 Valuation (continued)

As at 31 March 2013 and at 31 March 2012, the fair value of the available-for-sale (AFS) investment securities represents closing bid price quoted in an active market. These are classified as Level 1, with the exception for those investments securities reclassified to AFS as described in note 17.5, which are classified as Level 2, under the fair value hierarchy in accordance with IFRS 7.

The fair value of the financial assets and liabilities, which are measured at amortised cost and have a short re-pricing maturity, is not materially different from their carrying amount in the statement of financial position, except for held-to-maturity investments and loans and advances to customers as shown in table 6.1.

The fair value of derivatives held for risk management are based on valuation models and the methodology is to calculate the net present value of a series of expected cash flows, taking into account the different terms of each specific contract/instrument (discount cash flow, DCF). These models use as their basis independently sourced market parameters including, for example, interest rate yield curves. Most market parameters are either directly observable or are implied from instrument prices. The model may perform numerical procedures in the pricing such as interpolation when input values do not directly correspond to the most actively traded market trade parameters.

However, where valuations include significant unobservable inputs, the transaction price is deemed to provide the best evidence of initial fair value for accounting purposes. For valuations that include significant unobservable inputs, the difference between the model valuation and the initial transaction price is recognised in profit or loss.

Various factors influence the availability of observable inputs and these may vary from product to product and change over time. Factors include, for example, the depth of activity in the relevant market, the type of product, whether the product is new and not widely traded in the marketplace, the maturity of market modelling, etc.

To the extent that valuation is based on models or inputs that are not observable in the market, the determination of fair value can be more subjective, dependant on the significance of the unobservable input to the overall valuation.

Unobservable inputs are determined based on the best information available, for example by reference to similar assets, similar maturities or other analytical techniques.

Such derivatives held for risk management are classified as Level 2 under the fair value hierarchy in accordance with IFRS 7.



## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 6 Financial assets and liabilities (continued)

#### 6.1 Valuation (continued)

The table below sets out the gross carrying amounts and fair values of the Bank:

##### At 31 March 2013

		Amortised cost	Fair value through other comprehensive income	Fair value through profit or loss	Total carrying amount	Fair values
	Notes	€000	€000	€000	€000	€000
Balances with Central Bank of Malta, treasury bills and cash	14	29,163	40,892	-	70,055	70,055
Loans and advances to financial institutions	15	20,131	-	-	20,131	20,131
Loans and advances to customers	16	402,850	-	-	402,850	397,863
Investment securities	17	356,544	1,207,490	-	1,564,034	1,546,084
Derivative assets held for risk management	18	-	-	279	279	279
		808,688	1,248,382	279	2,057,349	2,034,412
Amounts owed to financial institutions	26	1,368,995	-	-	1,368,995	1,368,995
Amounts owed to customers	27	566,047	-	-	566,047	566,047
Debt securities in issue	28	15,664	-	-	15,664	16,302
Subordinated liabilities	29	12,341	-	-	12,341	12,931
		1,963,047	-	-	1,963,047	1,964,275

##### At 31 March 2012

		Amortised cost	Fair value through other comprehensive income	Fair value through profit or loss	Total carrying amount	Fair values
	Notes	€000	€000	€000	€000	€000
Balances with Central Bank of Malta, treasury bills and cash	14	63,656	-	-	63,656	63,656
Loans and advances to financial institutions	15	27,804	-	-	27,804	27,804
Loans and advances to customers	16	27,666	-	-	27,666	27,666
Investment securities	17	559,647	855,846	-	1,415,493	1,357,192
Derivative assets held for risk management	18	-	-	2,572	2,572	2,572
		678,773	855,846	2,572	1,537,191	1,478,890
Amounts owed to financial institutions	26	1,093,753	-	-	1,093,753	1,093,753
Amounts owed to customers	27	379,555	-	-	379,555	379,483
Debt securities in issue	28	19,672	-	-	19,672	20,000
		1,492,980	-	-	1,492,980	1,493,236

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 7 Net interest income

	1 Apr 2012 to 31 Mar 2013 €000	1 Jan 2011 to 31 Mar 2012 €000
<b>Interest income</b>		
Investment securities	36,621	63,584
Loans and advances to financial institutions	133	314
Loans and advances to customers	14,191	169
	-----	-----
	50,945	64,067
	-----	-----
<b>Interest expense</b>		
Amounts owed to customers	17,085	11,726
Amounts owed to financial institutions	8,995	21,105
Debt securities in issue	1,588	1,496
	-----	-----
	27,668	34,327
	-----	-----
<b>Net interest income</b>	23,277	29,740
	=====	=====

### 8 Net fee and commission expense

	1 Apr 2012 to 31 Mar 2013 €000	1 Jan 2011 to 31 Mar 2012 €000
Net portfolio and other management fees	(2,126)	(171)
Underwriting fee income	300	-
	-----	-----
	(1,826)	(171)
	=====	=====

Net fee and commission income includes €300,000 (2012: nil) derived from investments services activities.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 9 Net trading income and other operating income

#### 9.1 Net trading income

	1 Apr 2012 to 31 Mar 2013 €000	1 Jan 2011 to 31 Mar 2012 €000
Foreign exchange income		
- from derivative assets held for risk management	344	223
- from other activities	1,111	1,252
Gains on derivative assets/liabilities held for risk management	3,812	324
	-----	-----
	5,267	1,799
	=====	=====

‘Foreign exchange income from derivative assets held for risk management’ includes gains and losses from spot and forward contracts and other currency derivatives.

‘Foreign exchange income from other activities’ includes gains from foreign exchange in retail.

#### 9.2 Other operating income

	1 Apr 2012 to 31 Mar 2013 €000	1 Jan 2011 to 31 Mar 2012 €000
Realised gains on disposal of investments	26,464	48,826
Realised gains on redemption of loans and advances	989	-
Other income	81	105
	-----	-----
	27,534	48,931
	=====	=====

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 10 Administrative and other expenses

Administrative and other expenses include:

	1 Apr 2012 to 31 Mar 2013 €000	1 Jan 2011 to 31 Mar 2012 €000
Operating lease charges	1,891	786
Directors' fees	110	135
	-----	

Administrative and other expenses also include fees charged by the Bank's auditors for the year/period and are as follows:

	Audit services €000	Other assurances services €000	Tax advisory services €000	Other non-audit services €000
<b>Year to 31 March 2013</b>				
Auditors' remuneration	65	34	9	39
	-----	-----	-----	-----
<b>Period to 31 March 2012</b>				
Auditors' remuneration	80	57	11	4
	-----	-----	-----	-----

### 11 Personnel expenses

11.1 Personnel expenses incurred are analysed as follows:

	1 Apr 2012 to 31 Mar 2013 €000	1 Jan 2011 to 31 Mar 2012 €000
Directors' emoluments:		
- salaries	2,190	1,286
- defined contribution social security costs	8	9
Staff costs:		
- salaries	8,458	5,002
- defined contribution social security costs	246	164
	-----	-----
	10,902	6,461
	=====	=====

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 11 Personnel expenses (continued)

11.2 The weekly average number of persons employed was as follows:

	31 Mar 2013 No.	31 Mar 2012 No.
Executive and senior management	14	15
Other managerial, supervisory and clerical	139	61
Other	10	7
	<b>163</b>	<b>83</b>

11.3 The number of persons employed at the reporting date was as follows:

	31 Mar 2013 No.	31 Mar 2012 No.
Management and administration	<b>194</b>	<b>109</b>

### 12 Income tax expense

12.1

	1 Apr 2012 to 31 Mar 2013 €000	1 Jan 2011 to 31 Mar 2012 €000
Current tax expense	11,528	149
Deferred tax (income)/expense	(464)	304
<b>Income tax expense</b>	<b>11,064</b>	<b>453</b>

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 12 Income tax expense (continued)

- 12.2 The income tax expense and the result of accounting profit multiplied by the tax rate applicable in Malta, the Bank's country of incorporation, are reconciled as follows:

	1 Apr 2012 to 31 Mar 2013 €000	1 Jan 2011 to 31 Mar 2012 €000
Profit for the year/period	20,483	708
Income tax expense	11,064	453
	-----	-----
Profit before income tax	31,547	1,161
	=====	=====
Tax at the applicable rate of 35%	11,041	406
Tax effect of:		
Non-deductible expenses	1	1
Depreciation charges not deductible by way of capital allowances	22	45
Temporary differences not previously recognised	-	1
	-----	-----
Income tax expense	11,064	453
	=====	=====

### 13 Earnings per share

The calculation of the Bank's basic earnings per share at 31 March 2013 and 31 March 2012 was based on the profit attributable to ordinary shareholders and a weighted average number of ordinary shares outstanding.

	31 Mar 2013 No.	31 Mar 2012 No.
Weighted average number of ordinary shares ('000)	56,324	48,695
	=====	=====

The calculation of the Bank's adjusted basic earnings per share at 31 March 2013 and 31 March 2012 was based on the profit attributable to ordinary shareholders and a weighted average number of ordinary shares outstanding and 21,000,000 bonus shares issued after year end.

	31 Mar 2013 No.	31 Mar 2012 No.
Adjusted weighted average number of ordinary shares ('000)	77,324	69,695
	=====	=====

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 13 Earnings per share (continued)

	1 Apr 2012 to 31 Mar 2013 €000	1 Jan 2011 to 31 Mar 2012 €000
Profit for the year/period attributable to ordinary shareholders	20,483	708
	=====	
Earnings per share	36c	1c
	=====	
Adjusted earnings per share	27c	1c
	=====	

### 14 Balances with Central Bank of Malta, treasury bills and cash

#### 14.1

	31 Mar 2013 €000	31 Mar 2012 €000
Balances with Central Bank of Malta	28,956	63,572
Malta Government Treasury Bill	40,892	-
Cash	207	84
	-----	
	70,055	63,656
	=====	

**14.2** Balances with Central Bank of Malta include a reserve deposit of the Bank in terms of Regulation (EC) No 1745/2003 of the European Central Bank amounting to €3.074 million, (2012: €2.123 million) bearing interest at 0.75% (2012: 1%) per annum and an overnight deposit amounting to €25.0 million (2012: €61.0 million) bearing no interest (2012: 0.25%) per annum.

**14.3** The Balances with Central Bank of Malta also include a balance of €857,347 (2012: €449,585) which is pledged in favour of the Depositor Compensation Scheme (DCS) in terms of the Depositor Compensation Scheme Regulations (Subsidiary Legislation, 371.09) of the Laws of Malta.

In connection with the DCS, investment securities with a carrying amount of €2,603,480 (2012: €1,380,069), nominal value €2,475,000 (2012: €1,330,000) and a fair value of €2,678,137 (2012: €1,391,313) as at 31 March 2013, are pledged in favour of the DCS.



## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 15 Loans and advances to financial institutions

#### 15.1 Balances

	31 Mar 2013	31 Mar 2012
	€000	€000
At amortised cost:		
Repayable on call and at short notice	8,434	16,324
Term loans and advances	11,697	11,480
	-----	-----
	20,131	27,804
	=====	=====

15.2 Balances of loans and advances to financial institutions up to €69,578 (2010: €80,740) are pledged in favour of other banks providing credit card facilities to customers.

15.3 An amount of €1 million has been contributed to a clearing fund held by Eurex Clearing AG, of which the Bank is a member. The clearing fund protects members against losses until they leave the clearing fund.

15.4 Loans and advances to financial institutions as at 31 March 2013 and 31 March 2012 were neither past due nor impaired.

### 16 Loans and advances to customers

#### 16.1 Balances

	31 Mar 2013	31 Mar 2012
	€000	€000
At amortised cost:		
Loans and advances: retail	2,574	585
Loans and advances: corporate	399,600	27,081
	-----	-----
	402,174	27,666
	=====	=====

16.2 Loans and advances to customers as at 31 March 2013 and 31 March 2012, were neither past due nor impaired.

16.3 Loans and advances to customers: "retail" are secured by an equivalent amount of customer deposits, included in "Amounts owed to customers", with the exception of what is described in note 16.4 below. These deposits are pledged in favour of the Bank.

16.4 Loans and advances to customers: "retail" includes €100,000 loan sanctioned to a director of the Bank (2012: nil). This is secured by general hypothecs and carry an interest of 4.5% per annum.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 16 Loans and advances to customers (continued)

**16.5** As at 31 March 2013, €8.311 million of “loans and advances to customers: corporate” and €0.105 million of the “loans and advances to customers: retail” are expected to be recovered within 12 months after the reporting date.

**16.6** As at 31 March 2013, €1 million of “loans and advances to customers: corporate” were traded but beneficial ownership was not yet transferred and not recorded as purchases. Also, €10 million were sold but beneficial ownership was not yet transferred.

**16.7** Allowances for impairment

	31 Mar 2013	31 Mar 2012
	€000	€000
Specific allowances for impairment	-	-
	=====	
Collective allowances for impairment	676	-
	=====	
Balance as at 1 April/ 1 January	-	-
Impairment loss for the year/period:		
<i>Charge for the year/period</i>	676	-
	-----	
Balance at 31 March	676	-
	=====	

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 17 Investment securities

#### 17.1 Investment securities analysis

	31 Mar 2013	31 Mar 2012
	€000	€000
Held-to-maturity investment securities	356,544	609,918
Available-for-sale investment securities	1,207,490	805,575
	-----	-----
	1,564,034	1,415,493
	=====	=====

At 31 March 2013, €1,492 million (2012: €1,340 million) of investment securities are expected to be recovered after more than 12 months after the reporting date.

##### 17.1.1 Held-to-maturity investment securities by issuer

	31 Mar 2013	31 Mar 2012
	€000	€000
Government securities	65,542	125,103
Other securities	291,002	484,815
	-----	-----
	356,544	609,918
	=====	=====

##### 17.1.2 Available-for-sale investment securities by issuer

	31 Mar 2013	31 Mar 2012
	€000	€000
Government securities	64,823	7,846
Other securities	1,142,667	797,729
	-----	-----
	1,207,490	805,575
	=====	=====

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 17 Investment securities (continued)

#### 17.2 Balances

As at 31 March 2013	Gross carrying amount €000	Individually impairment amount €000	Net carrying amount €000
Held-to-maturity investment securities	356,544	-	356,544
Available-for-sale investment securities	1,207,490	-	1,207,490
	<b>1,564,034</b>	<b>-</b>	<b>1,564,034</b>
=====			
As at 31 March 2012	Gross carrying amount €000	Individually impairment amount €000	Net carrying amount €000
Held-to-maturity investment securities	672,803	62,885	609,918
Available-for-sale investment securities	805,575	-	805,575
	<b>1,478,378</b>	<b>62,885</b>	<b>1,415,493</b>
=====			

No evidence of impairment was identified on investment securities during year ended 31 March 2013.

- 17.3** Most of investment securities are pledged as collateral against the provision of borrowing facilities (note 26), except a carry value of €111.200 million (2012: €32.872 million) which are free and unencumbered securities at 31 March 2013.

Cash value of unutilised borrowing facilities (headroom) at 31 March 2013 amounted to €113.039 million (2012: €121.416 million).

- 17.4** As at 31 March 2013, the Bank has a commitment amounting to €75.000 million (2012: €70.612 million) to purchase further investment securities.

#### 17.5 Reclassifications and sales out of Held-to-Maturity (HTM) Investment Securities

A number of investment securities were identified for reclassification due to isolated and non-recurring events which could not have been reasonably anticipated. On 31 March 2013, as part of the year end assessment of the intention and ability to hold its existing HTM investments to maturity, the Bank reclassified HTM investments to AFS having an amortised cost of €163.967 million. There were no reclassifications of HTM investments securities to AFS in prior periods.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 17 Investment securities (continued)

#### 17.5 Reclassifications and sales out of Held-to-Maturity Investment Securities (continued)

The events that caused the Bank to reclassify or sell included:

- significant credit deterioration in the issuer's creditworthiness since acquisition
  - significant credit deterioration is represented by downgrades of 3 or more rating notches;
  - there were no default events on the reclassified HTM positions and no specific impairment provisions were deemed necessary;
  - a reduction in the carry value of the reclassified HTM positions of €2.356 million was recognised in other comprehensive income; and
  - the sales of HTM securities amounted to €68.474 million.
- unexpected withdrawal of eligibility for ECB repo financing
  - that could not reasonably have been foreseen when the investments were originally classified as HTM;
  - that has significantly altered the economic rationale at time of acquisition;
  - an increase in the carry value of the reclassified HTM positions of €0.423 million was recognised in other comprehensive income.

At 31 March 2013, the fair value of the reclassified HTM investment was €162.034 million. A total fair value loss of €1.933 million was recognised in other comprehensive income, that would not have been recognised if the reclassifications had not been made.

At 31 March 2013, the effective interest rates on reclassified HTM investment securities ranged from 1.3 percent to 4.8 percent.

### 18 Derivative assets held for risk management

	31 Mar 2013	31 Mar 2012
	€000	€000
Instrument type:		
Interest rate swaps	279	-
Interest rate swaptions	-	2,572
	-----	-----
	279	2,572
	=====	=====

The Bank established derivative lines with counterparties to purchase interest rate caps, swaps and swaptions, futures and other appropriate instruments approved for hedging interest rate risk.

The Bank uses over-the-counter interest rate swaps to hedge its exposure to changes in the fair values of its fixed rate AFS securities attributable to changes in market interest rates. Interest rate swaps are matched to specific positions of fixed rate AFS securities. Such derivatives are not held for trading purposes and are classified at fair value through profit and loss and are designated in a fair value hedging relationships.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 18 Derivative assets held for risk management (continued)

The fair values of derivatives designated as fair value hedges and the related notional amounts analysed by their remaining life, are as follows:

	31 Mar 2013	31 Mar 2012
	€000	€000
Derivative financial instruments designated as fair value hedges		
Interest rate swaps	279	-
	=====	
Notional Amounts		
More than 1 year	900,000	-
	=====	

### 19 Investment in subsidiaries

19.1	Name of the subsidiary	Incorporated in	Nature of business	Current equity interest %	Bank 31.Mar 2013 €	Bank 31 Mar 2012 €
	Mediterranean Global Advisory SA	Switzerland	Dormant	wholly owned	63,086	63,086
	Mediterranean Research Limited	United Kingdom	Dormant	wholly owned	2	2
	Medifin Estates (partnership)	Malta	Operating lease of branches	97%	1,450	-
					-----	
					64,538	63,088
					=====	

**19.2** Mediterranean Global Advisory SA and Mediterranean Research Limited are in the process of liquidation. The operations of Mediterranean Research Limited are being carried out by the Bank. Notwithstanding this, no impairment is deemed necessary.

**19.3** Medifin Estates is a partnership set up on 5 June 2012. The subsidiary enters into operating leases for property to be used as branches which are leased back to the Bank.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 20 Property and equipment

#### 20.1

	Improvements to premises	Computer equipment	Other equipment	Fixtures and fittings	Motor vehicles	Total
	€000	€000	€000	€000	€000	€000
<b>Cost</b>						
At 1 January 2011	928	1,943	89	676	146	3,782
Acquisitions	176	372	134	318	29	1,029
Disposals	-	(109)	-	-	-	(109)
At 31 March 2012	1,104	2,206	223	994	175	4,702
Acquisitions	-	14	5	371	39	429
Disposal	-	-	-	(3)	-	(3)
<b>At 31 March 2013</b>	<b>1,104</b>	<b>2,220</b>	<b>228</b>	<b>1,362</b>	<b>214</b>	<b>5,128</b>
=====						
<b>Depreciation</b>						
At 1 January 2011	464	169	35	387	131	1,186
Charge for the period	132	347	56	90	11	636
At 31 March 2012	596	516	91	477	142	1,822
Charge for the year	115	538	59	95	15	822
Release on disposal	-	-	-	(1)	-	(1)
<b>At 31 March 2013</b>	<b>711</b>	<b>1,054</b>	<b>150</b>	<b>571</b>	<b>157</b>	<b>2,643</b>
=====						
<b>Carrying amounts</b>						
At 1 January 2011	464	1,774	54	289	15	2,596
At 31 March 2012	508	1,690	131	517	33	2,880
<b>At 31 March 2013</b>	<b>393</b>	<b>1,166</b>	<b>78</b>	<b>791</b>	<b>57</b>	<b>2,485</b>
=====						

**20.2** The Bank operates from ten immovable properties which are held under operating lease agreements (see note 34).

**20.3** There were no capitalised borrowing costs related to the acquisition of property and equipment during the period (2012: nil).

**20.4** There was no property and equipment not put in use at the reporting date.



## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 21 Intangible assets

#### 21.1

	Software
	€000
<b>Cost:</b>	
At 1 January 2011	2,628
Acquisitions	4,517
Disposal	(5,401)
	-----
At 31 March 2012	1,744
	-----
<b>At 31 March 2013</b>	<b>1,744</b>
	=====
<b>Amortisation:</b>	
At 1 January 2011	1,257
Charge for the period	136
	-----
At 31 March 2012	1,393
	-----
Charge for the year	123
	-----
<b>At 31 March 2013</b>	<b>1,516</b>
	=====
<b>Carrying amounts:</b>	
At 1 January 2011	1,371
	=====
At 31 March 2012	351
	=====
<b>At 31 March 2013</b>	<b>228</b>
	=====

**21.2** There were no capitalised borrowing costs related to the acquisition of software during the year (2012: nil).

**21.3** During the period ended 31 March 2012, the cost of software of €995,473 was wholly transferred to a related company.

**21.4** There were no intangible assets not in use at the reporting date.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 22 Other assets

#### 22.1

	31 Mar 2013	31 Mar 2012
	€000	€000
Amount receivable from:		
Ultimate parent company	-	153
Immediate parent company	1,484	1,282
Subsidiary	20	20
Other group companies	11,319	9,075
Other assets	1,648	5,119
	-----	-----
	14,471	15,649
	=====	=====

22.2 Amounts receivable from ultimate parent company, immediate parent company, subsidiary and other group companies are interest free, unsecured and repayable on demand.

### 23 Prepayments and accrued income

	31 Mar 2013	31 Mar 2012
	€000	€000
Prepayments	1,570	1,016
Deferred expense	2,648	828
Accrued income	23,778	17,598
	-----	-----
	27,996	19,442
	=====	=====

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 24 Deferred tax (liabilities)/assets

24.1 Deferred tax assets are attributable to the following:

	Assets		Liabilities		Net	
	31 Mar 2013	31 Mar 2012	31 Mar 2013	31 Mar 2012	31 Mar 2013	31 Mar 2012
	€000	€000	€000	€000	€000	€000
Property and equipment	-	-	(309)	(368)	(309)	(368)
Available-for-sale securities	-	612	(5,161)	-	(5,161)	612
Tax losses carry forward	170	-	-	-	170	-
Collective allowances	238	-	-	-	238	-
	408	612	(5,470)	(368)	(5,062)	244

24.2 Movement in temporary differences

	Balance 01 Apr 12	Recognised		Balance 31 Mar 13
	€000	in profit or loss	in equity	€000
Property and equipment	(368)	59	-	(309)
Available-for-sale securities	612	-	(5,773)	(5,161)
Tax losses carry forward	-	170	-	170
Collective allowances	-	238	-	238
	244	467	(5,773)	(5,062)

	Balance 01 Jan 11	Recognised		Balance 31 Mar 12
	€000	in profit or loss	in equity	€000
Property and equipment	(64)	(304)	-	(368)
Available-for-sale securities	759	-	(147)	612
	695	(304)	(147)	244

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 25 Capital and reserves

	31 Mar 2013	31 Mar 2012
<b>25.1.1 Share capital</b>	<b>No.</b>	<b>No.</b>
Issued and fully paid up:		
Shares of €1 each		
Ordinary 'A' shares	62,350,106	56,030,106
Ordinary 'B' share	1	1
	-----	-----
	62,350,107	56,030,107
	=====	=====

**25.1.2** At 31 March 2013 the authorised share capital consisted of 100,000,000 (2012: 100,000,000) ordinary shares of €1 each. All issued shares are fully paid-up.

		31 Mar 2013	31 Mar 2012
	<b>Note</b>	<b>€000</b>	<b>€000</b>
At beginning of year/period		56,030	41,030
Issued for cash during the year/period	25.1.4	6,320	15,000
		-----	-----
At end of year/period - fully paid up		62,350	56,030
		=====	=====

**25.1.3** The holders of 'A' ordinary shares are entitled to receive dividends as declared from time to time and are entitled to one vote per share at meetings of the Bank. 'B' ordinary shareholders are not entitled to vote or to receive any dividends distributed.

**25.1.4** During the period ended 31 March 2012, by an extraordinary resolution dated 12 August 2011, it was resolved to increase the issued share capital by 15,000,000 ordinary shares to 56,030,107 issued ordinary shares of €1 each.

Furthermore, during the year ended 31 March 2013, by an extraordinary resolution dated 15 March 2013, it was resolved to increase the issued share capital by 6,320,000 ordinary shares to 62,350,107 issued ordinary shares of €1 each.

**25.2** The fair value reserve includes the cumulative net change in the fair value of available-for-sale investments, excluding impairment losses, until the investment is derecognised, net of deferred taxation.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 25 Capital and reserves (continued)

25.3 Share premium as at the reporting date represents the issue of shares as follows:

Issue date	Number of shares	Premium	Share premium
	No.	€	€000
10 August 2010	10,000,000	0.9155	9,155
29 September 2010	19,119,470	0.2254	4,309
			-----
			<b>13,464</b>
			=====

25.4 During the year ended 31 March 2013, by an extraordinary resolution dated 27 March 2013, it was resolved to provide the Bank a shareholders' contribution (Contribution) of €8,500,000. Following are the terms and conditions of the Contribution granted:

- The Bank has no obligation to bear any servicing cost or transfer any economic benefits of any kind to the Contributor or any other person in return;
- The Bank has no obligation to repay the Contribution;
- The Contribution is distributable only if the Bank's financial position and cash flow permits and at its sole discretion.

The Contribution is also eligible as Own Funds in terms of MFSA Banking Rule 3.

25.5 All reserves at the reporting date, except for retained earnings and the shareholders' contribution, are non-distributable. However, the shareholders' contribution reserve is distributable only and only if, the regulatory ratios are not breached and if the terms and conditions permit, as noted in note 25.4.

### 26 Amounts owed to financial institutions

	31 Mar 2013	31 Mar 2012
	€000	€000
Repayable on call and at short notice	20,570	562,587
Term loans and advances	1,348,425	531,166
	-----	-----
	<b>1,368,995</b>	<b>1,093,753</b>
	=====	=====

An amount €1,259 million from term loans and advances are secured by a pledge over the investment securities (note 17.3) and €82 million are secured by pledge over the loans and advances to customers: corporate.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 27 Amounts owed to customers

	31 Mar 2013	31 Mar 2012
	€000	€000
Repayable on demand	140,399	117,968
Term deposits	425,648	261,587
	<b>566,047</b>	<b>379,555</b>

### 28 Debt securities in issue

28.1	31 Mar 2013	31 Mar 2012
	€000	€000
At amortised cost:		
Debt securities in issued	<b>15,664</b>	<b>19,672</b>

	31 Mar 2013	31 Mar 2012
	€000	€000
Balance at the beginning of the year/period	<b>19,672</b>	14,735
Debt securities issued	-	4,937
Debt securities repurchased and cancelled	<b>(4,008)</b>	-
<b>Balance at end of year/period</b>	<b>15,664</b>	<b>19,672</b>

- 28.2** The debt securities, which are unsecured, are denominated in Euro, mature on 30 October 2015 and are listed on the Malta Stock Exchange. The interest payable is fixed at 6.25% per annum and the debt securities are redeemable at their nominal value.

On 27 June 2011, the Bank issued €5 million of debt securities which are fully fungible and consequently have the same terms and conditions, with the debt securities issued during the previous year.

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 28 Debt securities in issue (continued)

**28.3** The above liabilities will in the event of default or insolvency of the issuer, have a general claim on the assets of the Bank pari passu with other unsecured creditors. Bondholders therefore would rank after all interbank funding lines and repurchase agreements that are collateralised by investments securities through the said funding. The Bank has not had any defaults of interest or other breaches with respect to its debt securities during the year ended 31 March 2013 and period ended 31 March 2012.

**28.4** During the year ended 31 March 2013, the Bank purchased through market operations a nominal value of €4,095,200 of its 6.25% debt securities in issue, for cancellation in accordance with the provisions of section 7.9.8 of the Security Note forming part of the prospectus dated 13 September 2010 (as supplemented on 30 May 2011). All bonds so purchased by the Bank were cancelled.

As at 31 March 2013, the contractual amount due at maturity is €15,904,800.

**28.5** The carrying amount of the debt securities in issue is €240,798 lower than the contractual amount due at maturity (2012: €328,000).

### 29 Subordinated liabilities

**29.1**

	31 Mar 2013	31 Mar 2012
	€000	€000
At amortised cost:		
Subordinated debt securities		
- nominal value	12,500	-
- related transaction costs	(90)	-
- effect of foreign exchange revaluation	(69)	-
	-----	
Subordinated debt securities in issue	12,341	-
	=====	

**29.2** During the year under review, the Bank issued subordinated debt securities. The debt securities, which are unsecured, mature on 30 December 2019 and are listed on the Malta Stock Exchange. The interest payable is fixed at 7.50% per annum (effective interest rate 7.60%) and are redeemable at their nominal value.



## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 29 Subordinated liabilities (continued)

**29.3** The above liabilities will, in the event of the winding-up of the issuer, be subordinated to the claims of depositors and all other creditors of the issuer. The Bank has not had any defaults of interest or other breaches with respect to its subordinated debt securities during the year ended 31 March 2013.

**29.4** The carrying amount of the subordinated debt securities in issue is €158,610 lower than the contractual amount due at maturity.

### 30 Other liabilities

	31 Mar 2013	31 Mar 2012
	€000	€000
Other liabilities	760	611
VAT payable	340	71
	-----	-----
	1,100	682
	=====	=====

### 31 Accruals

	31 Mar 2013	31 Mar 2012
	€000	€000
Accrued expenses	4,124	2,069
Accrued interest expense	5,842	4,537
	-----	-----
	9,966	6,606
	=====	=====

### 32 Dividends

	31 Mar 2013	31 Mar 2012	31 Mar 2013	31 Mar 2012
	% per share	% per share	€000	€000
Gross of income tax:				
% per €1 share				
- interim	18	-	10,994	-
	=====	=====	=====	=====

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 32 Dividends (continued)

	31 Mar 2013 cents per share	31 Mar 2012 cents per share	31 Mar 2013 €000	31 Mar 2012 €000
<b>Net of income tax:</b>				
cent per €1 share				
- interim	11	-	7,146	-
	=====			

The directors have proposed a final gross ordinary dividend of €0.52 per share as bonus shares.

### 33 Cash and cash equivalents

Balances of cash and cash equivalents as shown in the statements of cash flows are analysed below:

	Notes	31 Mar 2013 €000	31 Mar 2012 €000
<b>Analysis of cash and cash equivalents:</b>			
Cash in hand		207	84
Call deposits		33,387	87,723
Repayable on call and at short notice		(20,570)	(562,587)
Amounts owed to financial institutions with maturity less than 3 months		(588,846)	(142,488)
<i>Per Statement of Cash Flows</i>		(575,822)	(617,268)
<b>Adjustment to reflect:</b>			
Balance with Central Bank of Malta		3,934	2,572
Malta Government treasury bill with original maturity over 3 months		40,892	-
Deposits with maturity over 3 months		11,767	1,081
Amounts owed to financial institutions with maturity over 3 months		(759,580)	(388,678)
<i>Per Statement of Financial Position</i>		(1,278,809)	(1,002,293)
		=====	
<b>Analysed as follows:</b>			
Balances with Central Bank of Malta, treasury bills and cash	14	70,055	63,656
Loans and advances to financial institutions	15	20,131	27,804
Amounts owed to financial institutions	26	(1,368,995)	(1,093,753)
		(1,278,809)	(1,002,293)
		=====	

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 34 Operating leases

During the period ended 31 March 2012, the Bank entered into four rental agreements relating to immovable properties. These are for non-cancellable lease periods of three, four, five and nine years for annual rents of €25,550, €35,400, €14,160 and €14,640 respectively.

During the year ending 31 March 2013, the Bank renewed the rental agreement for an immovable property for a period of 3 years at an annual rent of €70,000 with a further renewal period of 5 years at the same rate adjusted for inflation. Another agreement was revised for a thirty month period at an annual rent of €12,000. The Bank also signed rental agreements for two other immovable properties for a term of 7 years and 5 years respectively at an annual cost of €32,075 and €96,000 respectively. The latter is renewable for a further five year period at an annual cost of €140,000.

In July 2012, the Bank entered into a five year lease agreement for immovable property in London at an annual rental cost of GBP 94,800, renewable for a further period of 5 years at an annual rental cost of GBP 189,600.

In March 2013 the Bank entered into a 9 year lease for new premises in Belgium at an average yearly rent of €93,859. The lease can be terminated by the Bank after the end of the sixth year incurring a penalty cost of €43,098.

During the year the Bank leased IT-infrastructure and software from a related company. The lease term is renewable on a one-year rolling period.

At the end of the reporting year/period, the future minimum lease payments under non-cancellable operating leases are payable as follows:

	31 Mar 2013	31 Mar 2012
	€000	€000
Within one year	1,039	445
After one year but not more than five years	1,638	668
More than five years	608	341
	-----	-----
	3,285	1,454
	=====	=====

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 35 Related parties

#### 35.1 Immediate and ultimate parent company

The Bank is a wholly owned subsidiary of Medifin Holding Limited. The registered office of the parent company is situated at 10, St. Barbara Bastion, Valletta, Malta.

Medifin Holding Limited prepares consolidated financial statements of the Bank of which Mediterranean Bank plc and its subsidiaries form part. These financial statements are filed and available for public inspection at the Registrar of Companies in Malta.

The ultimate parent company is AnaCap Financial Partners II L.P. Their registered office is situated at Carinthia House, 9 -12 The Grange, St Peter Port, GY1 4BF, Guernsey.

#### 35.2 Transactions with key management personnel

In addition to their salaries (disclosed in note 11), the Bank also provides non-cash benefits to directors in the form of insurance and use of car and accommodation.

#### 35.3 Related party balances and transactions

During the course of its business, the Bank conducted business on commercial terms with various related parties.

The following table provides the total amount of transactions and balances, which have been entered into with related parties for the relevant financial year/period:

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 35 Related parties (continued)

#### 35.3 Related party balances and transactions (continued)

31 March 2013

Related party	Income from related parties	Expenses charged by related parties	Amounts owed by related parties	Amounts owed to related parties	Transaction type
	€000	€000	€000	€000	
<b>Immediate parent</b>					
	-	-	1,484	-	Other assets
	-	-	-	353	Amounts owed to customers
<b>Ultimate parent</b>					
	-	176	-	-	Monitoring fees
<b>Subsidiaries</b>					
	-	-	-	79	Amounts owed to customers
	-	-	20	-	Other assets
	-	-	-	81	Other liabilities
	-	84	-	-	Administration expenses
<b>Other Group companies</b>					
	-	-	11,319	-	Other assets
	150	-	-	-	Fee and commission income
	-	1,349	-	-	Lease expense
	-	-	-	5,604	Amounts owed to customers
	-	2	-	-	Interest expense
<b>Directors</b>					
	-	-	100	-	Loans and advances to customers
	-	110	-	-	Directors' fees
	1	-	-	-	Interest income
	-	2,198	-	-	Personnel expenses

Furthermore, as detailed in note 25, €7,146,000 were paid as dividends to the immediate parent which in turn re-invested €6,320,000 in ordinary A shares. Moreover, the immediate parent made two payments to the Bank as Shareholders' Contributions, amounting to €825,000 (15 March 2013) and €8,500,000 (27 March 2013).

## Notes to the Financial Statements

For the Year Ended 31 March 2013

### 35 Related parties (continued)

#### 35.3 Related party balances and transactions (continued)

31 March 2012

Related party	Income from related parties	Expenses charged by related parties	Amounts owed by related parties	Amounts owed to related parties	Transaction type
	€000	€000	€000	€000	
Immediate parent	-	-	1,282	-	Other assets
Ultimate parent	-	-	-	71	Accrued interest expense
	-	-	153	-	Other assets
	-	227	-	-	Monitoring fees
Subsidiaries	-	-	-	79	Amounts owed to customers
	-	-	20	-	Other assets
	-	-	-	81	Other liabilities
	-	1,823	-	-	Management fees
Other Group companies	-	-	9,075	-	Other assets
	1	-	-	-	Fee and commission income
	-	570	-	-	Lease expense
Directors	-	1	-	20	Accrued expense
	-	135	-	-	Directors' fees
	2	-	-	-	Interest income
	-	1,286	-	-	Personnel expenses

## Notes to the Financial Statements

For the Year Ended 31 March 2013

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### 36 Segmental information

The Bank has a single reportable segment represented by the investment in EU sovereign and sovereign related credit, covered bonds and other similar credit quality instruments. Information about the product and services and geographical areas are set out in notes 4,16,17 and 19 to the financial statements which provide information about the financial risks, credit concentrations by sector and location and revenues from the single reportable segment. The investment portfolio is spread across a large number of exposures diversified in government, financial institutions and other corporates. 12.5% of the interest income from these exposures related to one credit institutional counterparty represented by investments classified as held-to-maturity.

### 37 Events after the reporting date

As described in notes 13 and 32, €21.0 million will be distributed from the retained earnings as a final dividend by way of a bonus share issue. This will transfer €21.0 million from retained earnings as bonus shares. The final dividend will be executed on 10 May 2013, subject to approval by general meeting. Apart from the bonus share issue, there were no events after the reporting date that would have a material effect on the financial statements.





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## **Independent Auditors' Report**

### **To the Members of Mediterranean Bank plc**

#### **Report on the Financial Statements**

We have audited the separate financial statements of Mediterranean Bank plc (the "Bank") as set out on pages 24 to 97, which comprise the statement of financial position as at 31 March 2013 and the statements of comprehensive income, changes in equity and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

#### *Directors' Responsibility for the Financial Statements*

As explained more fully in the Directors' Responsibilities Statement set out on page 20, the directors are responsible for the preparation of financial statements that (a) give a true and fair view in accordance with International Financial Reporting Standards as adopted by the EU, and (b) are properly prepared in accordance with the provisions of the Companies Act, 1995 (Chapter 386, Laws of Malta) (the "Act") and the Banking Act, 1994 (Chapter 371, Laws of Malta). They are also responsible for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

#### *Auditors' Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with Article 179 of the Act and Article 31 of the Banking Act, 1994 (Chapter 371, Laws of Malta), and may not be appropriate for any other purpose.

In addition, we read the Directors' Report and consider the implications for our report if we become aware of any apparent material misstatements of fact.

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

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

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



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## Independent Auditors' Report (continued)

### To the Members of Mediterranean Bank plc

#### *Opinion on Financial Statements*

In our opinion, the financial statements:

- give a true and fair view of the unconsolidated financial position of the Bank as at 31 March 2013, and of its unconsolidated financial performance and its unconsolidated cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU; and
- have been properly prepared in accordance with the Companies Act, 1995 (Chapter 386, Laws of Malta) and the Banking Act, 1994 (Chapter 371, Laws of Malta).

#### **Report on Other Legal and Regulatory Requirements**

*Matters on which we are required to report by the Banking Act, 1994 (Chapter 371, Laws of Malta)*

In our opinion:

- we have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purpose of our audit;
- proper books of account have been kept by the Bank so far as appears from our examination thereof;
- the Bank's financial statements are in agreement with the books of account; and
- to the best of our knowledge and belief and, on the basis of the explanations given to us, the financial statements give the information required by law in force in the manner so required.

*Matters on which we are required to report by exception by the Companies Act, 1995 (Chapter 386, Laws of Malta) (the "Act"), other than those reported upon above*

We have nothing to report in respect of the following matters where the Act requires us to report to you if, in our opinion:

- the information given in the Directors' Report for the financial year for which the financial statements are prepared is not consistent with the financial statements; or
- certain disclosures of directors' remuneration specified by the Act are not made.



Noel Mizzi (Partner) for and on behalf of

**KPMG**  
Registered Auditors

9 May 2013



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## Independent Auditors' Report (continued)

### To the Members of Mediterranean Bank plc

*Report required by Listing Rule 5.98 issued by the Listing Authority in Malta on the Directors' Statement of Compliance with the Code of Principles of Good Corporate Governance (the "Principles") outlined in Appendix 5.1 to Chapter 5 (Continuing Obligations) of the Listing Rules (the "Appendix")*

Listing Rule 5.97 requires an Issuer whose securities are admitted to trading on a Regulated Market operating in Malta to prepare a corporate governance statement. In addition, as an Issuer registered in Malta, Listing Rule 5.94 requires that the Bank endeavours to adopt the Principles and to prepare a report explaining how it has complied with the provisions of the Appendix.

Our responsibility as independent auditors of the Bank, is laid down by Listing Rule 5.98, which requires us to issue a report on the Directors' Statement of Compliance with the Principles, which is set out on pages 6 to 14.

We review the Directors' Statement of Compliance, and report as to whether this Statement provides the disclosures required by Listing Rule 5.97. We are not required to, and we do not, consider whether the Board's statements on internal control and risk management systems cover all the risks and controls in relation to the financial reporting process, or form an opinion on the effectiveness of the Bank's corporate governance procedures or its risks and control procedures, nor on the ability of the Bank to continue in operational existence.

In our opinion, the Directors' Statement of Compliance set out on pages 6 to 14 provides the disclosures required by Listing Rule 5.97 issued by the Listing Authority of Malta.

Noel Mizzi (Partner) for and on behalf of

**KPMG**  
Registered Auditors

9 May 2013

## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

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## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

### Overview

Additional Regulatory Disclosures (the “Disclosures”) have been prepared in accordance with the requirements of Banking Rule BR/07, “Publication of Annual report and Audited Financial Statements”. Mediterranean Bank plc (the “Bank”) updates these Disclosures on an annual basis as a part of the Annual Report and Financial Statements preparation. The Disclosures are compiled by the Bank on the basis of its consolidated financial situation, and therefore, reference to the Bank implies the Group in view that the impact of the subsidiaries on the consolidated financial statements of the Bank is insignificant.

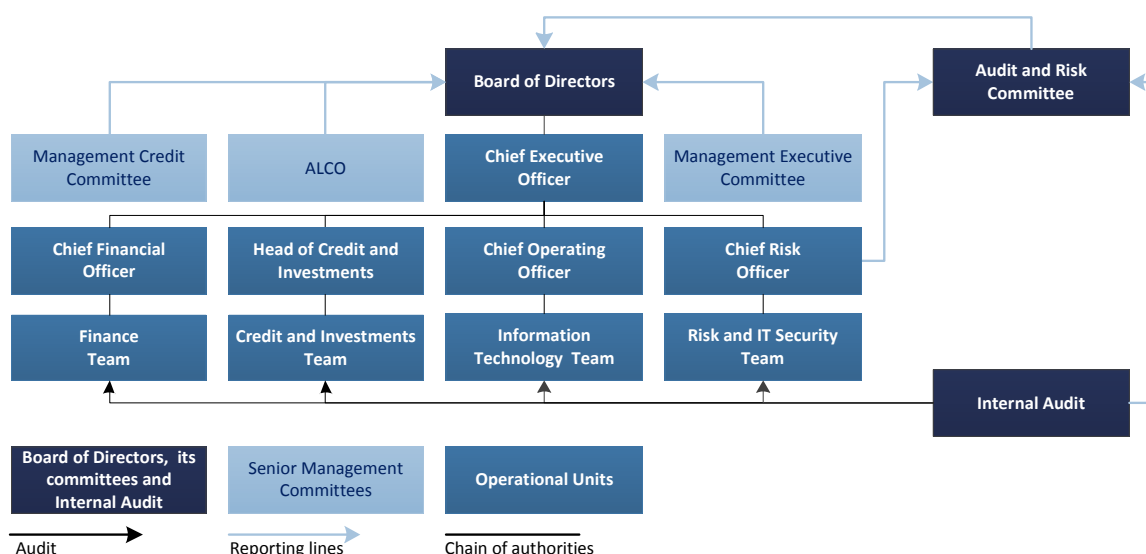
Consistent with the banking regulations, these Disclosures are not subject to external audit except where they are equivalent to those prepared under International Financial Reporting Standards (IFRS), as adopted by the EU, requirements in the Bank’s Annual Report. These Disclosures have been appropriately verified internally by the Bank’s management and Audit and Risk Committee, including a review by the internal auditor.

### 1 Risk Management Function

The Bank recognises the need for an effective and efficient risk management function and therefore has adopted a comprehensive process that provides a right balance between the fast growth rate of the Bank and the underlying risks.

The Bank’s objective is to deploy an integrated risk management approach to ensure an awareness of, and accountability for, the risks taken throughout the Bank, whilst developing the necessary tools required to address such risks. Such an integrated approach is realised through the governance structure of the Bank and relies on three principal lines of defence - (1) the management of business units, (2) a fully resourced Risk Management function, and (3) on-going independent reviews carried out by the Internal Audit function.

#### 1.1 Risk Management Governance





## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

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The **Board of Directors** has a general duty to ensure that the Bank conducts business in accordance with all relevant statutory and regulatory requirements. Its overall responsibility with regard to risk management is the establishment and oversight of the Bank's risk management framework. The Board sets the Bank's strategy and ensures an effective system of internal control and management of business risks, safeguarding a strong capital and liquidity base that is conducted in accordance with the requirements of the Malta Financial Services Authority (MFSA).

The Board has delegated specific powers and authority to the **Audit and Risk Committee** which is responsible for monitoring compliance with the Bank's risk management policies and procedures and for reviewing the adequacy of the Bank's risk management framework. Besides providing the necessary assistance to the Audit and Risk Committee, the Internal Audit Function carries out both regular and ad-hoc reviews of the risk management controls and procedures. The Internal Audit function reports its findings to the Audit and Risk Committee.

The Board has also established the following senior management committees:

1. Management Credit Committee;
2. Asset and Liability Committee (ALCO);
3. Executive Management Committee (EXCO).

The **Management Credit Committee** is responsible for approving credit recommendations and making other credit decisions under its delegated authority - this includes decisions on individual credits; reviewing and recommending credit to the Board; monitoring adherence to large exposure limits; consideration of credit hedging strategies; and recommending other concentration limits for Board approval. It also establishes transactional authority for members of the Credit and Investment Department. In addition, the Management Credit Committee reviews provisioning and lending policies; monitors the Bank's investment portfolios and reviews Management Information reports.

**Asset and Liability Committee (ALCO)** is responsible for management of funding, liquidity, interest rate and currency risks. ALCO sets and reviews overall policies and objectives for asset and liability management, capital management and allocation; capital usage and efficiency; transfer pricing; risk management; and underwriting, dealing and trading activities according to the risk appetite set by the Board. It also decides on the level of any credit impairments to be taken on the Bank's investments, after receiving recommendations from the Management Credit Committee.

**Executive Management Committee (EXCO)** represents the principal forum for conducting the business of the Bank and takes day-to-day responsibility for the efficient running of the business. In addition, the EXCO is responsible for the formulation and implementation of Board approved strategies and plans.

The Committee is authorised to take whatever steps are necessary to conduct the business of the Bank within the confines of the Board approved strategy, operating plans and budgets.

Additionally, the Board has set up a number of management level committees with the aim of identifying and addressing matters relating to operational risks namely, the Management Operations Committee, the New Customer Products Committee and the Treasury Services Committee.

## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

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### Risk Management Function

The Board has set up an independent and comprehensive risk management function under the leadership of the Chief Risk Officer. The aim of Risk Management is to create value for shareholders by supporting the institution in achieving its goals and objectives, and ultimately ensuring that the risks are commensurate with the rewards. It works closely with other groups within the Bank and provides independent oversight, analysis and reporting of the Bank's risk profile in all areas.

The Risk Management function is directly responsible for the oversight of market, credit, liquidity and operational risks, and the Chief Risk Officer is fully involved in the oversight of strategy and reputational risks by virtue of his seat on EXCO and his reporting line to the Audit and Risk Committee.

At the end of the reporting period, the Bank's Risk Management team comprised eight full-time professionals under the management of the Chief Risk Officer. Their responsibilities are divided as follows:

- Risk Architecture (4) - portfolio-level analysis and risk reporting, Operational Risk management and reporting.
- Risk analysis (2) - credit, liquidity and market risk analysis and review, supported by and working with analysts from the Credit and Investments team as appropriate.
- System support (2) - maintenance, enhancement and development of the Bank's primary risk reporting and portfolio management information system. Although using a well-known third-party system, the Bank has taken advantage of its open architecture to develop a number of additional capabilities.

After the end of the reporting period, the Bank's Information Security Manager transferred into the Risk Management department.

The Bank's formal risk reporting schedule and processes have been designed to comply with the Basel Committee's "Principles for effective risk data aggregation and risk reporting" (June 2012, revised January 2013). In particular, reporting frequencies have been established in accordance with Principle 10, with flash reports produced daily (either system-generated or created by operational departments) and more in-depth reports produced weekly or monthly by Risk Management. The latter include interpretation and commentary in accordance with Principle 9.

### 1.2 Risk Management Framework and Policies

The two key components of the Bank's Risk Management framework are an efficient separation of the Bank's Risk Management function and risk taking activities of the Bank, and a robust system of formal governance controls including an effective management committee structure, as described above, and a comprehensive set of internal policies.

The Bank's control policies are, of course, subject to continuous review and development, under the overall oversight of the Compliance function. Current key policies include the following:

- Terms of Reference for Board and Key Committee Structures
- Code of Ethics
- Conflict of Interest Policy
- Remuneration Policy
- Treasury Management Policy
- Credit and Investment Policy

## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

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- Impairment Provisioning Policy
- Operational Risk Management Policy
- CDD and Compliance Requirements Policy
- Anti Fraud Policy
- Cash Handling Policy
- Prevention of Money Laundering and Funding of Terrorism Manual
- Consumer Care Principles
- Outsourcing Policy
- Information Security Policy
- User Information Security Policy
- Admin Security Policy
- Business Continuity and Disaster Recovery Plans
- Staff Compliance Policy
- HR Policy

### 1.3 Risk Management Initiatives

During the year, a number of specific initiatives were implemented in order to strengthen further the Bank's Risk Management framework.

#### Staffing

In August 2012 the Bank recruited a Chief Risk Officer with more than 20 years' experience in the financial sector, gained at a number of major international institutions and including senior positions across a wide range of Risk Management disciplines.

#### Operational Risk oversight

The Bank's Operational Risk oversight processes have been strengthened in a number of ways. They are implemented by collecting key risk indicators (KRIs) which are then monitored against thresholds designed to provide early warning of an unacceptable increase in risk. Information is summarised in two ways, primarily according to the nature of the risk represented but also by the identity of the operating unit responsible for primary control of the risk. During the year, the enhancements made to these processes have included:

- Review of individual risks and associated KRIs and thresholds
- Methodology changes, for example to allow KRIs to be weighted to reflect their importance
- Back-testing of KRI thresholds against a quantitative assessment of operational risk
- Simplification and automation of the KRI collection and reporting process.

#### *Risk Analysis and Reporting*

The nature of the Bank's business means that liquidity, market and credit risks are strongly linked. During the year, the Bank has taken steps to consolidate its key risk analysis and reporting into a single, consistent package that recognises and demonstrates the inter-relationship between these risks. The package is produced by the Risk Management function and reviewed in detail by the Chief Risk Officer before being distributed to executives and to board and shareholder representatives to a fixed and reliable monthly schedule.

A higher-frequency report is produced and distributed to the same constituency, that clearly shows and breaks down changes to the Bank's asset and liability portfolios from week to week, and daily



## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

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automated reports have been built that provide key management information with a higher frequency still.

By largely eliminating the need for *ad hoc* management information, convergence around this common and consistent reporting set has delivered significant efficiency benefits, and the Bank has been able to reinvest the time saved into deepening the level of analysis performed.

### *Interest Rate Risk management and Hedge Accounting*

Movements in market interest rates affect the Bank in a number of different ways, either over time by changing projected future cash flows or through the economic value of the Bank's assets, liabilities and derivative hedges, which (depending on the applicable accounting treatment) may immediately impact the Bank's reported income or capital. The Bank has developed a framework that takes into account all of the different impacts and manages exposure to each measure in a manner compatible with the Bank's risk/return appetite.

The Bank has also opted for Hedge Accounting in order to minimise the volatility of reported income that arises because of the different accounting treatments of derivative hedges and the assets that they hedge; the Risk Management function has worked closely with the Credit and Investment team to construct optimal hedges and with the Finance team to ensure that Hedge Accounting is implemented in a robust and efficient manner.

## **2. Capital Risk Management**

### **2.1 Capital Adequacy and Own Funds**

Own funds represent the Bank's available capital and reserves for the purposes of capital adequacy. Capital adequacy is a measure of the financial strength of a bank, usually expressed as a ratio of its capital to its assets. Own Funds and Capital Adequacy Ratio are calculated in accordance with the MFSA Rules BR/03 and BR/04, respectively. The Bank adopts the appropriate processes to ensure that the minimum regulatory requirements are met at all times, through the assessment of its capital resources and requirements given current financial projections.

The following table represents the Bank's capital position as at 31 March 2013. Details on all Own Funds items are found in note 4.7 in the Bank's Annual Report 2013.

## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

<u>Own Funds</u>	€'000	€'000
<i>Paid up capital</i>		
Ordinary shares		62,350
Share premium account		13,464
<b>Total Paid Up Capital</b>		<b>75,814</b>
<i>Reserves</i>		
Shareholders' contribution	8,500	
Retained profits	21,191	
Other reserves	(3,429)	
<b>Total Reserves</b>		<b>26,262</b>
<b>Total Gross Original Own Funds</b>		<b>102,076</b>
<i>Deductions</i>		
Intangible assets (other than goodwill)	(228)	
Investment in subsidiaries	(33)	
<b>Total Deductions</b>		<b>(261)</b>
<b>TOTAL Original Own Funds</b>		<b>101,815</b>
 <i>Additional Own Funds</i>		
Subordinated loan capital	12,341	
<i>IFRS Prudential Filters: Increases to Additional Own Funds</i>	9,578	
<i>Deductions</i>	(32)	
<b>TOTAL Additional Own Funds</b>		<b>21,887</b>
 <b>Total Eligible Own Funds</b>		<b>123,702</b>
 <b>Capital Adequacy Ratio</b>		<b>15.66%</b>

### Capital Requirements

Capital requirements represent the amount of capital resources that a bank must hold. The Bank calculates its risk weighted credit risk exposure in accordance with the Standardised Approach as per the Banking Rule BR/04. To calculate the risk-weighted exposure amounts, risk weights are applied based on the exposure class and the related credit quality. Credit quality may be determined by reference to the credit assessments of External Credit Assessment Institutions (ECAIs) that have been determined as eligible by the MFSA. In the Bank's calculations, Senior Secured Loans and other corporate credit exposures are assigned risk weights corresponding to unrated positions and for the remainder of its securities investment portfolio the Bank has nominated well-known risk rating agencies such as Fitch, Standard and Poor's and Moody's.

## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

Accordingly, the Bank complies with the standard association of the external rating of ECAs with the credit quality steps prescribed in BR/04. The following table shows the exposure values after credit risk mitigation associated with each credit quality, gross of off balance sheet exposures and after removing asset items deducted from Own Funds (refer to Note 3.1)

### Credit risk exposure - analysis by credit quality step

	Credit quality step 1	Credit quality step 2	Credit quality step 3	Credit quality step 4	Credit quality step 5	Credit quality step 6	Unrated	Total
	€000	€000	€000	€000	€000	€000	€000	€000
Central Governments or Central Banks	102,721	69,489	-	35,218	-	15,114	-	222,542
Regional Governments or Local Authorities	-	-	-	50,586	-	-	-	50,586
Administrative Bodies and Non-Commercial Undertakings	13,137	-	-	-	-	-	-	13,137
Multilateral Development Banks	89,480	-	-	-	-	-	-	89,480
International Organisations	51,356	-	-	-	-	-	-	51,356
Institutions	2,370	29,912	100,434	-	-	-	1,662	134,378
Corporates	-	-	-	-	-	-	471,686	471,686
Covered Bonds	177,176	701,460	99,925	28,623	9,149	-	-	1,016,333
Securitisation Positions	44,895	52,500	20,959	-	-	-	-	118,354
Other	-	-	-	-	-	-	11,236	11,236
<b>Total</b>	<b>481,135</b>	<b>853,361</b>	<b>221,318</b>	<b>114,427</b>	<b>9,149</b>	<b>15,114</b>	<b>484,584</b>	<b>2,179,088</b>

A breakdown of the Bank's total exposure values, average exposure values over the year, risk-weighted exposure amounts and the minimum capital requirement of 8% are shown in the following table.

### Capital requirements - analysis by exposure type

	Exposure value 31.03.2013 €000	Exposure value average 31.03.2013 €000	RWAs 31.03.2013 €000	Capital required 31.03.2013 €000
Central Governments or Central Banks	222,542	160,109	-	-
Regional Governments or Local Authorities	50,586	50,535	-	-
Administrative Bodies and Non-Commercial Undertakings	13,137	7,829	2,627	210
Multilateral Development Banks	89,480	95,287	-	-
International Organisations	51,356	16,135	-	-
Institutions	134,378	152,181	14,345	1,148
Corporates	471,686	277,652	471,686	37,735
Covered Bonds	1,016,333	1,079,381	181,387	14,511
Securitisation Positions	118,354	131,827	56,188	4,495
Other	11,236	8,841	8,555	684
<b>Total</b>	<b>2,179,088</b>	<b>1,979,777</b>	<b>734,788</b>	<b>58,783</b>

Capital allocation for Operational Risk Capital Requirement is calculated, by the Bank, using the Basic Indicator Approach under the Banking Rule BR/04.

## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

The Foreign Exchange Risk Capital Requirement is calculated using the Basic Method in accordance with the Banking Rule BR/08.

At 31 March 2013, the capital requirements for credit, operational and foreign exchange risks totalled €63.2 million as shown in the table below:

<i>Total capital requirements</i>	<b>Risk weighted assets</b>	<b>Risk weight</b>	<b>Capital required</b>
	<b>31.03.2013</b>	<b>31.03.2013</b>	<b>31.03.2013</b>
	<b>€000</b>		<b>€000</b>
Operational risk	29,250	15%	4,388
Credit risk	734,788	8%	58,783
Foreign exchange risk	471	8%	38
<b>Total</b>			<b>63,209</b>

Own Funds of the Bank as at 31 March 2013 stood at €123.7 million (refer to note 2.1)

As the Bank does not have a trading book, no capital is allocated for trading book market risk.

### 2.2 Internal Capital Adequacy Assessment Process (ICAAP)

ICAAP is a procedure, adopted under Basel II, Pillar 2, to ensure that:

- risks faced by the Bank are appropriately identified, measured, aggregated and monitored;
- the capital coverage determined by internal regulations is sufficient for the fundamental risks the Bank is exposed to; and
- the Bank has an adequate risk management system in place, which it continuously develops in accordance with the risk factors identified.

The Bank covers Pillar 2 capital requirements through stress testing processes to forecast the Bank's projected capital requirements. Stress testing is a technique used by financial firms to gauge their potential vulnerability to severe but plausible events. This testing process contributes to the strategic planning of the Bank by guaranteeing that it can meet its minimum regulatory capital requirements under a stressed environment.

Under the supervision of a dedicated working Group consisting of the Bank's senior management, the preparation of the ICAAP is carried out by the relevant departments that include: Risk Management, Finance and Credit and Investment. After the completion of an iterative process of review and feedback, the senior management team present their observations to the Board of Directors for their consideration. The non-executive Directors play a crucial role in providing the Bank with an independent evaluation of the document, assisted by the Bank's Internal Audit function.

## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

### 3. Credit Risk

#### 3.1 Scope and Nature of Credit Risk

Credit risk is the risk of financial loss to the Bank if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Bank's loans and advances to customers and other banks, and investment debt securities. For risk management reporting purposes, the Bank considers and consolidates all elements of credit risk exposure (such as individual obligor default risk, country and sector risk).

<i>Credit risk by exposure type</i>	Balance sheet value 31.03.2013 €000	Exposure value 31.03.2013 €000	Exposure value 31.03.2013 %
Balances with Central Bank of Malta, treasury bills and cash	70,055	70,055	3.2%
Investment securities	1,564,034	1,564,034	71.8%
Derivative assets held for risk management	279	279	0.0%
Loans and advances to customers: corporate	399,600	399,600	18.3%
Loans and advances to customers: retail	2,574	2,574	0.1%
Loans and advances to financial institutions	20,131	20,131	0.9%
Property and equipment	2,485	2,485	0.1%
Intangible assets	228	228	0.0%
Investments in subsidiaries	65	65	0.0%
Other assets due from group companies	12,823	12,823	0.6%
Other assets	1,648	1,648	0.1%
Prepayments and accrued income	27,996	27,996	1.3%
<b>Total assets</b>	<b>2,101,918</b>	<b>2,101,918</b>	<b>96.5%</b>
Off-balance sheet items and value adjustments		80,892	3.7%
Asset items deducted from own funds		-3,722	-0.2%
<b>Total exposure</b>		<b>2,179,088</b>	<b>100%</b>

Credit risk arises primarily in the form of deterioration in credit quality leading to an obligor defaulting on debt instruments held in the Bank's investments portfolio or on senior secured loans extended to corporate counterparties. Included in the Bank's investment portfolio are senior tranches of third party pooled investments; these are included in investment securities and assigned to securitisation positions by class. The performance of such investments is primarily driven by the performance of the underlying assets.

Additionally, the Bank is exposed to credit risk in respect of repo and derivative exposures. The Bank has in place a number of standard master netting agreements for repo counterparties which allows it to assess the related exposure on a net basis. For over-the-counter derivative products, the "marking-to-market" approach to credit risk as per Banking Rule BR/04 is applied by the Bank.

## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

The Bank analyses and monitors its credit risk exposure by breaking the portfolio down in a number of ways, including:

1. exposure class;
2. geographic distribution;
3. residual maturity; and
4. counterparty type.

### *Credit risk exposure - analysis by exposure class*

	Exposure - 31.03.2013 €000	Exposure - 31.03.2013 %
Central Governments or Central Banks	222,542	10.2%
Regional Governments or Local Authorities	50,586	2.3%
Administrative Bodies and Non-Commercial Undertakings	13,137	0.6%
Multilateral Development Banks	89,480	4.1%
International Organisations	51,356	2.4%
Institutions	134,378	6.2%
Corporates	471,686	21.6%
Covered Bonds	1,016,333	46.6%
Securitisation Positions	118,354	5.4%
Other	11,236	0.6%
<b>Total</b>	<b>2,179,088</b>	<b>100.0%</b>

### *Credit risk exposure - analysis by geographical region*

	Europe 31.03.2013 €000	North America 31.03.2013 €000	Total 31.03.2013 €000
Central Governments or Central Banks	222,542	-	222,542
Regional Governments or Local Authorities	50,586	-	50,586
Administrative Bodies and Non-Commercial Undertakings	13,137	-	13,137
Multilateral Development Banks	89,480	-	89,480
International Organisations	51,356	-	51,356
Institutions	130,248	4,130	134,378
Corporates	471,686	-	471,686
Covered Bonds	986,435	29,898	1,016,333
Securitisation Positions	118,354	-	118,354
Other	11,060	176	11,236
<b>Total</b>	<b>2,144,884</b>	<b>34,204</b>	<b>2,179,088</b>

## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

<i>Credit risk exposure - analysis by residual maturity</i>	<i>Less than 1 year</i>	<i>1 to 5 years</i>	<i>Over 5 years</i>	<i>Total</i>
	<b>31.03.2013</b>	<b>31.03.2013</b>	<b>31.03.2013</b>	<b>31.03.2013</b>
	€000	€000	€000	€000
Central Governments or Central Banks	81,050	51,755	89,737	222,542
Regional Governments or Local Authorities	-	50,586	-	50,586
Administrative Bodies and Non-Commercial Undertakings	-	13,137	-	13,137
Multilateral Development Banks	-	10,866	78,614	89,480
International Organisations	-	13,183	38,173	51,356
Institutions	111,641	11,787	10,950	134,378
Corporates	6,384	408,590	56,712	471,686
Covered Bonds	50,172	566,666	399,495	1,016,333
Securitisation Positions	10,336	16,926	91,092	118,354
Other	6,282	2,469	2,485	11,236
<b>Total</b>	<b>265,865</b>	<b>1,145,965</b>	<b>767,258</b>	<b>2,179,088</b>

<i>Capital requirements - analysis by counterparty type</i>	<i>Public sector</i>	<i>Financial</i>	<i>Other</i>	<i>Total</i>
	<b>31.03.2013</b>	<b>31.03.2013</b>	<b>31.03.2013</b>	<b>31.03.2013</b>
	€000	€000	€000	€000
Central Governments or Central Banks	194,445	28,097	-	222,542
Regional Governments or Local Authorities	50,586	-	-	50,586
Administrative Bodies and Non-Commercial Undertakings	13,137	-	-	13,137
Multilateral Development Banks	-	89,480	-	89,480
International Organisations	-	51,356	-	51,356
Institutions	-	134,378	-	134,378
Corporates	-	-	471,686	471,686
Covered Bonds	-	1,016,333	-	1,016,333
Securitisation Positions	-	118,354	-	118,354
Other	-	-	11,236	11,236
<b>Total</b>	<b>258,168</b>	<b>1,437,998</b>	<b>482,922</b>	<b>2,179,088</b>

### 3.2 Managing Credit Risk

#### *Risk Management Objectives*

The Bank's objective is to maximise its investment returns while maintaining a sound and prudent investment profile. To facilitate achieving this target, the Bank invests in a diversified portfolio comprising both high-quality assets with strong ratings stability which support the Bank's deposit-taking, and in loans to corporations with appropriate risk characteristics.

#### *Hedging and mitigation of credit risk*

The efficient and controlled use of credit risk is a key part of the Bank's business model; risk is primarily mitigated by the use of thorough and robust investment limits and investment approval and portfolio review processes. The Bank's Credit and Investment Policy permits it, subject to the prior approval of the Board of Directors, to manage its credit risk through credit hedges, although to date it has not done so.

## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

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### ***Credit and Investment Policy***

The purpose of the Credit and Investment Policy is to establish the credit standards, internal controls, reporting requirements and approval processes that govern the selection and ongoing management of the investment assets of the Bank.

The Board of Directors has established limits for exposures to individual credits based on Maltese regulatory requirements (including, without limitation, Banking Rule BR/02 of the Malta Financial Services Authority, governing Large Exposures of Credit Institutions), as well as prudential requirements. Exposure limits are monitored on an ongoing basis by the Chief Risk Officer and the Head of Credit and Investment with the support of their respective departments, and of the Treasury Department to the extent they relate to a derivative or repo counterparty. Credit and Investment Policy among others outlines the following specific exposures and trading limits:

- Concentration limits;
- Country limits;
- Minimum credit quality within each asset class.

Limits on counterparty exposure are established by ALCO. Such limits relate to net exposure, after application of cash (and cash equivalent) collateral, as provided in industry-standard documentation such as the ISDA and GMRA agreements, and the Treasury Management Policy.

### ***Treasury Management Policy***

The purpose of the Treasury Management Policy is to provide a framework within which treasury is authorised to prudently manage interest rate, foreign exchange, funding, liquidity, counterparty and investment risk, and any other associated risks related to managing the Balance Sheet.

The Treasury Management Policy includes the following approved limits:

- Deposit limits;
- Investment limits;
- Repo counterparty haircut limits;
- Foreign exchange settlement limits.

### ***Credit Quality Analysis***

All securities in the portfolio, as well as corporate loans undergo a thorough analytical credit research process. The research process reviews all securities and corporate loans not only from a credit perspective but also from a legal, financial and ratings perspective. The Credit and Investment department, which manages the research process, is composed of highly-trained individuals with specialised skill sets and years of experience in the Fixed Income and Corporate Syndicated Loans markets. The research process subjects potential investments to scenario analysis to determine whether they can withstand significant adverse credit and market events. Additionally, the portfolio is subject to a continual and thorough surveillance process in order to identify any securities and loans the performance of which requires increased monitoring.

With the exception of the corporate lending portfolio, most of the securities in the Bank's investment portfolio are accepted by the ECB as eligible collateral and all of the securities (or their issuers) are rated by at least two from Fitch, Standard and Poor's and Moody's rating agencies.



## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

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The assessment of asset quality, adequacy of provisions, and the disclosure of credit risk are requirements by IFRS and the MFSA Banking Rule BR/09 “The Credit and Country Risk Provisioning of Credit Institutions Rule”. These regulations require that a specific provision is created where a review of credit facilities reveals that the creditworthiness of a borrower has deteriorated significantly and as a result recovery of a credit facility is in serious doubt.

ALCO determines when financial assets have become impaired individually or collectively and to what extent such impaired assets should be provided for / written down, all in accordance with IFRS and the Banking Rule BR/09 “The Credit and Country Risk Provisioning of Credit Institutions Rule” of the MFSA and the Bank’s Impairment Provisioning Policy. ALCO receives recommendations from the Management Credit Committee to assist it with this determination.

### ***Impairment Provisioning Policy***

The scope of the Impairment Provisioning Policy is to establish effective provisioning standards, internal controls, reporting requirements and approval processes that will govern the ongoing monitoring of credit risk exposures inherent in the investment securities and loan portfolios.

In accordance with the policy, impaired investment securities and loans are those where a loss event has occurred and the Bank establishes that it is unlikely that it will collect the full principal and/or interest due in accordance with the contractual terms of the underlying agreement(s).

During the year ended 31 March 2013, the Bank did not deem it necessary to provide for additional specific impairment but has allocated a collective provision of €676k against its Senior Secured Loans portfolio based on market probabilities of default.

During the financial year ended 31 March 2013, there were no forbearance activities.

### **3.3 Settlement Risk**

The Bank’s activities may give rise to risk at the time of settlement of transactions and trades. Settlement risk is the risk of loss due to the failure of an entity to honour its obligations to deliver cash, securities or other assets as contractually agreed.

#### ***Mitigation of settlement risk***

For all types of investment transactions the Bank mitigates this risk by conducting settlements through a settlement / clearing agent to ensure that a trade is settled only when both parties have fulfilled their contractual settlement obligations. Settlement limits form part of the credit approval / limit monitoring process described earlier. Furthermore, the Bank has a number of master netting agreements covering repurchase transactions and securities with its counterparties.

## **4 Liquidity Risk**

### **4.1 Scope and Nature of Liquidity Risk**

Liquidity risk is the risk that the Bank will encounter difficulty in meeting obligations associated with its financial liabilities that are settled by delivering cash or another financial asset.

### **4.2 Managing Liquidity Risk**

## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

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### ***Risk Management Objective***

The Bank's objective in managing liquidity risk is to ensure that, as far as possible, it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Bank's reputation.

### ***Asset-Liability Management Policy***

The purpose of the Asset-Liability Management Policy is to establish the standards, internal controls, reporting requirements and approval processes that govern the ongoing management of (i) the Bank's liquidity and asset-liability mix and (ii) the Bank's market, interest rate and currency risk.

Treasury maintains a portfolio of short-term liquid assets to ensure that there is sufficient unencumbered liquidity within the Bank. The liquidity requirements of the Bank are met through the international repo market, the Eurex repo market and also through ECB secured funding to cover any short-term fluctuations. Longer bi-lateral term funding (for example in the form of total return swaps) is also in place to address any structural liquidity requirements. In addition, deposits and issuance of debt securities provides further support to the Bank's liquidity requirements.

### ***Liquidity Risk Management Framework***

The Bank has designed its liquidity risk management processes and systems to ensure that at all times the Bank maintains a sufficient stock of cash and liquid assets to meet all of its liquidity requirements in the short term and over time. The Bank will at all times ensure that it is in full compliance with all applicable regulatory requirements, including, and not limited to, the Minimum Liquid-Asset Requirement and MFSA Rule BR/05.

In order to ensure that the Bank has adequate liquidity to meet its obligations, the Bank analyses its liquidity using four key approaches:

1. Liquidity Ladder Analysis
2. Scenario Analysis: a forward-looking liquidity risk framework based on projected prices and credit ratings of assets in the Bank's base case scenario and a number of stress scenarios
3. Maximum Cumulative Outflow (MCO) Analysis
4. Key metrics including Net Cash and the Net Cash to Wholesale Funding Ratio

Inputs to these analyses, and the analyses themselves, are provided by the Treasury and Risk Management groups, based both on expected and stressed cash flow profiles. Potential material changes in future liquidity requirements are discussed in ALCO.

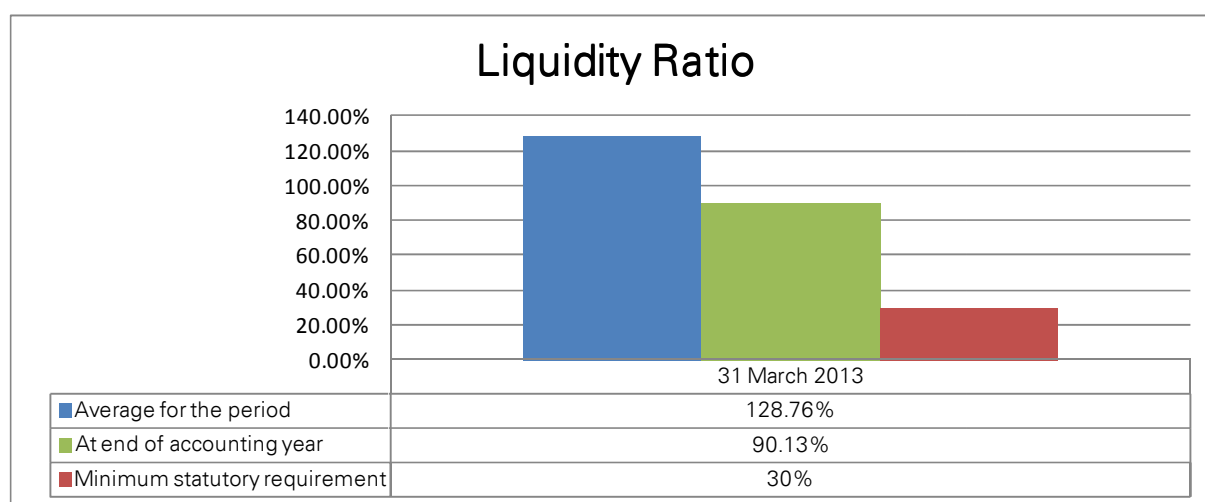
The Bank actively manages the risk from short-term tenor of deposits through maintaining competitive pricing and constant monitoring of market trends. The majority of the Bank's customer deposit portfolio comprises term deposits rather than deposits that can be withdrawn at short notice, and the Bank continues to develop new deposit products that will improve its liquidity risk position.

The key measure used by the Bank for managing liquidity risk is the ratio of the net liquid assets to wholesale funding. For this purpose net liquid assets are considered as including cash and cash equivalents and investment grade debt securities for which there is an active and liquid market as a

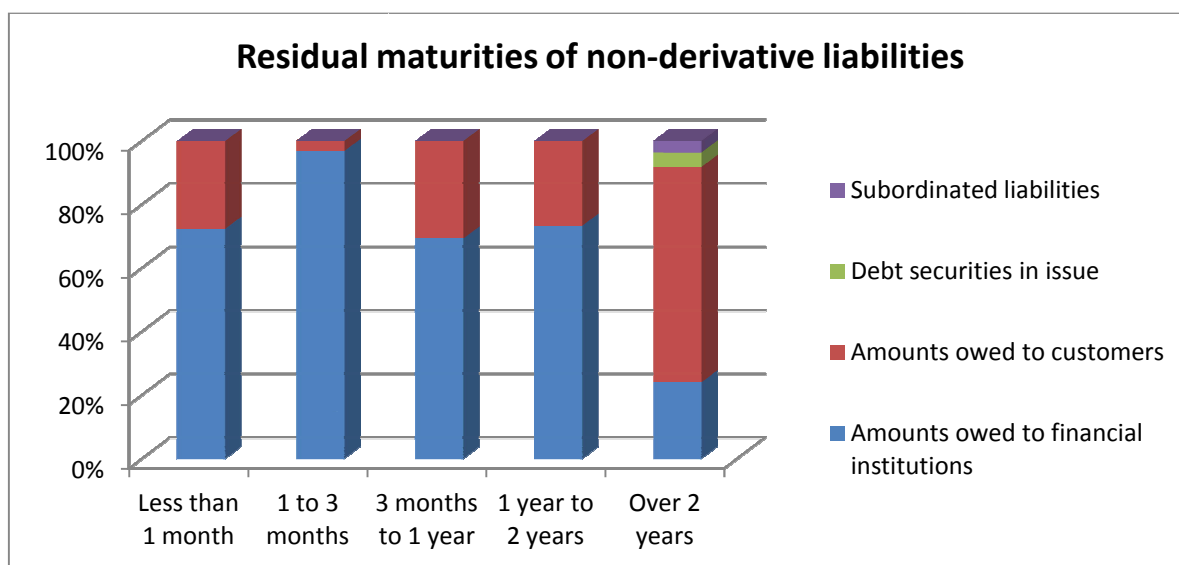
## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

percentage to the actual wholesale funding of the Bank. A similar, but not identical, calculation is the liquidity ratio as reported in line with BR/05, which at the reporting date and during the reporting period was as follows:



The depicted liquidity ratios are above the statutory minimum of 30% as prescribed by BR/05.



The table above shows the potential undiscounted cash flows on the Bank's non-derivative financial liabilities assuming that all liabilities are crystallised into cash at the earliest contractually permitted date. The Bank's cash flows on these instruments may vary significantly from this analysis. For example, demand deposits from customers are expected to maintain a stable or increasing balance.

To manage the liquidity risk arising from financial liabilities, the Bank holds liquid assets comprising cash and cash equivalents and investment grade debt securities for which there is an active and

## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

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liquid market. The Bank does not expect that the disposal of such securities to cover possible liquidity gaps would result in material losses.

### 5. Market Risk

#### 5.1 Scope and Nature of Market Risk

Market risk is the risk that changes in market prices, such as interest rate, foreign exchange rates and credit spreads (not relating to changes in the obligor's / issuer's credit standing) will affect the Bank's income or the value of its holdings of financial instruments.

#### 5.2 Managing Market Risks

##### *Risk Management Objectives*

The key objective of managing market risk is to maximize the Bank's returns on interest rate and foreign exchange rate risks. With the exception of translation risk arising on the Bank's net investment in its foreign operations (which is negligible), all foreign exchange risk within the Bank is managed and hedged by the Treasury department. Accordingly, the foreign exchange position is treated as part of the Bank's investment portfolio for risk management purposes. The overall authority for market risk is vested in ALCO which is responsible for the development of detailed risk management policies and for the day-to-day review of their implementation.

The Bank's *Treasury Management Policy* provides the framework within which treasury prudently manages interest rate, foreign exchange, funding, liquidity, counterparty and investment risk, and any other associated risks related to managing the assets and liabilities presented on the statement of financial position. Regular reviews of the policy are conducted to test robustness of the policy's risk control limits within both normalised and stressed environments.

The Bank's *Asset-Liability Management Policy* establishes the standards, internal controls, reporting requirements and approval processes that govern the ongoing management of (i) the liquidity and asset-liability mix of the Bank and (ii) the Bank's market, interest rate and currency risk.

#### 5.3 Currency Risk

Currency risk is the risk that the value of a financial instrument will fluctuate due to the changes in foreign exchange rates. The Bank is exposed to currency risk on foreign exchange along the parameters set by the Treasury Management Policy. In the majority of cases the Bank covers this risk by ensuring that its foreign currency denominated liabilities are matched with corresponding assets in the same currency. Any mismatches that can arise are monitored accordingly.

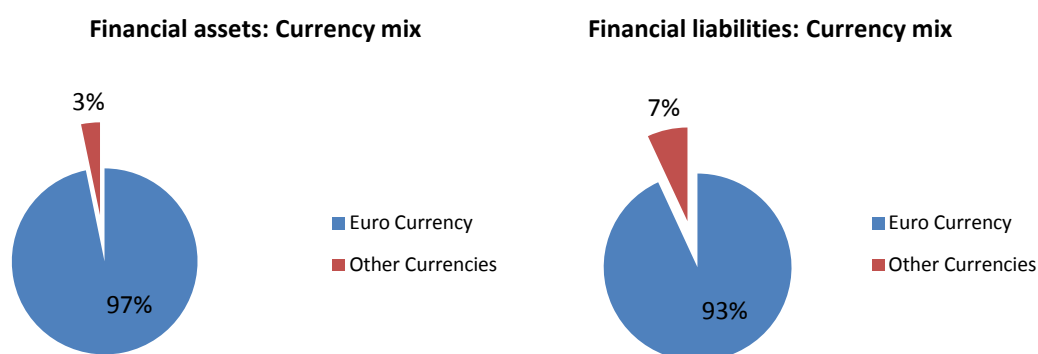
##### *Hedging and mitigation of currency risk*

The Bank focuses its activities largely on euro denominated assets and liabilities, thus it runs a limited foreign exchange risk. The Bank also seeks to minimise foreign exchange risk by hedging all major exposures in this area in accordance with the prevailing ALCO strategy. All foreign currency forward contracts, option contracts or foreign exchange spot deals are to be entered into only with banks on the approved foreign exchange counterparty list set by ALCO.

The following diagrams depict an analysis of the financial assets and financial liabilities of the Bank into relevant currency mix.

## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013



### 6. Interest Rate Risk in Non-Trading Book

#### 6.1 Scope and Nature of Interest Rate Risk

The principal risk to which non-trading portfolios are exposed is the risk of loss from fluctuations in the future cash flows or fair values of financial instruments because of a change in market interest rates.

#### 6.2 Managing Interest Rate Risk

##### *Risk Management Objectives*

Interest rate risk is managed principally through monitoring exposure to moves in market interest rates, both through their effect on future cash flows and through their effect on the current economic values of financial instruments, and by having pre-approved limits on these exposures. ALCO is the monitoring body for compliance with these limits and is assisted by Risk Management in its monitoring activities.

In order to evaluate the risk arising through fluctuations in future cash flows, these flows are projected for both assets and liabilities on a base case and stressed scenarios of the relevant yield curves. A comparison report demonstrates the effects of interest rate stresses on Net Interest Margin over a number of years. The risk arising from fluctuations in fair value is calculated for each section of the Bank's portfolio, showing exposure to individual market rates to a high degree of granularity. It is then expressed both as a risk to reported income and capital, and as an economic measure that can be compared to the risk reported using a cash flow approach.

The outputs from the interest rate reports are used by ALCO to determine the appropriateness of the Bank's interest rate risk exposure and manage the assets and liabilities accordingly.

A summary of the Bank's interest rate gap position on non-trading portfolios is as follows.

## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

31 March 2013	Re-pricing in:			
	Carrying amount €000	Less than 3 months €000	3 months to 1 year €000	More than 1 year €000
Balances with Central Bank of Malta and treasury bills	69,848	45,975	19,941	3,932
Investment securities	1,564,034	401,626	3,699	1,158,709
Loans and advances to financial Institutions	20,131	20,131	-	-
Loans and advances to customers	402,174	385,871	13,834	2,469
	2,056,187	853,603	37,474	1,165,110
Amounts owed to financial institutions:				
- Due to Central Bank of Malta	107,000	107,000	-	-
- Due to clearing houses	695,000	345,000	205,000	145,000
- Due to other banks	566,995	551,609	14,649	737
Amounts owed to customers	566,047	185,465	94,932	285,650
Debt securities issued	15,664	-	-	15,664
Subordinated liabilities	12,341	-	-	12,341
	1,963,047	1,189,074	314,581	459,392
Interest rate gap	93,140	(335,471)	(277,107)	705,718

The management of interest rate risk against interest rate gap limits is supplemented by monitoring the sensitivity of the Bank's financial assets and liabilities to various interest rate scenarios. The estimated impact on Net Interest Margin (NIM) as a result of a 100 and 200 basis points (bps) movement and on Fair Value Reserve as a result of a 100 and 200 basis points (bps) parallel fall or rise in the yield curves, after taking into account the effect of hedge accounting, and making the assumption that market rates will never become negative, would be as follows:

31 March 2013	100 bps parallel increase €000	100 bps parallel decrease €000	200 bps parallel increase €000	200 bps parallel decrease €000
Impact on NIM	8,964	(7,906)	18,537	(7,928)
Impact on EV	19,614	(16,965)	41,512	(13,084)

### *Hedging and mitigation of interest rate risk*

Interest rate risk positions are managed by Treasury and Credit and Investments, in conjunction with Risk, by strategically positioning the asset and liability interest rate re-pricing profiles as well as by purchases of interest rate derivatives, primarily swaps. In addition, Treasury uses advances to

## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

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financial institutions and deposits from financial institutions to manage the overall position arising from the Bank's non-trading activities.

### 7. Operational Risk

#### 7.1 Scope and Nature of Operational Risk

Operational risk is the risk of direct or indirect loss arising from a wide variety of causes associated with the processes, personnel, technology and infrastructure, and from external factors other than credit, market and liquidity risks such as those arising from legal and regulatory requirements and generally accepted standards of corporate behaviour. Operational risks arise from all of the Bank's operations and are faced by all business entities.

#### 7.2 Managing Operational Risk

##### *Risk Management Objective*

The Bank's objective is to manage operational risk so as to balance the avoidance of financial losses and damage to the Bank's reputation with overall cost effectiveness and to avoid control procedures that restrict initiative and creativity while maintaining risk taking within a tolerable limit.

The primary responsibility for the development and implementation of controls to address operational risk is assigned to senior management within each business unit. This responsibility is supported by the development of overall Bank standards for the management of operational risk in the following areas:

- requirements for appropriate segregation of duties, including the independent authorisation of transactions
- requirements for the reconciliation and monitoring of transactions
- compliance with regulatory and other legal requirements
- documentation of controls and procedures
- requirements for the periodic assessment of operational risks faced, and the adequacy of controls and procedures to address the risks identified
- requirements for the reporting of operational losses and proposed remedial action
- development of contingency plans
- training and professional development
- ethical and business standards
- risk mitigation, including insurance where this is effective

##### *Operational Risk Management Policy*

In developing a policy for the management of operational risk, the Bank recognises the importance of having adequate risk management principles in place. Regardless of the nature and scale of the operations, the objective of the operational risk policy is to clearly set out the role of stakeholders, the process through which operational risks are identified, managed, measured and controlled, and is ultimately intended to embed and maintain a strong operational risk and internal control culture. In this respect, the operational risk policy supported by an operational risk framework is objectively formulated within the context of the Bank's operations and specified risk appetite and tolerance in line with industry standards.

## Additional Regulatory Disclosures in terms of Appendix 2 of Banking Rule 7

For the Year Ended 31 March 2013

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### ***User Information Security Policy***

The Bank identifies the potential to benefit from technology through increased efficiency and lower risk exposures from an operational perspective. Plans to further automate processes beyond those at the core of the business are in place, and in this respect, the risk management function liaises with the business analysis function to aid prioritisation of related projects.

During the year ended 31 March 2013, the Bank launched its e-banking services. The exposure to the accompanying risks are being managed by the Information Security Risk Team, which is involved in carrying out risk assessments in relation to such projects which have so far included security and choice of solutions for client use.

### ***Business Continuity Planning***

The Business Continuity Plan (BCP) is intended to provide the Bank with a plan of actions necessary to restore business to a minimum acceptable level in the event of a disruption, with specific focus on the prioritisation of the recovery of the business processes and the required technology required to support such processes.

The main objective of the plan is to restore critical business operations in a timely manner in the event of a business disruption by minimizing the number of critical decisions to be made at the time of the event by:

- Ensuring that clear instructions regarding the action plan are communicated to staff members and relevant parties; and,
- Ensuring that all necessary human resources, material resources and technology are in place to support critical processes.

In the event that any of the critical business units experience a significant disruption, the Business Continuity Team is responsible for directing the business effectively and as efficiently as possible.

Risk Architecture ensures that the BCP remains effective by keeping the plan up to date as the business evolves, and by testing the plan on a regular basis.

Additionally, the Bank also put in place an IT Disaster Recovery Plan. The plan defines every system and classifies these according to a priority level and an associated level of tolerance to failure. Critical systems are supported by three levels of redundancy and a number of backups are held in secure locations. An alternative location equipped with the required IT infrastructure is set up so that the Bank may execute critical business processes in a disaster scenario.

In light of the Bank's development pace and the low tolerance to business disruption, both the Business Continuity and the IT Disaster Recovery Plans are reviewed on a regular basis.

## **8. Remuneration Policy and Practices**

Information on remuneration policy and practices is disclosed in the Remuneration Report to the Annual Report.



## Five Year Summary

### Statements of Comprehensive Income

	31 Mar 2013 €000	31 Mar* 2012 €000	31 Dec 2010 €000	31 Dec 2009 €000	31 Dec 2008 €000
Interest income	50,945	64,067	41,834	4,544	1,298
Interest expense	(27,668)	(34,327)	(14,188)	(1,357)	(670)
<b>Net interest income</b>	<b>23,277</b>	<b>29,740</b>	<b>27,646</b>	<b>3,187</b>	<b>628</b>
Fee and commission income	951	253	124	114	266
Fee and commission expense	(2,777)	(424)	(1,154)	(176)	(170)
<b>Net fee and commission (expense)/income</b>	<b>(1,826)</b>	<b>(171)</b>	<b>(1,030)</b>	<b>(62)</b>	<b>96</b>
<b>Net trading income</b>	<b>5,267</b>	<b>1,799</b>	<b>346</b>	<b>103</b>	<b>53</b>
<b>Other operating income</b>	<b>27,534</b>	<b>48,931</b>	<b>3,280</b>	<b>116</b>	<b>-</b>
<b>Operating income</b>	<b>54,252</b>	<b>80,299</b>	<b>30,242</b>	<b>3,344</b>	<b>777</b>
Impairment loss on financial asset	(676)	(62,885)	-	-	(93)
Personnel expenses	(10,902)	(6,461)	(5,137)	(723)	(426)
Administrative expenses	(10,183)	(9,020)	(5,675)	(3,256)	(1,703)
Depreciation and amortisation	(944)	(772)	(365)	(227)	(610)
<b>Operating expenses</b>	<b>(22,705)</b>	<b>(79,138)</b>	<b>(11,177)</b>	<b>(4,206)</b>	<b>(2,832)</b>
<b>Profit/(loss) before income tax</b>	<b>31,547</b>	<b>1,161</b>	<b>19,065</b>	<b>(862)</b>	<b>(2,055)</b>
Tax expense	(11,064)	(453)	(3,955)	-	(1,274)
<b>Profit/(loss) for the financial period</b>	<b>20,483</b>	<b>708</b>	<b>15,110</b>	<b>(862)</b>	<b>(3,329)</b>

\*15 month period to from 1 January 2011 to 31 March 2012

## Five Year Summary

### Statements of Financial Position

	31 Mar 2013 €000	31 Mar 2012 €000	31 Dec 2010 €000	31 Dec 2009 €000	31 Dec 2008 €000
<b>Assets</b>					
Balances with Central Bank of Malta and cash	70,055	63,656	10,526	39,757	590
Loans and advances to financial institutions	20,131	27,804	35,801	14,045	35,251
Loans and advances to customers	402,174	27,666	-	9	2
Investment securities	1,564,034	1,415,493	1,324,114	636,323	-
Derivative assets held for risk management	279	2,572	-	-	-
Investment in subsidiaries	65	63	-	-	-
Property, plant and equipment	2,485	2,880	2,682	839	1,011
Intangible assets	228	351	1,371	246	2
Other assets	14,471	15,649	1,728	478	7
Prepayments and accrued income	27,996	19,442	14,646	5,750	100
Deferred income tax asset	-	244	695	-	-
<b>Total assets</b>	<b>2,101,918</b>	<b>1,575,820</b>	<b>1,391,563</b>	<b>697,447</b>	<b>36,963</b>
<b>Liabilities</b>					
Amounts owed to financial institutions	1,368,995	1,093,753	1,134,986	578,698	122
Amounts owed to customers	566,047	379,555	172,847	72,078	33,825
Debt Securities in Issue	15,664	19,672	14,735	-	-
Subordinated liabilities	12,341	-	-	-	-
Other liabilities	1,100	682	778	859	283
Accruals and deferred income	9,966	6,606	4,855	1,552	194
Current tax	7,660	166	3,891	-	-
Deferred tax liability	5,062	-	-	-	-
	<b>1,986,835</b>	<b>1,500,434</b>	<b>1,332,092</b>	<b>653,187</b>	<b>34,424</b>
<b>Equity</b>					
Called up issued share capital	62,350	56,030	41,030	39,521	10,402
Share premium	13,464	13,464	13,464	13,464	-
Retained Earnings/(accumulated losses)	21,191	7,029	6,382	(8,729)	(7,867)
Fair value reserve	18,078	(1,137)	(1,410)	-	-
Exchange differences on consolidation	-	-	5	4	4
	<b>115,083</b>	<b>75,386</b>	<b>59,471</b>	<b>44,260</b>	<b>2,539</b>
<b>Total liabilities and equity</b>	<b>2,101,918</b>	<b>1,575,820</b>	<b>1,391,563</b>	<b>697,447</b>	<b>36,963</b>

## Five Year Summary

### Statements of Cash Flows

	31 Mar 2013 €000	31 Mar* 2012 €000	31 Dec 2010 €000	31 Dec 2009 €000	31 Dec 2008 €000
<b>Cash flows from operating activities</b>					
Interest and commission receipts	52,741	60,158	38,158	1,642	1,391
Interest payments	(30,128)	(30,287)	(13,828)	(594)	(664)
Payments to employees and suppliers	(15,715)	(26,984)	(9,328)	(3,055)	(1,712)
<b>Operating profit/(loss) before changes in operating assets/liabilities</b>	<b>6,898</b>	<b>2,887</b>	<b>15,002</b>	<b>(2,007)</b>	<b>(985)</b>
(Increase)/decrease in operating assets:					
- reserve deposits with Central Bank of Malta	(1,360)	(68)	(1,971)	21	211
- loans advanced to customers and financial institutions	(297,583)	(27,250)	(1,038)	334	(870)
- investment securities	91,657	1,091,620	(694,718)	(638,882)	-
Increase in operating liabilities:					
- amounts owed to customers and financial institutions	474,850	(171,114)	291,006	616,229	5,214
Tax paid	(4,038)	(3,847)	-	-	-
<b>Net cash generated from/ (used in) operating activities</b>	<b>270,424</b>	<b>892,228</b>	<b>(391,719)</b>	<b>(24,305)</b>	<b>3,570</b>
<b>Cash flows from investing activities</b>					
Acquisition of property and equipment	(431)	(1,026)	(2,142)	(41)	(7)
Disposal of property and equipment	-	109	-	-	-
Acquisition of intangible assets	-	(4,517)	(1,191)	(197)	-
Disposal of intangible assets	-	5,401	-	-	-
Acquisition of available-for-sale assets	(1,170,867)	(3,184,077)	(81,489)	(59,525)	-
Disposal of available-for-sale assets	941,592	1,987,289	84,768	59,641	-
Acquisition of assets held-for-risk management	13,749	(4,728)	-	-	-
Advances to parent	(200)	(1,273)	(77)	-	-
Advances to Group companies	(2,071)	(3,575)	-	-	-
<b>Net cash used in investing activities</b>	<b>(218,228)</b>	<b>(1,206,397)</b>	<b>(131)</b>	<b>(122)</b>	<b>(7)</b>
<b>Cash flows from financing activities</b>					
Proceeds from the issue of share capital	6,320	15,000	1,509	42,584	402
Proceeds from Shareholder's Contribution	9,325	-	-	-	-
Proceeds from the issue of debt securities	-	4,937	14,735	-	-
Repayment of bank loans	-	-	-	-	(41)
Re-purchase of debt securities	(4,095)	-	-	-	-
Proceeds from the issue of subordinated debt securities	12,341	-	-	-	-
Interest paid on financial liabilities	-	-	-	-	(5)
Dividends paid	(7,143)	-	-	-	-
<b>Net cash from financing activities</b>	<b>16,748</b>	<b>19,937</b>	<b>16,244</b>	<b>42,584</b>	<b>356</b>
<b>Net change in cash and cash equivalents</b>	<b>41,446</b>	<b>(294,232)</b>	<b>(375,606)</b>	<b>18,157</b>	<b>3,919</b>
Cash and cash equivalents at beginning	(617,268)	(323,036)	52,570	34,413	30,494
<b>Cash and cash equivalents period end</b>	<b>(575,822)</b>	<b>(617,268)</b>	<b>(323,036)</b>	<b>52,570</b>	<b>34,413</b>

\*15 month period to from 1 January 2011 to 31 March 2012

## Five Year Summary

### Bank Ratios

	31 Mar 2013 %	31 Mar* 2012 %	31 Dec 2010 %	31 Dec 2009 %	31 Dec 2008 %
Net interest income and other operating income to total assets	2.4%	1.9%	2.2%	0.9%	1.8%
Operating expenses to total assets	1.08%	5%	1.1%	1.1%	7.9%
Cost to income ratio	41.9%	98.4%	37.0%	125.8%	364.6%
Profit / (loss) before tax to total assets	1.5%	0.08%	1.8%	(0.2%)	(5.7%)
Profit / (loss) before tax on equity	41.6%	2.25%	36.8%	(3.7%)	(51.4%)
Profit / (loss) after tax to equity	27.0%	0.05%	29.1%	(3.7%)	(83.2%)
	2013 No	2012 No	2010 No	2009 No	2008 No
Shares in issue	62,350,107	56,030,107	41,030,107	39,520,970	10,401,500
	2013 €	2012 €	2010 €	2009 €	2008 €
Net assets per share	33.68	30.47	25.83	18.88	3.49
Earnings / (loss) per share (cents) based on profit after tax	36c	1c	37.4c	(4.4)c	(32.5)c

\*15 month period to from 1 January 2011 to 31 March 2012

## Company Information

Directors' interest in the share capital of the Bank or in any related company as at 31 March 2013:

<b><u>Medifin Holding Limited C34111</u></b>				
	<b>Type &amp; Class of Shares</b>	<b>Issued Shares</b>	<b>% Paid Up</b>	<b>Nominal Value Per Share in EUR</b>
Mark Watson Holdings Limited	Ordinary B	627,855	100	1.000000
	Ordinary C	1,200,000	100	0.001000
HCS Holdings Limited	Ordinary B	224,233	100	1.000000
	Ordinary C	540,000	100	0.001000
JVP Holdings Limited	Ordinary B	362,903	100	1.000000
	Ordinary C	870,000	100	0.001000
AnaCap Financial Partners II L.P.	Ordinary A	40,188,556	100	1.000000
	Ordinary D	15,000,000	100	0.001000
XDP Holdings Limited	Ordinary C	180,000	100	1.000000
E- WealthS Ltd	Ordinary C	90,000	100	1.000000
Carey Pensions and Benefits	Ordinary C	120,000	100	1.000000

<u>Mediterranean Bank plc</u> <u>C34125</u>				
	Type & Class of Shares	Issued Shares	% Paid Up	Nominal Value Per Share in EUR
Medifin Holding Limited	Ordinary A	62,350,106	100	1.000000
	Number of shares		Number of holders	
Class A	62,350,106		1	
Class B	1		1	
	Number of holders			
Range	Class "A"		Class "B"	
1 - 500	-		1	
501 - 1000	-		-	
1001 - 5000	-		-	
5001 & over	1		-	

## Company Information

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The holders of ordinary A shares are entitled to one vote for each share. The holder of ordinary B share is not entitled to vote in respect of its shares

### Company Secretary

Edward Jaccarini

### Senior Management

Watson, Mark A.  
Bonello Ghio, Lorraine  
Calleja, Raymond  
Catania, Deo  
Chatard Vincent  
Cini, Charles  
Jaccarini, Edward  
Schmeltzer, Henry  
Vicent, Joaquin  
Wallace, Dominic

Chief Executive Officer  
Head of Personnel and Administration  
Head of Consumer Banking  
Head of Treasury  
Chief Operating Officer  
Head of Corporate Banking  
Chief Financial Officer  
Head of International Strategy and Head of Legal  
Head of Credit and Investments  
Chief Risk Officer

### Registered address:

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### Telephone:

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