MFC MERCHANT BANK LIMITED

Annual Report and Financial Statements
31 December 2016

Company Registration Number: C31608

Directors' report

The directors present their annual report and the audited financial statements of MFC Merchant Bank Limited (the "Bank") for the year ended 31 December 2016.

Principal activities

The principal activity of MFC Merchant Bank Limited is the operation of a credit institution under the Banking Act, Cap 371 of the Laws of Malta, in accordance with the credit institution licence granted by the Malta Financial Services Authority.

Review of the business

On 2 June 2015, the Bank's immediate parent company at the time BAWAG P.S.K. Bank für Arbeit und Wirtschaft und Österreichische Postparkasse Aktiengessellschaft ("BAWAG P.S.K.") had concluded a Share Sale and Purchase Agreement in order to sell its 100% shareholding in the Bank to MFC Bancorp Limited ("MFC"). Following regulatory approval by the European Central Bank and the Malta Financial Services Authority (MFSA), a new banking licence was issued on 1 February 2016 and the Bank changed its name to MFC Merchant Bank Limited.

The 2015 Share Sale and Purchase Agreement had mandated the Bank to dispose of certain legacy financial assets and financial liabilities. Following the finalisation of the disposal process by end 2015, the Bank had embarked on a business restructuring process during early 2016, aligning the infrastructure and governance structure of the Bank to its new business orientation. The main focus of the Bank's new strategy was on merchant banking, comprising specific areas of corporate banking and supply chain transactions including structured trade finance solutions, and factoring business. Apart from its bond portfolio, during 2016 most of the Bank's new business was related to factoring transactions, sourced through MFC group entities.

Profit after tax for the financial year under review was €1,425,841 (2015: €514,763). Total assets as at 31 December 2016 stood at €52,625,042 (2015: €87,092,483). The Bank's financial position is satisfactory and the directors expect that the current position will be sustained in the foreseeable future.

Future business developments

During 2017, the Bank's main business strategy will focus on merchant banking. The business development momentum is expected to increase and the directors are confident that the 2017 financial targets will be achieved. The directors believe that a cost-efficient and risk averse niche strategy in the field of merchant banking can be expanded further, initially based on business relations with the parent and its group entities, but with the potential for enhancement to a new client base and the objective to create substantial value added to its shareholders.

Directors' report – continued

Key performance indicators

The Board of directors tracks the Bank's progress in implementing its strategy with a range of financial measures or key performance indicators ('KPIs'). Progress is assessed by comparison with the Bank's budgets and historical performance. The financial KPIs tracked by the Board of the Bank are presented in the following table.

	2016	**2015**
Profit before tax	€1,425,841	€514,763
Cost to income ratio	62.84%	42.90%
Return on equity	2.20%	0.59%
Capital Adequacy Ratio	88.68%	169.64%

The Board of directors does not monitor any specific non-financial KPIs.

Risk management

MFC Merchant Bank Limited faces a range of business, financial and operational risks. The Bank adopts a robust corporate governance framework with a bank-wide risk management approach, to understand what its risks are, how much risk is acceptable, and to be able to manage it to create value for shareholders while meeting regulatory requirements ensuring integrity, ethical and transparent behaviour.

At a strategic level, the Bank's financial risk management objectives are:

i. To ensure appropriate identification of the Bank's significant risks;
ii. To ensure that the Bank's plans are consistent with its Risk Appetite;
iii. To optimise risk/return decisions by taking them as closely as possible to the business, while establishing strong and independent review and challenge structures; and
iv. To help the Bank's Management improve the control and co-ordination of risk taking across the business.

A detailed review of the Bank's use of financial instruments, it's exposure to liquidity risk, credit risk and market risk, and the respective financial risk management objectives and policies is included in Note 2 to the financial statements.

Results and dividends

The income statement is set up on page 10. The directors do not recommend the payment of a final dividend and propose that the balance of retained earnings amounting to €1,940,603 (2015: accumulated losses of €13,402,460) be carried forward to the next financial year.

Directors' report – continued

Changes in share capital

During the year, the following capital reductions took place following regulatory approval by the MFSA:

- on 29 January 2016, €13,917,222 out of the accumulated losses was offset by way of capital reduction;
- on 10 May 2016, the issued share capital of the Bank was reduced by 36,082,778 shares of €1 each to 50,000,000 shares of €1 each;
- by virtue of an extraordinary resolution dated 27 October 2016, it was resolved to further reduce the issued share capital of the Bank by 40,000,000 shares of €1 each to 10,000,000 shares of €1 each.

The capital reduction duly approved and resolved on 27 October 2016 became effective after the expiration of the three-month statutory notice period. This was implemented after year-end on 9 February 2017. Further information is disclosed in Note 13 of the Financial Statements.

Directors

The directors of the Bank who held office during the year were:

Christian Farrugia - Chairman
Otto Karasek
Samuel Morrow (appointed on 29 January 2016)
Ferdinand Steinbauer (appointed on 29 January 2016)
Friedrich Hondl (appointed on 29 January 2016)
Gordon Cordina (appointed on 29 January 2016 and resigned on 31 January 2017)
Satyen Shah (appointed on 29 January 2016 and resigned on 1 March 2017)
Friedrich Spandl (resigned on 29 January 2016)
Enver Sirucic (resigned 29 January 2016)

In accordance with the Bank's articles of association, the directors remain in office until they resign or are otherwise removed from office.

Statement of directors' responsibilities for the financial statements

The directors are required by the Maltese Banking Act, 1994 and the Maltese Companies Act, 1995 to prepare financial statements that give a true and fair view of the state of affairs of the Bank as at the end of each reporting period and of the profit or loss for that period.

In preparing the financial statements, the directors are responsible for:

- ensuring that the financial statements have been drawn up in accordance with International Financial Reporting Standards as adopted by the EU;
- selecting and applying appropriate accounting policies;
- making accounting estimates that are reasonable in the circumstances; and
- ensuring that the financial statements are prepared on the going concern basis unless it is inappropriate to presume that the Bank will continue in business as a going concern.

The directors are also responsible for designing, implementing and maintaining 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, and that comply with the Maltese Banking Act, 1994 and the Maltese Companies Act, 1995. They 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.

Directors' report – continued

Statement of directors' responsibilities for the financial statements - continued

The financial statements of MFC Merchant Bank Limited for the year ended 31 December 2016 are included in the Annual Report 2016, which is published in hard-copy printed form and may be made available on the Bank's website. The directors are responsible for the maintenance and integrity of the Annual Report on the website in view of their responsibility for the controls over, and the security of, the website. Access to information published on the Bank's website is available in other countries and jurisdictions, where legislation governing the preparation and dissemination of financial statements may differ from requirements or practice in Malta.

Auditors

PricewaterhouseCoopers have indicated their willingness to continue in office and a resolution for their re-appointment will be proposed at the Annual General Meeting.

On behalf of the board

Christian Farrugia
Chairman

Otto Karasek
CEO and Director

Registered Office:
The Plaza Commercial Centre
Level 4, Suite 7
Bisazza Street
Sliema SLM1640
Malta

27 April 2017

Independent auditor's report

To the Shareholders of MFC Merchant Bank Limited

Report on the audit of the financial statements

Our opinion

In our opinion:

- MFC Merchant Bank Limited's financial statements give a true and fair view of the Bank's financial position as at 31 December 2016, and of the Bank's financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards ('IFRSs') as adopted by the EU; and
- The financial statements have been prepared in accordance with the requirements of the Maltese Companies Act (Cap. 386) and the Maltese Banking Act (Cap.371).

What we have audited

MFC Merchant Bank Limited's financial statements, set out on pages 9 to 53, comprise:

- the statement of financial position as at 31 December 2016;
- the statement of comprehensive income for the year then ended;
- the statement of changes in equity for the year then ended;
- the statement of cash flows for the year then ended; and
- the notes to the financial statements, which include a summary of significant accounting policies.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report.

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

Independence

We are independent of the Bank in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) together with the ethical requirements of the Accountancy Profession (Code of Ethics for Warrant Holders) Directive issued in terms of the Accountancy Profession Act (Cap. 281) that are relevant to our audit of the financial statements in Malta. We have fulfilled our other ethical responsibilities in accordance with the IESBA Code.

Independent auditor's report - continued

To the Shareholders of MFC Merchant Bank Limited

Other information

The directors are responsible for the other information. The other information comprises the Directors' report, the Additional Regulatory Disclosures and the 5 Year Summary, (but does not include the financial statements and our auditor's report thereon), which we obtained prior to the date of this auditor's report.

Our opinion on the financial statements does not cover the other information.

In connection with our audit of the financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

With respect to the directors' report, we also considered whether the directors' report includes the disclosures required by Article 177 of the Maltese Companies Act (Cap. 386).

Based on the work we have performed, in our opinion:

- The information given in the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the directors' report has been prepared in accordance with the Maltese Companies Act (Cap. 386).

In addition, in light of the knowledge and understanding of the Bank and its environment obtained in the course of the audit, we are required to report if we have identified material misstatements in the directors' report and other information that we obtained prior to the date of this auditor's report. We have nothing to report in this regard.

Responsibilities of the directors and those charged with governance for the financial statements

The directors are responsible for the preparation of financial statements that give a true and fair view in accordance with IFRSs as adopted by the EU and the requirements of the Banking Act 1994 and the Maltese Companies Act (Cap. 386), and 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.

In preparing the financial statements, the directors are responsible for assessing the Bank's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Bank or to cease operations, or have no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Bank's financial reporting process.

Independent auditor's report - *continued*

To the Shareholders of MFC Merchant Bank Limited

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 Bank's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Bank's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Bank to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

Independent auditor's report - continued

To the Shareholders of MFC Merchant Bank Limited

Report on other legal and regulatory requirements

Opinion on other matters prescribed by the Maltese Banking Act (Cap. 371)

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 of those books;
- the Bank's financial statements are in agreement with the books of account; and
- to the best of our knowledge and according to the explanations given to us, the financial statements give the information required by any law in force in the manner so required.

Other matters on which we are required to report by exception

We also have responsibilities under the Maltese Companies Act (Cap. 386) to report to you if, in our opinion:

- returns adequate for our audit have not been received from branches not visited by us; and
- certain disclosures of directors' remuneration specified by law are not made in the financial statements, giving the required particulars in our report.

We have nothing to report to you in respect of these responsibilities.

PricewaterhouseCoopers
78, Mill Street
Qormi
Malta

FAxis.

Fabio Axisa
Partner

27 April 2017

Statement of financial position

	Notes	As at 31 December 2016 €	2015 €
ASSETS			
Cash and cash equivalents	4	**1,000**	1,000
Financial assets designated as at fair value through profit or loss	5	**-**	2,694,500
Financial assets classified as available-for-sale	6	**8,546,350**	6,329,900
Loans and advances to banks	7	**1,502,911**	77,820,821
Loans and advances to customers	8	**41,126,732**	-
Derivative financial instruments	9	**611**	-
Property, plant and equipment	10	**97,257**	85,554
Intangible assets	11	**43,671**	-
Accrued income and other assets	12	**1,306,510**	160,708
Total assets		**52,625,042**	87,092,483
EQUITY AND LIABILITIES			
Equity			
Share capital	13	**50,000,000**	100,000,000
Fair value reserve	14	**216,270**	280,837
Retained earnings/(accumulated losses)		**1,940,603**	(13,402,460)
Total equity		**52,156,873**	86,878,377
Liabilities			
Amounts owed to customers	15	**59**	-
Other liabilities	16	**468,110**	214,106
Total liabilities		**468,169**	214,106
Total equity and liabilities		**52,625,042**	87,092,483
MEMORANDUM ITEMS			
Commitments	17	**1,606,022**	15,769

The notes on pages 14 to 53 are an integral part of these financial statements.

The financial statements on pages 9 to 53 were authorised for issue by the board on 27 April 2017 and were signed on its behalf by:

Christian Farrugia
Director

Otto Karasek
CEO and Director

Income statement

	Notes	Year ended 31 December 2016 €	2015 €
Interest income	18	**1,110,820**	4,510,079
Interest expense	19	**(57)**	(1,299,799)
Net interest income		**1,110,763**	3,210,280
Fee and commission income	20	**861,762**	27,224
Fee and commission expense	20	**(21,907)**	(22,067)
Net fee and commission income		**839,855**	5,157
Net trading losses	21	**(263,438)**	(474,060)
Gains on disposal of available-for-sale financial assets		**408,666**	48,193
Other operating expenditure		**(14,004)**	(288,000)
Operating income		**2,081,842**	2,501,570
Net reversal of impairment charges/(impairment charges)	22	**652,235**	(913,709)
Administrative expenses	23	**(1,308,236)**	(1,073,098)
Profit for the year		**1,425,841**	514,763

The notes on pages 14 to 53 are an integral part of these financial statements.

Statement of comprehensive income

		Year ended 31 December	
	Notes	**2016** **€**	2015 €
Profit for the year		**1,425,841**	514,763
Other comprehensive income:			
Items that may be subsequently reclassified to profit or loss			
Fair valuation of available-for-sale financial assets:			
Net changes in fair value arising during the year, before tax	6	**344,099**	84,993
Reclassification adjustments – net amounts reclassified to profit or loss upon disposal, before tax		**(408,666)**	(48,193)
Other comprehensive income for the year, net of tax		**(64,567)**	36,800
Total comprehensive income for the year		**1,361,274**	551,563

The notes on pages 14 to 53 are an integral part of these financial statements.

Statement of changes in equity

	Notes	Share capital €	Fair value reserve €	Retained earnings €	Total equity €
Balance at 1 January 2015		100,000,000	244,037	(13,917,223)	86,326,814
Comprehensive income					
Profit for the year		-	-	514,763	514,763
Other comprehensive income					
Fair valuation of available-for-sale financial assets:					
Net changes in fair value arising during the year, net of tax	6	-	84,993	-	84,993
Reclassification adjustments – net amounts reclassified to profit or loss, before tax		-	(48,193)	-	(48,193)
Total comprehensive income		-	36,800	514,763	551,563
Balance at 31 December 2015		**100,000,000**	**280,837**	**(13,402,460)**	**86,878,377**
Comprehensive income					
Profit for the year		-	-	1,425,841	1,425,841
Other comprehensive income:					
Fair valuation of available-for-sale financial assets					
Net changes in fair value arising during the year, net of tax	6	-	344,099	-	344,099
Reclassification adjustments – net amounts reclassified to profit or loss, before tax		-	(408,666)	-	(408,666)
Total comprehensive income		-	(64,567)	1,425,841	1,361,274
Transactions with owners					
Offsetting of accumulated losses	13	(13,917,222)	-	13,917,222	-
Reduction in ordinary share capital	13	(36,082,778)	-	-	(36,082,778)
Total transactions with owners		(50,000,000)	-	13,917,222	(36,082,778)
Balance at 31 December 2016		**50,000,000**	**216,270**	**1,940,603**	**52,156,873**

The notes on pages 14 to 53 are an integral part of these financial statements.

Statement of cash flows

	Notes	As at 31 December 2016 €	2015 €
Cash flows from operating activities			
Interest and commission income received		**1,875,576**	6,230,298
Interest and commission expense paid		**(597,931)**	(199,922)
Net expense on foreign exchange transactions		**(641,956)**	-
Cash payments to employees and suppliers		**(1,337,697)**	(1,033,258)
Cash flows (used in)/generated from operating activities before changes in operating assets and liabilities		**(702,008)**	4,997,118
Changes in operating assets and liabilities:			
Net decrease/(increase) in loans and advances to customers	8	**(41,126,732)**	72,218,931
Net increase/(decrease) in amounts owed to customers	15	**59**	(2,134,808)
Net decrease in amounts owed to banks		**-**	(211,537,600)
Net (decrease)/increase in other liabilities		**(13,329)**	2,377
Net cash used in from operating activities		**(41,842,010)**	(136,453,982)
Cash flows from investing activities			
Proceeds from disposal of investments at fair value through profit or loss		**2,607,000**	162,040,003
Purchase of available-for-sale investments	6	**(50,015,187)**	-
Proceeds from disposal of available-for-sale investments	6	**48,367,045**	18,132,035
Proceeds from disposal of investments classified as loans and receivables		**-**	89,155,300
Proceeds from disposal of interest in subsidiary undertaking		**-**	595
Purchase of property, plant and equipment	10	**(46,641)**	(31,165)
Net cash generated from investing activities		**912,217**	269,296,768
Cash flows from financing activities			
Reduction in share capital		**(36,082,778)**	-
Net cash used in from financing activities		**(36,082,778)**	-
Net movement in cash and cash equivalents		**(77,012,571)**	132,842,786
Cash and cash equivalents at beginning of year		**77,821,821**	(46,797,678)
Effect of exchange rate changes on cash and cash equivalents		**694,661**	(8,223,287)
Cash and cash equivalents at end of year	25	**1,503,911**	77,821,821

The notes on pages 14 to 53 are an integral part of these financial statements.

Notes to the financial statements

1. Summary of significant accounting policies

The principal accounting policies adopted in the preparation of these financial statements are set out below. Unless otherwise stated, these policies have been consistently applied to all the years presented.

1.1 Basis of preparation

The Bank's financial statements have been prepared in accordance with the requirements of International Financial Reporting Standards (IFRSs) as adopted by the EU and with the requirements of the Banking Act, 1994 and the Maltese Companies Act, 1995. These financial statements are prepared under the historical cost convention, as modified by the fair valuation of financial assets and financial liabilities at fair value through profit or loss, including derivative financial instruments, and investments classified as available-for-sale.

The preparation of financial statements in conformity with IFRSs as adopted by the EU requires the use of certain accounting estimates. It also requires the directors to exercise their judgment in the process of applying the Bank's accounting policies (see Note 3 - Critical accounting estimates, and judgments in applying accounting policies).

Standards, interpretations and amendments to published standards effective in 2016

During the financial year ended 31 December 2016, the Bank adopted new standards, amendments and interpretations to existing standards that are mandatory for the Bank's accounting period beginning on 1 January 2016. The adoption of these revisions to the requirements of IFRSs as adopted by the EU did not result in substantial changes to the Bank's accounting policies.

Standards, interpretations and amendments to published standards that are not yet effective

Certain new standards, amendments and interpretations to existing standards have been published by the date of authorisation for issue of these financial statements but are mandatory for accounting periods beginning after 1 January 2016.

IFRS 9, 'Financial instruments', addresses the classification and measurement of financial assets and financial liabilities, impairment of financial assets and hedge accounting.

In this respect, during 2016, the Bank has set up an Implementation Programme ('the Programme') to prepare for IFRS 9 adoption. The Programme is sponsored by the Chief Finance Officer.

To date, the Programme has been directed towards preliminary impact analysis, particularly around risk modelling methodologies for the calculation of impairment. The Programme's focus during 2017 will be on finalising its impairment model as well as performing an impact assessment of the classification and measurement requirements.

Classification and measurement

IFRS 9 replaces the guidance in IAS 39 that relates to the classification and measurement of financial instruments. IFRS 9 retains but simplifies the mixed measurement model and establishes three primary measurement categories for financial assets: amortised cost, fair value through Other Comprehensive Income ('OCI') and fair value through profit or loss.

The classification and measurement of financial assets will depend on how these are managed (the entity's business model) and their contractual cash flow characteristics. These factors determine whether the financial assets are measured at amortised cost, fair value through other comprehensive income ('FVOCI') or fair value through profit or loss ('FVPL').

1. **Summary of significant accounting policies** - continued

1.1 Basis of preparation - continued

Classification and measurement - continued

The combined effect of the application of the business model and the contractual cash flow characteristics tests may result in some differences in the population of financial assets measured at amortised cost or fair value compared with IAS 39.

The Bank plans to conduct an assessment of potential classification and measurement changes to financial assets during 2017, based on the composition of the balance sheet as at 31 December 2016. This may not be fully representative of the impact as at 1 January 2018 because IFRS 9 requires that business models be assessed based on the facts and circumstances from the date of initial application. In addition, the contractual terms and conditions of the financial assets assessed as at 31 December 2016 may not reflect the contractual terms and conditions of the local group's financial assets at transition. The Bank plans to publish the impact of this assessment in its Annual Report and Financial Statements for the year ending 31 December 2017.

The classification of financial liabilities is expected to remain unchanged.

Impairment

There is now a new expected credit losses model that replaces the incurred loss impairment model used in IAS 39.

The impairment requirements apply to financial assets measured at amortised cost and FVOCI, and certain loan commitments and financial guarantee contracts. At initial recognition, an impairment allowance (or provision in the case of commitments and guarantees) is required for expected credit losses ('ECL') resulting from default events that are possible within the next 12 months ('12-month ECL').

In the event of a significant increase in credit risk, an allowance (or provision) is required for ECL resulting from all possible default events over the expected life of the financial instrument ('lifetime ECL'). Financial assets where 12-month ECL is recognised are considered to be 'stage 1'; financial assets which are considered to have experienced a significant increase in credit risk are in 'stage 2'; and financial assets for which there is objective evidence of impairment, so are considered to be in default or otherwise credit impaired, are in 'stage 3'.

The assessment of credit risk and the estimation of ECL are required to be unbiased and probability-weighted, and should incorporate all available information, which is relevant to the assessment including information about past events, current conditions and reasonable and supportable forecasts of economic conditions at the reporting date. In addition, the estimation of ECL should take into account the time value of money. As a result, the recognition and measurement of impairment is intended to be more forward-looking than under IAS 39 and the resulting impairment charge will tend to be more volatile. It will also tend to result in an increase in the total level of impairment allowances, since all financial assets will be assessed for at least 12-month ECL and the population of financial assets to which lifetime ECL applies is likely to be larger than the population for which there is objective evidence of impairment in accordance with IAS 39.

The Bank is still in the process of assessing the impact that the impairment requirements will have on its financial statements. The following similarities and differences are likely to be important to understanding the potential effect of the change in the Bank's impairment charge resulting from the implementation of IFRS 9.

1. Summary of significant accounting policies - continued

1.1 Basis of preparation - continued

Impairment - continued

Stage 1

In accordance with IAS 39, incurred but not yet identified impairment is recognised on individually assessed loans for which no evidence of impairment has been specifically identified by estimating a collective allowance determined after taking into account factors including the estimated period between impairment occurring and the loss being identified.

Under IFRS 9, financial assets which are not considered to have significantly increased in credit risk have loss allowances measured at an amount equal to 12 months ECL. This 12-month time horizon is likely to be equal to or longer than the period estimated under IAS 39, which will tend to result in IFRS 9 allowances being larger than the current collective impairment allowance charge.

Stage 2

With IFRS 9, financial assets are considered to be in stage 2 when their credit risk has increased significantly since initial recognition, so it is appropriate to recognise lifetime ECL. Since this is not a concept in IAS 39, it is likely to result in increased allowances as the result of the recognition of lifetime ECL for population of assets that are not considered to be credit impaired. Albeit, based on the portfolio composition as at 31 December 2016, the impact on the Bank is expected to be less material than for other banks, owing to the fact that less than 10% of the Bank's loans and advances to customers have contractual maturities in excess of one year.

For loans and advances whose contractual maturity exceeds 12 months, the Bank is still in the process of determining which criteria would be considered to constitute a significant increase in credit risk and whether credit quality disclosures included within this Annual Report may be reflective of the populations in stage 2.

Stage 3

Financial assets will be included in stage 3 when there is objective evidence that the loan is credit impaired. The objective evidence that is used is the same as the criteria used by the Bank to determine whether an individually significant loan is impaired in accordance with IAS 39. Therefore, the population included in stage 3 is expected to be consistent with impaired loans under IAS 39 which are considered individually significant. Changes may be made to these calculations to ensure the measurement requirements of IFRS 9 are met.

The policy on the write-off of loans and advances is expected to remain unchanged.

Until reliable estimates of the impact are available, particularly on the interaction with the regulatory capital requirements, further information on the expected impact on the financial position and on capital planning cannot be provided.

Hedge accounting

The general hedge accounting requirements aim to simplify hedge accounting, creating a stronger link with risk management strategy and permitting hedge accounting to be applied to a greater variety of hedging instruments and risks, but do not explicitly address macro hedge accounting strategies, which are particularly important for banks. As a result, IFRS 9 includes an accounting policy choice to remain with IAS 39 hedge accounting.

1. **Summary of significant accounting policies** - continued

1.1 Basis of preparation - continued

Hedge accounting - continued

Although the Bank deploys hedging strategies to mitigate or offset risk that arise from its activities, none of its strategies achieve hedge accounting in terms of IAS 39. Accordingly, the Bank expects that IFRS 9 will have no impact in this regard.

Transition

The classification and measurement and impairment requirements are applied retrospectively by adjusting the opening balance sheet at the date of initial application, with no requirement to restate comparative periods. The mandatory application date for the standard as a whole is 1 January 2018. Thus, the Bank does not intend to restate its comparative periods. Accordingly, all adjustments resulting from the transition will be applied by adjusting the opening balance sheet as at 1 January 2018.

Comparison of IAS 39 accounting policies with IFRS 9

The accounting policies and accounting estimates and judgements for the impairment of loans and advances and available-for-sale financial assets (in accordance with IAS 39 'Financial Instruments') are set out in Note 1.4. Their equivalents for financial assets at amortised cost and at FVOCI (in accordance with IFRS 9) are expected to be developed during 2017.

1.2 Foreign currency transactions and balances

a) Functional and presentation currency

Items included in the financial statements are measured using the currency of the primary economic environment in which the entity operates ('the functional currency'). The financial statements are presented in euro, which is the Bank's functional and presentation currency.

b) Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions or valuation where items are remeasured. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in profit or loss.

1.3 Financial assets

The Bank classifies its financial assets in the following categories: at fair value through profit or loss, loans and receivables and available-for-sale investments. The classification depends on the purpose for which the financial assets were acquired. Management determines the classification of its financial assets at initial recognition.

Initial recognition and derecognition

The Bank recognises a financial asset in its statement of financial position when it becomes a party to the contractual provisions of the instrument. Regular way purchases and sales of financial assets are recognised on the trade date, which is the date on which the Bank commits to purchase or sell the asset. Accordingly, the Bank uses trade date accounting for regular way contracts when recording financial asset transactions.

1. **Summary of significant accounting policies** - continued

1.3 Financial assets - continued

Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or have been transferred and the Bank has transferred substantially all risks and rewards of ownership or the Bank has not retained control of the asset.

Financial assets at fair value through profit or loss

This category comprises two sub-categories: financial assets classified as held-for-trading, and financial assets designated by the Bank as at fair value through profit or loss upon initial recognition.

A financial asset is classified as held-for-trading if it is acquired principally for the purpose of selling or repurchasing it in the near term or if it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.

Derivatives are also categorised as held-for-trading unless they are designated and effective as hedging instruments. Assets in this category are classified as current assets if expected to be settled within twelve months; otherwise, they are classified as non-current.

The Bank's held-for-trading financial instruments consist of derivative contracts.

Financial instruments included in this category are recognised initially at fair value; transaction costs are taken directly to profit or loss. Gains and losses arising from changes in fair value are included directly in profit or loss and are reported as 'Net trading (losses)/gains'. Interest income on financial assets held-for-trading are also included in 'Net trading (losses)/gains'.

The Bank also designates certain financial assets upon initial recognition as at fair value through profit or loss (fair value option). This designation cannot subsequently be changed.

According to IAS 39, the fair value option is only applied when the following conditions are met:

- the application of the fair value option reduces or eliminates an accounting mismatch that would otherwise arise; or
- the financial assets are part of a portfolio of financial instruments which is risk managed and reported to senior management on a fair value basis; or
- the financial assets consist of debt hosts and embedded derivatives that must be separated.

The Bank's financial assets at fair value through profit or loss upon initial recognition consist of local government bonds. Gains and losses arising from changes in fair value are included directly in profit or loss and are reported as 'Net trading (losses)/gains'. Interest income on financial assets at fair value through profit or loss are included in 'Net interest income'.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:

(a) those that the Bank intends to sell immediately or in the short term, which are classified as held-for-trading, and those that the entity upon initial recognition designates as at fair value through profit or loss;
(b) those that the Bank upon initial recognition designates as available-for-sale; or
(c) those for which the holder may not recover substantially all of their initial investment, other than because of credit deterioration.

1. **Summary of significant accounting policies** - continued

1.3 Financial assets - continued

Loans and receivables arise when the Bank provides money, goods or services directly to a debtor with no intention of trading the asset. They are included in current assets except for maturities greater than twelve months after the end of the reporting period. The latter are classified as non-current assets. Loans and receivables mainly consist of balances held with the Central Bank of Malta and other credit institutions, loans and advances to customers, and any income accruing on each of these assets.

Loans and receivables are initially recognised at fair value – which is the cash consideration to originate or purchase the loan including any transaction costs – and measured subsequently at amortised cost using the effective interest rate method. Amortised cost is the initial measurement amount adjusted for the amortisation of any difference between the initial and maturity amounts using the effective interest method. Interest on loans and receivables is included in profit or loss and is reported as 'Interest and similar income'.

In the case of an impairment, the impairment loss is reported as a deduction from carrying value of the loan and receivable and recognised in profit or loss as 'Impairment losses'.

Available-for-sale financial assets

Available-for-sale investments are financial assets that consist of local government bonds and foreign debt securities which are intended to be held for an indefinite period of time, which may be sold in response to needs for liquidity or changes in interest rates, exchange rates or that are not classified as loans and receivables, held-to-maturity investments or financial assets at fair value through profit or loss. They are included in non-current assets unless the asset matures or management intends to dispose of it within twelve months of the end of the reporting period.

Available-for-sale financial assets are initially recognised at fair value, which is the cash consideration including any transaction costs, and measured subsequently at fair value with gains and losses (in case of monetary assets) being recognised in other comprehensive income, except for impairment losses and foreign exchange gains and losses, until the financial asset is derecognised. If an available-for-sale financial asset is determined to be impaired, the cumulative gain or loss previously recognised in other comprehensive income is reclassified to profit or loss. Interest income on available-for-sale assets is calculated using the effective interest method, and is recognised in profit or loss as are foreign currency gains and losses on monetary assets classified as available-for-sale. Changes in the fair value of monetary securities denominated in foreign currency classified as available-for-sale are analysed between translation differences resulting from changes in the amortised cost of the security and other changes in the carrying amount of the security.

Translation differences related to changes in amortised cost are recognised in profit or loss, and other changes in carrying amount are recognised in other comprehensive income. The fair values of quoted investments are based on current bid prices.

1. Summary of significant accounting policies - continued

1.4 Impairment of financial assets

Assets carried at amortised cost

The Bank assesses at the end of each reporting period whether there is objective evidence that a financial asset or group of financial assets is impaired. A financial asset or a group of financial assets is impaired and impairment losses are incurred only if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

The criteria that the Bank uses to determine that there is objective evidence of an impairment loss include:

(a) significant financial difficulty of the issuer or obligor;
(b) a breach of contract, such as a default or delinquency in interest or principal payments;
(c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
(d) it becomes probable that the borrower will enter bankruptcy or other financial reorganisation; or
(e) observable data exists indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the portfolio. Such data includes:

  (i) adverse changes in the payment status of borrowers in the portfolio as a whole; and
  (ii) national or local economic conditions that correlate with defaults on the assets in the portfolio.

The Bank does not hold assets that are not individually significant. Therefore, the Bank first assesses whether objective evidence of impairment exists individually for all financial assets carried at amortised cost. If the Bank determines that no objective evidence of impairment exists it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

The amount of the loss is measured 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 financial asset's original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognised in profit or loss. If a loan has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract.

The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics. Those characteristics are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated.

1. Summary of significant accounting policies - continued

1.4 Impairment of financial assets - continued

Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets in the Bank and historical loss experience for assets of peer groups with credit risk characteristics similar to those in the Bank since the Bank does not have specific loss experiences. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not currently exist.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss is reversed by adjusting the allowance account. The amount of the reversal is recognised in profit or loss.

Assets classified as available-for-sale

The Bank assesses at the end of each reporting period whether there is objective evidence that a financial asset or a group of financial assets is impaired.

If any such evidence exists for available-for-sale financial assets, the cumulative loss – measured as the difference between amortised cost and the current fair value, less any impairment loss on that financial asset previously recognised in profit or loss – is removed from equity and recognised in profit or loss. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale 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 through profit or loss.

1.5 Offsetting financial instruments

Financial assets and liabilities are offset and the net amount is reported in the statement of financial position when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

1.6 Derivative financial instruments and hedge accounting

Derivative financial instruments, including currency forward swaps, are initially recognised at fair value on the date on which a derivative contract is entered into, and are subsequently re-measured at their fair value. Fair values for currency swaps are determined using forward exchange market rates at the end of the reporting period. Discounting techniques, reflecting the fact that the respective exchange or settlement will not occur until a future date, are used when the time value of money has a significant effect on the fair valuation of these instruments.

The Bank principally uses currency swaps as a hedge of foreign exchange risk thereby entering into commitments to exchange one set of cash flows for another. All the Bank's derivative transactions provide effective economic hedges under the Bank's risk management policies. The method of recognising the resulting fair value gain or loss depends on whether the derivative is designated as a hedging instrument, and if so, the nature of the item being hedged. The Bank designates certain derivatives as hedges of the fair value of recognised assets or liabilities or firm commitments (fair value hedge). Hedge accounting is used for derivatives designated in this way provided certain criteria are met.

The Bank documents, at the inception of the transaction, the relationship between hedged items and hedging instruments, as well as its risk management objective and strategy for undertaking various hedge transactions. The Bank also documents its assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values of hedged items.

1. **Summary of significant accounting policies** - continued

1.6 Derivative financial instruments and hedge accounting - continued

(a) Fair value hedges

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in profit or loss, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk. The net result, representing the hedge ineffectiveness, is recorded in 'Net trading gains/losses'. If the hedge no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of a hedged item for which the effective interest method is used is amortised to profit or loss over the period to maturity and recorded as 'Interest income'.

(b) Derivatives that do not qualify for hedge accounting

Certain derivative instruments do not qualify for hedge accounting. Changes in the fair value of any derivative instrument that does not qualify for hedge accounting are recognised immediately in profit or loss under 'Net trading gains/losses'.

1.7 Intangible assets

Acquired computer software licences are capitalised on the basis of the costs incurred to acquire and bring to use specific software. These costs are amortised over their estimated useful lives of five years. Costs associated with maintaining computer software programme are recognised as an expense as incurred.

Development costs that are directly attributable to the design and testing of identifiable and unique software products controlled by the Bank are recognised as intangible assets when the following criteria are met:

- it is technically feasible to complete the software product so that it will be available for use;
- management intends to complete the software product and use it;
- there is an ability to use the software product;
- it can be demonstrated how the software product will generate probable future economic benefits;
- adequate technical, financial and other resources to complete the development and to use the software product are available; and
- the expenditure attributable to the software product during its development can be reliably measured.

At the end of each reporting period, intangible assets are reviewed for indications of impairment or changes in estimated future economic benefits. If such indications exist, the intangible assets are analysed to assess whether their carrying amount is fully recoverable (Note 1.9).

1.8 Property, plant and equipment

All property, plant and equipment is stated at historical cost less depreciation. Historical cost includes expenditure that is directly attributable to the acquisition of the items.

Subsequent costs are included in the asset's carrying amount or are recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Bank and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognised. All other repairs and maintenance are charged to profit or loss during the financial period in which they are incurred.

1. **Summary of significant accounting policies** - continued

1.8 Property, plant and equipment- continued

Depreciation is calculated using the straight-line method to allocate the cost of the assets to their residual values over their estimated useful lives, as follows:

	%
Computer equipment	25
Office improvements and equipment	10-25
Others	25

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at the end of each reporting period. An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount (Note 1.9).

Gains and losses on disposals are determined by comparing the proceeds with the carrying amount and are recognised in profit or loss.

1.9 Impairment of non-financial assets

Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash inflows (cash-generating units). The impairment test can also be performed on a single asset when the fair value less cost to sell or the value in use can be determined reliably.

1.10 Current and deferred tax

The tax expense for the period comprises current and deferred tax. Tax is recognised in profit or loss, except to the extent that it relates to items recognised in other comprehensive income or directly in equity. In this case, the tax is also recognised in other comprehensive income or directly in equity, respectively.

The current income tax charge is calculated on the basis of the tax laws enacted or substantively enacted at the end of the reporting period.

Deferred tax is recognised, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. Deferred tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred tax is determined using tax rates (and laws) that have been enacted or substantively enacted by the end of the reporting period and are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax assets are recognised only to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised.

1.11 Share capital

Ordinary shares are classified as equity. Incremental costs directly attributable to the issue of new shares are shown in equity as a deduction, net of tax, from the proceeds.

1. **Summary of significant accounting policies** – continued

1.12 Financial liabilities

The Bank recognises a financial liability on its statement of financial position when it becomes a party to the contractual provisions of the instrument. The Bank's financial liabilities are composed of financial liabilities at fair value through profit or loss (classified as 'Derivative financial instruments) and financial liabilities which are not at fair value through profit or loss (classified as 'Other liabilities') under IAS 39. Derivative financial instruments are initially recognised at fair value on the date a derivative contract is entered into and are subsequently re-measured at their fair value. Financial liabilities not at fair value through profit or loss are recognised initially at fair value, being the fair value of consideration received, net of transaction costs that are directly attributable to the acquisition or the issue of the financial liability, these liabilities are subsequently measured at amortised cost. The Bank derecognises a financial liability from its statement of financial position when the obligation specified in the contract or arrangement is discharged, is cancelled or expires.

Financial liabilities measured at amortised cost comprise principally amounts owed to banks, amounts to customers, trade and other payables (Note 1.13) together with other liabilities.

Derivatives are categorised as financial liabilities classified as held for trading. Gains and losses arising from changes in fair value of financial liabilities classified held for trading are included directly in profit or loss and are reported as 'Net trading (losses)/gains'. Interest expenses on financial liabilities held for trading are included in 'Net interest income'.

1.13 Trade and other payables

Trade payables comprise obligations to pay for goods or services that have been acquired in the ordinary course of business from suppliers. Accounts payable are classified as current liabilities if payment is due within one year or less (or in the normal operating cycle of the business if longer). If not, they are presented as non-current liabilities.

Trade and other payables are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method.

1.14 Off-balance sheet instruments

Where the Bank undertakes to make a payment on behalf of its customers for guarantees issued for which an obligation to make a payment has not arisen at the reporting date, those are included in these financial statements as contingent liabilities.

Where the Bank has confirmed its intention to provide funds to a customer in the form of loans and other credit facilities and the Bank has not made payments at the end of the reporting period, those committed facilities are included in these financial statements as commitments.

1.15 Interest income and expense

Interest income and expense for all interest-bearing financial instruments are recognised within 'Interest income' and 'Interest expense' in profit or loss using the effective interest method.

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Bank estimates cash flows considering all contractual terms of the financial instrument (for example, prepayment options) but does not consider future credit losses.

1. Summary of significant accounting policies - continued

1.15 Interest income and expense- continued

The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

1.16 Fee and commission income and expense

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 account servicing fees and investment management fees are recognised as the related services are performed. Fees that are earned on the execution of a significant act are recognised as revenue when the significant act has been completed. Other fees and commission expense relate mainly to transaction service fees which are expensed as the services are received.

1.17 Leases

The Bank is the lessee

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to profit or loss on a straight-line basis over the period of the lease.

1.18 Cash and cash equivalents

Cash and cash equivalents are carried in the statement of financial position at face value. Cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition, including cash in hand, deposits held at call with banks and other short-term highly liquid investments with original maturities of three months or less.

1.19 Dividend distribution

Dividend income is recognised when the right to receive income is established. Usually this is the ex-dividend date for equity securities.

2. Financial risk management

2.1 Financial risk factors

The Bank's activities expose it to a variety of financial risks and these activities involve the analysis, evaluation, acceptance and management of some degree of risk or combination of risks. The Bank's aim is to achieve an appropriate balance between risk and return and minimise potential adverse effects on the entity's financial performance.

The Board of directors oversees credit, market, funding and liquidity, operational and strategic business risks. The Bank has developed an integrated risk management framework to identify, assess, manage and report risks and risk adjusted returns.

The Bank's risk management policies are designed to identify and analyse risks, to set appropriate risk limits and controls, and to monitor the risks and adherence to limits by means of reliable and up-to-date information systems. The Board is responsible for the overall effectiveness of the risk management function, which function is however carried out by all the members of the Bank's management.

The Bank's treasury function is responsible for managing assets, liabilities and the overall financial position and is also responsible for the management of funding and liquidity risks. The Bank's risk oversight function has the overall responsibility for the development of the entity's risk strategy and the implementation of risk principles, framework, policies and related limits.

(a) Credit risk

The Bank takes on exposure to credit risk, which is the risk that a counterparty will cause a financial loss for the Bank by failing to discharge an obligation. Credit risk is the most important risk for the Bank's business; accordingly management carefully manages its exposure to this risk. Credit exposures arise principally through the Bank's participation in trade financing transactions, through the Bank's transactions with correspondent banks, and through its investments in debt securities and other exposures arising from its investing activities.

2. Financial risk management - continued

2.1 Financial risk factors - continued

(a) Credit risk - continued

The Bank's principal credit risk exposures relating to on-balance sheet financial assets analysed by IAS 39 categorisation and off-balance sheet instruments, reflecting the maximum exposure to credit risk before collateral held or other credit enhancements, are as follows:

	2016	2015
	€	€
Credit risk exposures relating to on-balance sheet assets:		
Financial assets at fair value through profit or loss:		
Investment in Malta Government Stocks (Note 5)	-	2,694,500
Financial assets classified as available-for-sale (Note 6):		
Debt securities	**8,546,350**	6,329,900
Loans and receivables:		
Loans and advances to banks (Note 7)	**1,502,911**	77,820,821
Loans and advances to customers (Note 8)	**41,126,732**	-
Accrued interest income (Note 12)	**780,432**	96,408
Held for trading financial assets:		
Derivative financial instruments	**611**	-
	51,957,036	86,941,629
Credit risk exposures relating to off-balance sheet instruments:		
Commitments	**1,500,000**	-

The exposures set out in the preceding table are based on carrying amounts as reported in the statement of financial position. The table represents the maximum credit risk exposure to the Bank at 31 December 2016 and 2015, without taking account of any collateral held or any other credit enhancements attached.

2. Financial risk management - continued

2.1 Financial risk factors - continued

(a) Credit risk – continued

In order to manage its principal risk exposures arising from its financial assets, primarily its loans and advances to customers, the Bank compiles and updates credit review reports in respect of these financial assets. Where available, reference is also made to external reviews of primary borrowers.

At year end, apart from the shareholder loan amounting to €40,000,000 referred to in Note 13, there were no other loans to customers that were considered to be reportable as large exposures, exceeding 10% of the Bank's Total Own Funds.

The geographical concentration of the Bank's financial assets as at the end of the reporting period is analysed below. For the purposes of this table, the Bank has allocated exposures to regions based on the country of domicile of the respective counterparties or customers.

	Malta	Other EU countries	Rest of world	Total
	€	€	€	€
As at 31 December 2016				
Financial assets classified as available-for-sale	3,536,778	5,009,572	-	8,546,350
Loans and advances to banks	138,815	1,364,096	-	1,502,911
Loans and advances to customers	40,000,000	810,000	316,732	41,126,732
Derivative financial instruments	-	611	-	611
Accrued income and other assets	47,945	732,482	5	780,432
	43,723,538	**7,916,761**	**316,737**	**51,957,036**
As at 31 December 2015				
Financial assets designated at fair value through profit or loss	2,694,500	-	-	2,694,500
Financial assets classified as available-for-sale	6,329,900	-	-	6,329,900
Loans and advances to banks	205,546	77,615,275	-	77,820,821
Accrued income and other assets	96,408	-	-	96,408
	9,326,354	**77,615,275**	**-**	**86,941,629**

2. Financial risk management - continued

2.1 Financial risk factors - continued

(a) Credit risk - continued

Loans and advances to customers, gross of allowances, are analysed by industry concentration as follows:

	2016	2015
	€	€
Financial and insurance activities	**40,000,000**	-
Manufacturing	**810,000**	-
Electricity, gas, steam and air conditioning supply	**316,732**	-
Wholesale and retail	-	961,246
	41,126,732	961,246

Loans and advances to customers for the financial years ending 31 December 2016 include €40,000,000 due from a related party.

The following table presents the Bank's loans and advances to customers, gross of impairment allowances, by level of collateral:

	2016	2015
	€	€
Loans and advances to customers		
Fully collateralised	-	202,076
Uncollateralised	**41,126,732**	759,170
	41,126,732	961,246

As at 31 December 2016, the uncollateralised loans to customers include loans amounting to €40,000,000 to shareholders that are repayable through direct capital reduction set-off as disclosed in Note 13.

At 31 December 2016, all loans and advances to customers were categorised as fully performing assets.

As at 31 December 2015, the Bank had impaired loans and advances to customers with a nominal gross value of €961,246, which had been deemed fully impaired. A reversal of impairment charge amounting to €961,246 had been reflected upon the recognition of €652,235 in respect of amounts provided in 2015.

Loans and advances to banks and other financial assets

In the normal course of business, the Bank places funds, carries out transactions and enters into forward foreign exchange contracts mainly with listed international banks and local banks with a strong credit standing, subject to the application of a limit framework.

As part of its treasury management activities the Bank invests in listed sovereign bonds issued by local government and also in listed debt securities issued by foreign credit institutions. These

2. Financial risk management - continued

2.1 Financial risk factors - continued

(a) Credit risk - continued

transactions are monitored through the practical use of exposure limits. External ratings such as Moody's rating or their equivalents are used for monitoring these credit risk exposures.

(b) Market risk

The Bank takes on exposure to market risk, which is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risks arise from open positions in interest rate and currency products, all of which are exposed to general and specific market movements and changes in the level of volatility of market rates or prices such as interest rates, credit spreads, foreign exchange rates and equity prices.

Foreign exchange risk

The Bank takes on exposure to the effects of fluctuations in the prevailing foreign currency exchange rates on its financial position and cash flows. Foreign exchange risk is the risk to earnings and value caused by a change in foreign exchange rates. Foreign exchange risk arises when financial assets or liabilities are denominated in currencies which are different from the Bank's functional currency.

The Bank manages its currency risk on an ongoing basis by ensuring that foreign currency liabilities are utilised to fund assets denominated in the same foreign currency thereby matching asset and liability positions as much as is practicable. To the extent that such matching is not possible, the Bank hedges its open foreign exchange exposures by entering into foreign exchange forward contracts with terms matching those of the hedged items.

The following tables summarise the Bank's exposure to foreign currency risk at 31 December. Included in the tables are the Bank's financial instruments at carrying amounts, categorised by currency.

2. **Financial risk management** - continued

2.1 Financial risk factors - continued

(b) Market risk continued

Foreign exchange risk - continued

	Euro	**Other currencies**	**Total**
	€	**€**	**€**
As at 31 December 2016			
Financial assets			
Financial assets classified as available-for-sale	8,546,350	-	8,546,350
Loans and advances to banks	1,470,351	32,560	1,502,911
Loans and advances to customers	40,810,000	316,732	41,126,732
Derivative financial instruments	-	611	611
Accrued interest income and other assets	590,038	190,394	780,432
Total financial assets	51,416,739	540,297	51,957,036
Financial liabilities			
Amounts owed to customers	59	-	59
Accrued interest payable and other liabilities	287,643	180,467	468,110
Total financial liabilities	287,702	180,467	468,169
Net on-balance sheet position	51,129,037	359,830	
Off-balance sheet notional position		(317,169)	
Net currency exposure		**42,661**	

2. Financial risk management - continued

2.1 Financial risk factors – continued

(b) Market risk - continued

Foreign exchange risk - continued

	Euro	Other currencies	Total
	€	€	€
As at 31 December 2015			
Financial assets			
Financial assets designated at fair value through profit or loss	2,694,500	-	2,694,500
Financial assets classified as available-for-sale	6,329,900	-	6,329,900
Loans and advances to banks	77,804,160	16,661	77,820,821
Accrued interest income and other assets	96,408	-	96,408
Total financial assets	86,924,968	16,661	86,941,629
Financial liabilities			
Accrued interest payable and other liabilities	214,106	-	214,106
Total financial liabilities	214,106	-	214,106
Net on-balance sheet position	86,710,862	16,661	
Net currency exposure		**16,661**	

The notional amounts of the derivative contracts at the end of the reporting period substantially match the carrying amount of the net foreign currency exposure. Based on this, the Board believes that the foreign exchange risk is not material in view of the fact that exchange differences on the net financial position exposures are substantially offset by fair value differences on the derivative contracts. Accordingly, a sensitivity analysis for foreign exchange risk disclosing how profit or loss and equity would have been affected by changes in foreign exchange rates that were reasonably possible at the end of the reporting period is not deemed necessary since the directors are of the opinion that the net impact (after hedging transactions) would be insignificant.

2. Financial risk management - continued

2.1 Financial risk factors – continued

Interest rate risk

Cash flow interest rate risk is the risk that the future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Fair value interest rate risk is the risk that the value of a financial instrument will fluctuate because of changes in market interest rates.

The exposure to cash flow and fair value interest rate risk as at 31 December is shown below:

	Floating rates €	Fixed rates €	Total €
At 31 December 2016			
Interest-bearing assets			
Financial assets classified as available-for-sale:			
Debt securities	5,009,572	3,536,778	8,546,350
Loans and receivables:			
Loans and advances to banks	1,502,911	-	1,502,911
Loans and advances to customers	316,732	40,810,000	41,126,732
Net exposure	**6,829,215**	**44,346,778**	**51,175,993**

	Floating rates €	Fixed rates €	Total €
At 31 December 2015			
Interest-bearing assets			
Financial assets designated at fair value through profit or loss:			
Investment in Malta Government Stocks	-	2,694,500	2,694,500
Financial assets classified as available-for-sale:			
Debt securities	-	6,329,900	6,329,900
Loans and receivables:			
Loans and advances to banks	77,820,821	-	77,820,821
Net exposure	**77,820,821**	**9,024,400**	**86,845,221**

As at 31 December 2016 and 2015, the Bank did not have any interest-bearing financial liabilities.

Financial instruments issued at fixed rates potentially expose the Bank to fair value interest rate risk. Loans and advances to customers and loans and advances to banks are measured at amortised cost and are therefore not subject to fair value interest rate risk.

The Bank's instruments that are fair valued comprise principally the Bank's debt securities. A significant proportion of the Bank's investments in debt securities are subject to fixed interest rates. This exposes the Bank to the risk of losses arising from fair value interest rate risk. The Bank manages this risk by using sensitivity analysis utilising modified duration, which measures the potential loss in market value arising from a 200 basis-point upward parallel shift in yields. The estimated impact of an immediate 200 basis point increase in yields as at 31 December 2016 on the fair valuation of its fixed rate available-for-sale debt securities amounts to a loss of €0.39m (2015: loss of €0.63m). The fair value of loans and receivables measured at amortised cost is not expected to fluctuate considerably due to their short term nature.

2. Financial risk management - continued

2.1 Financial risk factors - continued

(b) Market risk - continued

Interest rate risk - continued

Financial assets and liabilities issued at variable rates expose the Bank to cash flow interest rate risk. As outlined above, the Bank was also exposed to cash flow interest rate risk principally in respect of certain financial assets that were subject to floating interest rates.

Taking cognisance of the nature of the Bank's financial assets and liabilities as described above, under the requirements of IFRS 7, a sensitivity analysis in respect of interest rate changes is required in relation to the Bank's net floating rate assets or liabilities.

At the end of the reporting period, if interest rates had increased by 1% (assuming a parallel shift of 100 basis points in yields) with all other variables held constant, in particular foreign currency exchange rates, the pre-tax result for the year would increase by €0.68m (2015: increase by €0.78m). Taking cognisance of the current low interest rate environment, the Bank does not expect interest rates to decrease by a further 100 basis points. Accordingly, the disclosure relating to an assumed decrease in interest rates by a 100 basis points is not deemed necessary.

The following table summarises the Bank's exposures to interest rate risk. It includes the entity's financial instruments at carrying amounts, categorised by re-pricing dates, taking cognisance of the instruments' interest rate terms. The re-pricing period in respect of the entity's interest bearing assets and liabilities subject to fixed interest rates is equivalent to the remaining period to maturity.

	Within one month	Within three months but over one month	Within one year but over three months	More than one year	Total
	€	€	€	€	€
As at 31 December 2016					
Financial assets					
Financial assets classified as available-for-sale	-	5,009,572	-	3,536,778	8,546,350
Loans and advances to banks	1,502,911	-	-	-	1,502,911
Loans and advances to customers	316,732	40,810,000	-	-	41,126,732
	1,819,643	**45,819,572**	-	**3,536,778**	**51,175,993**
Interest rate gap	**1,819, 643**	**45,819,572**	-	**3,536,778**	
Cumulative gap	**1,819,643**	**47,639,215**	**47,639,215**	**51,175,993**	

2. **Financial risk management** - continued

2.1 Financial risk factors - continued

(b) Market risk - continued

Interest rate risk - continued

	Within one month €	Within three months but over one month €	Within one year but over three Months €	More than one year €	Total €
As at 31 December 2015					
Financial assets					
Financial assets designated at fair value through profit or loss	-	-	-	2,694,500	2,694,500
Financial assets classified as available-for-sale	-	-	-	6,329,900	6,329,900
Loans and advances to banks	77,820,821	-	-	-	77,820,821
	77,820,821	**-**	**-**	**9,024,400**	**86,845,221**
Interest rate gap	**77,820,821**	**-**	**-**	**9,024,400**	
Cumulative gap	**77,820,821**	**77,820,821**	**77,820,821**	**86,845,221**	

(c) Liquidity risk

Liquidity risk is the risk that the Bank is unable to meet its payment obligations associated with its financial liabilities when they fall due and to replace funds when they are withdrawn. The consequence may be the failure to meet obligations to repay depositors and fulfil commitments.

The Bank manages this risk, by maintaining a strong base of shareholders' capital considering the stage of its operations. The Bank manages its asset base with liquidity in mind, and monitors future cash flows and changes in available liquidity on a regular basis.

The Bank holds a diversified portfolio of cash and high-quality highly-liquid securities to support payment obligations and contingent funding in a stressed market environment. The Bank's assets held for managing liquidity risk comprise:

- short term placements with other banks; and
- unencumbered Malta Government stocks amounting to €3,536,778 (2015: €9,024,400) and other debt securities amounting to €5,009,572 (2015: Nil) that are readily acceptable as collateral for open market operations with the European Central Bank.

Liquidity is managed by the Bank's treasury function through the Bank's liquidity management process. Liquidity management includes:

- day to day funding, managed by monitoring future cash flows to ensure that requirements can be met including plans for replenishment of funds as they mature;

2. Financial risk management - continued

2.1 Financial risk factors - continued

(c) Liquidity risk - continued

- maintaining a portfolio of highly marketable assets that can easily be liquidated as protection against any unforeseen interruption to cash flow;
- monitoring the liquidity ratios of the statement of financial position against internal and regulatory requirements; and
- managing the concentration and profile of debt maturities.

Moreover, sources of liquidity are regularly reviewed by the treasury function to maintain a diversification by provider, product and term. Monitoring takes the form of cash flow projections for the next day, week and month respectively, as these are key periods for short-term liquidity management. Medium-term liquidity management is a regular subject at the meetings of the Board of directors. Built on cash flow projections on a monthly and quarterly basis, the Board steers the medium-term liquidity position of the Bank and proactively sets actions to avoid any liquidity gaps.

The following table discloses financial assets and liabilities at the end of the reporting period by remaining period to maturity.

	Within one month	Within three months but over one month	Within one year but over three months	More than one year	Total
	€	€	€	€	€
As at 31 December 2016					
Financial assets					
Derivative financial instruments	611	-	-	-	611
Financial assets classified as available-for-sale	-	5,009,572	-	3,536,778	8,546,350
Loans and advances to banks	1,502,911	-	-	-	1,502,911
Loans and advances to customers	316,732	40,810,000	-	-	41,126,732
Accrued income and other assets	50,550	955,960	300,000	-	1,306,510
	1,870,804	**46,775,532**	**300,000**	**3,536,778**	**52,482,114**
Financial liabilities					
Amounts owed to customers	59	-	-	-	59
Other liabilities	34,700	433,410	-	-	468,110
	34,759	433,410	-	-	468,169
Maturity gap	**1,836,045**	**46,342,122**	**300,000**	**3,536,778**	
Cumulative gap	**1,836,045**	**48,178,167**	**48,478,167**	**52,014,945**	

2. Financial risk management - continued

2.1 Financial risk factors - continued

(c) Liquidity risk - continued

	Within one month €	Within three months but over one month €	Within one year but over three months €	More than one year €	Total €
As at 31 December 2015					
Financial assets					
Financial assets designated at fair value through profit or loss	-	-	-	2,694,500	2,694,500
Financial assets classified as available-for-sale	-	-	-	6,329,900	6,329,900
Loans and advances to banks	77,820,821	-	-	-	77,820,821
Accrued income and other assets	12,027	132,715	15,966	-	160,708
	77,832,848	132,715	15,966	9,024,400	87,005,929
Financial liabilities					
Other liabilities	142,757	71,349	-	-	214,106
Maturity gap	**77,690,091**	**61,366**	**15,966**	**9,024,400**	
Cumulative gap	**77,690,091**	**77,751,457**	**77,767,423**	**86,791,823**	

The following table analyses the Bank's principal undiscounted cash flows payable under non-derivative financial liabilities into relevant maturity groupings based on the remaining period at the end of the reporting period to the contractual maturity date.

	Within one month €	Within three months but over one month €	Within one year but over three months €	More than one year €	Total €	Carrying amount €
As at 31 December 2016						
Amounts owed to customers	59	-	-	-	59	59
Other liabilities	34,700	433,410	-	-	468,110	468,110
	34,759	**433,410**	-	-	**468,169**	**468,169**
As at 31 December 2015						
Other liabilities	**142,757**	**71,349**	-	-	**214,106**	**214,106**

2. Financial risk management - continued

2.1 Financial risk factors - continued

(c) Liquidity risk - continued

The Bank's currency derivatives are settled on a gross or net basis depending on the agreed terms of the underlying derivatives. The following tables analyse the Bank's derivative financial instruments into relevant maturity groupings based on the remaining period at the end of the reporting period to the contractual maturity date. The amounts disclosed in the tables are the contractual undiscounted cash flows.

	Contracted undiscounted cash flows	
	Within one month	**Total**
	€	**€**
At 31 December 2016		
Inflows	317,460	317,460
Outflows	(317,169)	(317,169)
	291	**291**

(d) Operational risk

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. The Bank's Board of directors is primarily responsible for the development and implementation of policies and procedures to ensure that operational risks are managed effectively. The Bank mitigates the possibility of impact risk events through the implementation of a business continuity plan, which encompasses risk mitigation achieved through back-up information security infrastructures, back-up disaster recovery sites and insurance covers over particular business risks. Such systems enable the Bank to operate on an ongoing basis and limit losses in the event of severe business disruption.

For regulatory reporting purposes, the Bank currently uses the Basic Indicator Approach to assess the operational risk capital requirements and accordingly allocates 15% of average gross operating income for a three year period in accordance with regulatory requirements. The operational risk regulatory capital requirement as at December 2016 amounted to €705,602 (2015: €856,488).

2. Financial risk management - continued

2.2 Capital risk management

The Bank's objectives when managing capital, which is a broader concept than the 'equity' as disclosed in the statement of financial position, are:

- to comply with the capital requirements set by the Malta Financial Services Authority (MFSA);
- to safeguard the Bank's ability to continue as a going concern so that it can continue to provide returns for shareholders and benefits for other stakeholders; and
- to maintain a strong capital base to support the development of its business.

Capital adequacy and the use of regulatory capital are monitored on an ongoing basis by the Bank's management, employing techniques based on the guidelines developed by the Basel Committee and the European Union Directives and Regulations, as implemented by the MFSA for supervisory purposes.

In terms of its banking licence conditions, the Bank is required to maintain at all times a minimum ratio of total regulatory capital to risk-weighted assets ("Capital requirements ratio") of 12%. During the year, the Bank has met all externally imposed capital requirements.

The minimum capital requirements are calculated for credit, market and operational risks. During the year, the Bank utilised the Standardised Approach for credit risk, the Basic Indicator Approach for operational risk and the Basic Method for foreign exchange risk in order to calculate the Pillar 1 minimum capital requirements. For credit risk, under the standardised approach, risk weights are determined according to credit ratings provided by internationally recognised credit agencies such as Moody's or their equivalents and by using the applicable regulatory risk weights for unrated exposures. The Basic Indicator Approach requires that the Bank allocates capital for operational risk by taking 15% of the average gross income, while the Basic Method requires the Bank to allocate 8% of its overall net foreign exchange position to calculate the capital requirement for foreign exchange risk.

The following table shows the components of own funds and accordingly the basis for the calculation of the Bank's capital adequacy ratio:

	2016	2015
	€	€
Common Equity Tier 1 (CET1) capital		
Share capital	**50,000,000**	100,000,000
Investment fair value reserve	**216,270**	280,837
Retained earnings/(accumulated losses)	**514,763**	(13,402,460)
Less:		
Intangible assets	**(43,671)**	-
Adjustment relating to unrealised gains and losses	**(86,508)**	(168,502)
CET1 capital	**50,600,854**	86,709,875
Total capital / own funds	**50,600,854**	86,709,875

The Bank has excluded the impact of current year profits from the above analysis.

2. Financial risk management - continued

2.3 Fair value of financial instruments

Financial instruments measured at fair value

The following table analyses financial instruments that are measured in the statement of financial position at fair value, by level of the following fair value measurement hierarchy. The different levels have been defined as follows:

- Quoted prices (unadjusted) in active markets for identical assets or liabilities (level 1).
- Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices) (level 2).
- Inputs for the asset or liability that are not based on observable market data (that is, unobservable inputs) (level 3). If one or more of the significant inputs is not based on observable market data, the instrument is included in level 3. The Bank does not hold any level 3 instruments.

The following table presents the Bank's financial instruments that are measured at fair value.

	Level 1	**Level 2**	**Total**
	€	**€**	**€**
As at 31 December 2016			
Assets			
Derivative financial instruments	-	611	611
Financial assets classified as available-for-sale	3,536,778	5,009,572	8,546,350
Total financial assets at fair value	**3,536,778**	**5,010,183**	**8,546,961**
As at 31 December 2015			
Assets			
Financial assets designated at fair value through profit or loss	2,694,500	-	2,694,500
Financial assets classified as available-for-sale	6,329,900	-	6,329,900
Total financial assets at fair value	9,024,400	-	9,024,400

There were no transfers between levels 1 and 2 during the year.

2. Financial risk management - continued

2.3 Fair value of financial instruments - continued

Financial instruments measured at fair value - continued

(a) Financial instruments in level 1

The fair value of financial instruments traded in active markets is based on quoted market prices at the end of the reporting period. A market is regarded as active if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service, or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. The quoted market price used for financial assets held by the Bank is the current bid price.

Instruments included in level 1 comprise primarily debt instruments issued by the Government of Malta and listed on the Malta Stock Exchange.

(b) Financial instruments in level 2

Fair values for the Bank's derivative contracts are determined utilising valuation techniques, involving primarily the use of discounted cash flow techniques. The fair values referred to are determined by reference to market prices or rates (including forward foreign exchange rates) quoted at the end of the reporting period. The valuation techniques used are supported by observable market prices or rates since their variables include only data from observable markets. The Bank's derivative financial instruments are accordingly categorised as level 2 instruments.

The Bank's holding of debt securities issued by a foreign credit institution have been categorised as Level 2 instruments as its fair value is determined using a discounted cash flow technique based on the instruments contractual cash flows and observable market interest rates.

Financial instruments not measured at fair value

Loans and advances to banks and customers are carried at amortised cost in the statement of financial position. The directors consider the carrying amounts of loans and advances to customers and banks to be a reasonable estimate of their fair value principally in view of the relatively short periods to repricing or maturity from the end of the reporting periods.

These estimates are considered level 2 fair value estimates.

3. Critical accounting estimates, and judgments in applying accounting policies

Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

In the opinion of the directors, the accounting estimates and judgments made in the course of preparing these financial statements are not difficult, subjective or complex to a degree which would warrant their description as critical in terms of the requirements of IAS 1.

The directors believe there are no areas involving a higher degree of judgement that have the most significant effect on the amounts recognised in the financial statements; and there are no key assumptions and other key sources of estimation uncertainty relating to estimates that require directors' most difficult, subjective or complex judgments.

4. Cash and cash equivalents

	2016	2015
	€	€
Cash in hand	**1,000**	1,000

5. Financial assets designated as at fair value through profit or loss

	2016	2015
	€	€
Listed debt securities – Malta Government Stocks	-	2,694,500

Financial assets at fair value through profit or loss at 31 December 2015 consisted of investments in Malta Government Stocks. These financial assets have been designated as assets at fair value through profit or loss in view of the fact that they were risk managed on a fair value basis.

As at 31 December 2015, the Bank had impaired loans and advances to customers with a nominal gross value of €961,246, which had been deemed fully impaired. A reversal of impairment charge amounting to €961,246 had been reflected upon the recognition of €652,235 in respect of amounts provided in 2015.

6. Financial assets classified as available-for-sale

	2016	2015
	€	€
Debt securities	**8,546,350**	6,329,900

The movement in available-for-sale investments may be summarised as follows:

	2016	2015
	€	€
Year ended 31 December		
At 1 January	**6,329,900**	23,562,498
Acquisitions	**50,015,187**	-
Disposals/redemptions	**(48,367,045)**	(18,132,035)
Amortisation of premiums and discounts	**(210,806)**	25,888
Foreign exchange movements	**435,015**	788,556
Net fair value movements	**344,099**	84,993
At 31 December	**8,546,350**	6,329,900

The Bank's investments consist entirely of listed securities and are analysed by issuer as follows:

	2016	2015
	€	€
Local government	**3,536,778**	6,329,900
Credit institutions	**5,009,572**	-
	8,546,350	6,329,900

7. Loans and advances to banks

	2016	2015
	€	€
Repayable on call and at short notice	**1,502,911**	77,820,821

Loans and advances with a contractual maturity of three months or less are included in cash and cash equivalents for the purposes of the statement of cash flows (Note 25).

8. Loans and advances to customers

	2016	2015
	€	€
Loans and advances to customers	**41,126,732**	-

Loans and advances to customers amounting to €40,000,000 consist of terms loan to a related party (Note 27). As at 31 December 2016, there were no loans that necessitied specific impairment allowances (2015: €961,246).

Analysis of loans and advances to customers by fixed and variable interest rates:

	2016	2015
	€	€
Loans and advances to customers subject to:		
- fixed interest rates	**40,810,000**	-
- variable interest rates	**316,732**	-
	41,126,732	-

The movement in specific impairment allowances in respect of loans and advances to customers during the year was as follows:

	2016	2015
	€	€
At beginning of year	**(961,246)**	(793,547)
Reversal of impairment charges/(impairment charges)	**-**	(1,090,782)
Released upon recognition	**961,246**	923,083
At end of year	**-**	(961,246)

As at 31 December 2015, the Bank had fully impaired loans and advances to customers with a nominal gross value of €961,246 in respect of which a reversal of impairment losses amounting to €961,246 has been recognised in profit or loss throughout the current year.

9. Derivative financial instruments

The fair values of derivative financial instruments held at the end of each reporting period are set out in the following table:

	2016	2015
	€	€
Derivative financial instruments		
- currency forwards	**611**	-

The Bank enters into derivative contracts, mainly foreign exchange forwards to hedge the foreign currency exposures arising out of investments in debt securities and certain customer loans. While these derivative transactions provide effective economic hedges, hedge accounting under the requirements of IAS 39 has not been adopted in this respect. Accordingly, these derivative contracts held for risk management purposes have been classified as held-for-trading in these financial statements in accordance with IAS 39.

The derivative financial instruments at 31 December 2016 relate to the forward purchase of €317,460 against CAD at the average contractual rate of 1.4175 maturing within one month from the end of the reporting period.

10. Property, plant and equipment

	Computer equipment €	Office improvements and equipment €	Others €	Total €
At 1 January 2015				
Cost	219,151	93,753	19,538	332,442
Accumulated depreciation	(180,648)	(54,294)	(19,538)	(254,480)
Net book amount	38,503	39,459	-	77,962
Year ended 31 December 2015				
Opening net book amount	38,503	39,459	-	77,962
Additions	34,101	3,136	-	37,237
Disposals	(6,072)	-	-	(6,072)
Depreciation charge	(23,373)	(6,272)	-	(29,645)
Depreciation released on disposals	6,072	-	-	6,072
Closing net book amount	49,231	36,323	-	85,554
At 1 January 2016				
Cost	247,180	96,889	19,538	363,607
Accumulated depreciation	(197,949)	(60,566)	(19,538)	(278,053)
Net book amount	49,231	36,323	-	85,554
Year ended 31 December 2016				
Opening net book amount	49,231	36,323	-	85,554
Additions	40,311	6,330	-	46,641
Depreciation charge	(27,620)	(7,318)	-	(34,938)
Closing net book amount	**61,922**	**35,335**	**-**	**97,257**
At 31 December 2016				
Cost	287,491	103,219	19,538	410,248
Accumulated depreciation	(225,569)	(67,884)	(19,538)	(312,991)
Net book amount	**61,922**	**35,335**	**-**	**97,257**

11. Intangible assets

	Computer software €
At 1 January 2015 and 31 December 2015	
Cost	200,935
Accumulated amortisation	(200,935)
Net book amount	-
Year ended 31 December 2016	
Opening net book amount	-
Additions	47,381
Amortisation charge	(3,710)
Closing net book amount	**43,671**
At 31 December 2016	
Cost	248,316
Accumulated amortisation	(204,645)
Net book amount	**43,671**

During the year ended 31 December 2015, there were no movements in intangible assets.

12. Accrued income and other assets

	2016 €	2015 €
Accrued interest and other income	**780,432**	96,408
Deferred fee expense	**450,000**	-
Prepayments	**76,078**	64,300
	1,306,510	160,708

13. Share capital

	2016 €	2015 €
Authorised		
500,000,000 (2015: 500,000,000) Ordinary shares of €1 each	**500,000,000**	500,000,000
Issued and fully paid up		
50,000,000 (2015: 100,000,000) Ordinary shares of €1 each	**50,000,000**	100,000,000

The holders of ordinary shares are entitled to receive dividends as declared from time to time and are entitled to one vote per share at general meetings of the Bank. All shares rank equally with regard to the Bank's residual assets.

On 29 January 2016, BAWAG P.S.K. , the parent company of the Bank as at 31 December 2015, concluded the sale of the Bank. By virtue of a shareholders' resolution dated 29 January 2016, the Bank, which was previously known as BAWAG Malta Bank Limited, changed its name to MFC Merchant Bank Limited.

Following this sale, the new shareholders resolved to reduce the issued share capital of the Bank from €100,000,000 to €86,082,778 by offsetting the Bank's accumulated losses equivalent to €13,917,222 as at 31 December 2014. This reduction became effective immediately on 29 January 2016 in terms of article 83(5) of the Companies Act (Cap 386). This issued share capital of the Bank was again reduced by €36,082,778, comprising shares of €1 each. This second reduction to €50,000,000, which has been approved by the Malta Financial Services Authority, became effective after the expiration of the three-month statutory notice period, on 10 May 2016.

In August 2016, the shareholders of the Bank requested formal approval from the MFSA to further reduce the issued share capital of the Bank to €10,000,000 and concurrently grant a loan to its shareholders of €40,000,000. The said loan and capital reduction amounts would then be offset after the expiration of the three-month statutory notice period.

MFSA approval in this respect was granted on 20 October 2016. The formal capital reduction process was then initiated via an extraordinary shareholders' resolution dated 27 October 2016 by virtue of which the issued share capital of the Bank was reduced by €40,000,000, comprising shares of €1 each to 10,000,000 shares of €1 each. The process for capital reduction and corresponding shareholder loan was then implemented on 9 February 2017.

14. Fair value reserve

The fair value reserve reflects the effects of the fair value measurement of financial instruments classified as available-for-sale, net of any deferred taxes. Any gains or losses are not recognised in profit or loss until the asset has been sold or impaired.

15. Amounts owed to customers

	2016	2015
	€	€
Call accounts	**59**	-

Amounts owed to customers are classified as liabilities at amortised cost.

16. Other liabilities

	2016	2015
	€	€
Accrued interest and fee expense	**393,522**	-
Deferred fee income	**14,750**	-
Other payables and accrued expenses	**59,838**	214,106
	468,110	214,106

17. Contingent liabilities and commitments

Contingencies

	2016	2015
	€	€
Contingent items		
Contingent liabilities - guarantees	**3,000,000**	1,865,000
Contingent assets - guarantees	**(1,500,000)**	(1,865,000)
	1,500,000	-

Contingent liabilities comprise guarantees issued by the Bank in favour of third parties. Contingent liabilities originating from guarantees issued as at 31 December 2016 included an amount of €1,500,000 issued to a related party (2015: no guarantees were issued to related parties).

On 31 December 2015, the Bank entered into an Assignment and Novation Agreement (the "Novation") with its former parent company in terms of which the latter was to assume certain rights and obligations relating to guarantees previously issued in favour of third parties by the Bank. The Novation was subject to the consent given by such third parties. As at reporting date, such consent was not yet obtained by the Bank and consequently, the Bank is still reflecting contingent liabilities arising out of these guarantees. The Bank is fully indemnified against any claims arising out of such contingent liabilities by means of a back-to-back guarantee issued in its favour by its former parent company. The back-to-back guarantee is included under contingent assets – guarantees.

17. Contingent liabilities and commitments - continued

Operating lease commitments

The future minimum lease payments under non-cancellable operating leases where the Bank is a lessee are as follows:

	2016	2015
	€	€
- Not later than one year	**33,722**	15,769
- Later than one year and not later than five years	**72,300**	-
	106,022	15,769

The Bank's operating lease commitments relate to leases of property, motor vehicles and computer software, with standard contractual terms.

18. Interest income

	2016	2015
	€	€
On financial assets classified as available-for-sale:		
- coupon interest	**1,102,264**	2,904,515
- net amortisation of premiums and discounts	**(210,806)**	25,888
On loans and advances to customers	**219,360**	1,579,525
On loans and advances to banks	**2**	151
	1,110,820	4,510,079

19. Interest expense

	2016	2015
	€	€
On amounts owed to banks	**57**	722,684
On derivative financial instruments	**-**	577,059
On amounts owed to customers	**-**	56
	57	1,299,799

20. Fee and commission income and expense

(a) Fee and commission income

	2016	2015
	€	€
Merchant banking fees	**755,500**	-
Fee income on factoring services	**83,104**	-
Other fee income	**23,158**	27,224
	861,762	27,224

(b) Fee and commission expense

	2016	2015
	€	€
Other fee expense	**21,907**	22,067

21. Net trading losses

	2016	2015
	€	€
Net fair value (losses)/gains on derivative financial instruments	**(641,345)**	204,980
Gain on fair value hedge accounting	**-**	19,689
Gain on disposal of investment securities classified as loans and receivables	**-**	456,472
Net losses on disposal of financial instruments classified as at fair value through profit or loss	**(67,000)**	(2,184,907)
Net fair value gains on performance-linked notes	**-**	931,440
Foreign exchange differences	**444,907**	98,266
	(263,438)	(474,060)

22. Net reversal of impairment charges/(impairment charges)

	2016	2015
	€	€
Reversal of impairment charges	**652,235**	-
Amounts impaired during the year	-	(913,709)
	652,235	(913,709)

23. Administrative expenses

	2016	2015
	€	€
Staff costs		
- Staff salaries	**349,411**	348,337
- Social security costs	**12,417**	12,420
Directors' emoluments	**359,901**	86,189
Depreciation of property, plant and equipment (Note 10)	**34,938**	29,645
Amortisation of intangible assets (Note 11)	**3,710**	-
Operating lease expenses	**32,831**	32,853
Other administrative expenses	**515,028**	570,045
Recharge of subsidiaries' administrative expenses	-	(6,391)
	1,308,236	1,073,098

Other administrative expenses mainly comprise maintenance expenditure, professional fees, marketing expenses and other services or expense items which are incurred in the course of the Bank's operations.

Average number of persons employed by the Bank throughout the financial year:

	2016	2015
- Managerial	**5**	5
- Clerical	**2**	3
	7	8

Auditor's remuneration

Fees charged by the auditor for services rendered during the financial year relate to the following:

	2016	2015
	€	€
Annual statutory audit	**24,669**	10,000
Other assurance services	**15,000**	-
	39,669	10,000

24. Tax expense

Current taxation

The tax on the Bank's profit before tax differs from the theoretical amount that would arise using the effective tax rate applicable to the Bank as follows:

	2016	2015
	€	€
Profit before tax	**1,425,841**	514,763
Tax on profit at 35%	**(499,044)**	(180,167)
Tax effect of:		
Disallowable expenses	**365,530**	6,179
Tax losses absorbed in the current year	**133,514**	173,988
	-	-

Deferred Taxation

At 31 December 2016, the Bank had an unutilised tax loss balance amounting to €66,105,793 (2015: €66,466,117) on which no deferred tax asset was recognised in the statement of financial position in view of the uncertainty of realisation of these tax benefits. Tax losses have no expiry date.

25. Cash and cash equivalents

For the purposes of the statement of cash flows, cash and cash equivalents comprise the following balances with contractual maturities of not more than three months and which form an integral part of the Bank's cash management:

	2016	2015
	€	€
Cash in hand	**1,000**	1,000
Loans and advances to banks	**1,502,911**	77,820,821
	1,503,911	77,821,821

26. Significant non-cash transaction

During 2016, the new shareholders resolved to reduce the issued share capital of the Bank from €100,000,000 to €86,082,778 by offsetting the Bank's accumulated losses equivalent to €13,917,222 as at 31 December 2014 (refer to Note 13). This reduction became effective immediately on 29 January 2016 in terms of Art 83(5) of the Companies Act (Cap 386).

27. Related party transactions

Related parties of the Bank include the ultimate parent company, MFC Bancorp Limited, including its branches, all entities controlled by the ultimate parent, key management personnel, close family members of key management personnel and entities which are controlled or jointly controlled by key management personnel or their close family members.

27. Related party transactions - continued

As at 31 December 2015, the immediate parent company of the Bank was BAWAG P.S.K. Bank für Arbeit und Wirtschaft und Österreichische Postparkasse Aktiengessellschaft, a company incorporated and registered in Austria, the registered office of which is Georg-Coch Platz, A-1018, Vienna, Austria. The ultimate controlling entity was Cerberus Capital Management, L.P. which is incorporated and registered in the United States of America, the registered office of which is 299 Park Avenue, New York, NY 10171, United States of America.

On 29 January 2016, BAWAG P.S.K. sold its 100% shareholding in the Bank to MFC Industrial Limited (subsequently renamed to MFC Bancorp Limited on 15 February 2016) which then became the new ultimate controlling entity of the Bank.

Key management personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of MFC Merchant Bank Limited, being the directors of the Bank.

During the year, the Bank carried out the following transactions with the ultimate parent company and its controlled entities:

	2016	2015
	€	€
Assets		
Derivatives	**611**	-
Loans and advances to banks	-	77,615,275
Loans and advances to customers	**40,000,000**	-
Accrued income and other assets	**332,917**	-
Liabilities		
Amounts owed to customers	**59**	-
Other liabilities	-	98,610
Contingent items		
Contingent liabilities - guarantees	**1,500,000**	-
Contingent assets - guarantees	-	1,865,000
Income statement		
Interest and similar income	**214,984**	147
Interest and similar expense	-	(1,298,576)
Fee and commission income	**1,134,203**	8,400
Fee and commission expense	-	(29,922)
Net fair value (loss)/gain on derivative financial instruments	**(641,345)**	204,980
Administrative expenses	-	(212,958)

All transactions with related parties, including lending and financing transactions, were carried out on an arm's length basis in accordance with the Bank's policy. For the years ended 31 December 2016 and 2015, the Bank has not recognised any impairment losses relating to amounts owed by related parties.

Key management personnel compensation, consisting of directors' remuneration, has been disclosed in Note 23 to these financial statements. Directors' emoluments comprise solely of short-term employee benefits.

28. Statutory information

MFC Merchant Bank Limited is a limited liability company and is incorporated in Malta.

The immediate parent company of MFC Merchant Bank Limited is MFC Holding Limited, a company registered in Malta that owns all the shares of MFC Merchant Bank Limited with the exception of one share held by MFC Bancorp Ltd. Its registered address is 171, Old Bakery Street, Valletta, Malta. The immediate parent is exempt from the preparation of consolidated financial statements.

MFC Merchant Bank Limited is ultimately owned by MFC Bancorp Ltd, a company registered in Canada, with its registered office at 1000, Cathedral Place, 925, West Georgia Street, Vancouver, BC V6C 3L2, Canada.

The financial statements of MFC Merchant Bank Limited are included in the consolidated financial statements of MFC Bancorp Ltd, which are prepared in accordance with the requirements of International Financial Reporting Standards.

Additional Regulatory Disclosures
31 December 2016

1. Risk management

1.1 Overview of risk disclosures

The Additional Regulatory Disclosures ('ARDs') were prepared by the Bank in accordance with the Pillar 3 quantitative and qualitative disclosure requirements as governed by Banking Rule 07 ('BR/07'): Publication of Annual Report and Audited Financial Statements of Credit Institutions authorised under the Banking Act, 1994, issued by the Malta Financial Services Authority. These disclosures are based on the disclosure requirements of Directive 2013/36/EU (Capital Requirements Directive) and EU Regulation No. 575/2013 (Capital Requirements Regulation) of the European Parliament and of the Council of 26 June 2013. These ARDs will be published on an annual basis as part of the Annual Report of the Bank and seek to increase public disclosure relative to a Bank's capital structure and adequacy as well as its risk management policies and practices.

In line with the banking regulatory requirements, these ARDs are not subject to an external audit, except to the extent that any disclosures are equivalent to those made in the Financial Statements which are prepared in accordance with the requirements of International Financial Reporting Standards ('IFRS') as adopted by the EU. Through internal verification procedures the Bank ensures that these disclosures are presented fairly.

1.2 Risk management framework

The Board of directors has the overall responsibility for the establishment and oversight of the Bank's risk management framework. The risk management framework is a core component necessary for the financial soundness and stability of the Bank's business model.

The business model adopted by the Bank throughout the years has been primarily based on corporate banking and structured finance transactions consistent with its parent group business strategy. Following the change in shareholders in 2016, the Bank will continue to handle corporate banking business but will re-align its business model by focusing on developing its merchant banking activities.

The Bank is committed to creating added value for its shareholders and in keeping with this mission, the Bank's strategy targets sustainable growth and an acceptable risk profile. In this respect, the Bank's return on assets calculated as its net profit, expressed as a percentage of average total assets, for the reporting period ended 31 December 2016 was 2%.

The Bank takes on risk with the aim of generating profits and therefore considers risk management a core competency that helps produce higher returns for its various stakeholders. The Bank bases its risk management objectives and policies on international guidelines, such as the Basel III Accord, corresponding Directives and Regulations of the European Union, including technical standards, as well as contemporary international banking practices. In this respect, the Board of directors deems the risk management framework adopted by the Bank to be adequate and hence gives assurance to the Bank's stakeholders that the risk management systems adopted by the Bank are appropriate in relation to the Bank's risk profile and strategy.

1. Risk management - continued

1.2 Risk management framework - continued

The main categories of risk to which the Bank is exposed to are:

- Credit risk: Credit risk stems from the loss of equity and profit as a result of the possible non-prompt repayment or non-payment of existing and contingent obligations by the Bank's counterparties. Therefore this represents the risk that the deterioration in the financial condition of a borrower will cause the asset value to decrease or be extinguished. Country risk and settlement risk are also included in this category. Country risk refers to the risk of losses arising from economic or political changes that affect the country in which the asset is originated. Settlement risk refers to the risk of losses through failure of the counterparty to settle outstanding dues on the settlement date owing to bankruptcy or other causes.

- Market risk: Risk of losses arising from unfavourable changes in the level and volatility of interest rates, foreign exchange rates or investment prices.

- Liquidity risk: Liquidity risk may be divided into two sub-categories:

  - Market (product) liquidity risk: risk of losses arising from difficulty in accessing a product or market at the required time, price and volume.

  - Funding liquidity risk: risk of losses arising from a timing mismatch between investing, placements and fund raising activities resulting in obligations missing the settlement date or satisfied at higher than normal rates.

- Operational risk: Risk of damage resulting from the lack of skilful management or good governance within the Bank and the inadequacy of proper control, which might involve internal operations, personnel, system or external occurrences that in turn affect the income and capital funds of financial institutions. The Bank has adopted an operational risk management framework and procedures, which provide for the identification, assessment, management, monitoring and reporting of the Bank's operational risks.

The Bank aims to manage these risks by applying methods that meet best practice and considers it important to have a clear distribution of responsibilities for risk management across the Bank, from the Board of directors, and the Risk Committee, to senior management and internal audit.

The Board of directors is ultimately responsible for the establishment and oversight of the Bank's risk management framework through the development and monitoring of compliance with the Bank's risk management policies. The aim of the risk management framework is to support the Bank in achieving its goals and objectives and ensure that the risks are commensurate with the rewards.

The Board establishes the risk appetite of the Bank which is the maximum risk that the Bank is willing to assume to meet business targets. The risk appetite is set in a process based on a thorough analysis of its current risk profile. The Bank identifies a number of key risk components and for each, determines a target that represents the Bank's perception of the component in question. The Bank's risk appetite is a key tool to ensure coherence between the Bank's strategic considerations regarding risk-taking and day-to-day decisions.

1. **Risk management** - continued

1.2 **Risk management framework** - continued

The Risk Committee is appointed to oversee the formulation of the Bank's overall risk management policy, to review risk measurement and monitoring mechanisms within the Bank and to monitor the effectiveness of the Bank's risk management practices. In the course of managing this framework the Risk Committee focuses on four key infrastructure components of effective risk management programmes with specific control activities:

- Active Senior Management oversight;
- Adequate detailed policies, procedures and discretionary limits;
- Adequate risk-measurement, monitoring and management information systems; and
- Comprehensive internal controls.

The Risk Committee convened 2 times during the period under review.

Authority to operate the Bank is delegated to the Business Committee within the limits set by the Board, together with members of Senior Management. The Business Committee is made up of the Bank's Chief Executive Officer together with 2 non-executive directors. Members of Senior Management include the Chief Officers, namely the Chief Finance Officer, the Chief Treasury Officer, the Chief Operations Officer and other senior risk officials, who report to the Chief Executive Officer. Senior Management, under the direction of the CEO, are responsible for the Bank's day-to-day operations. The Bank has an appropriate organisational structure for planning, executing, controlling and monitoring business operations in order to achieve the Bank's objectives.

The Bank's risk management framework establishes the processes and procedures required for entity wide risk management. The core functions of the Bank's risk management processes are to identify all key risks for the Bank, measure these risks, manage the risk positions and determine capital allocations.

The Bank's independent Internal Audit function reviews the adequacy and proper operation of internal controls in individual areas of operation, and performs ad-hoc reviews of risk management controls and procedures. The Internal Audit function reports its findings to the Audit Committee.

2. **Credit risk**

2.1 **Introduction to credit risk**

Credit risk is the risk of suffering financial loss, should any of the Bank's clients or market counterparties fail to fulfil their contractual obligations to the Bank. Credit exposures arise principally through the Bank's granting of credit facilities. The Bank's business activities during the financial period under review principally consisted of the granting of intra-group loans, factoring transactions, merchant banking services and maintaining a medium to short term debt security portfolio.

Credit risk constitutes the Bank's largest risk in view of its credit lending activities and therefore the Bank is fully aware of the implications of such risk and places great importance on its effective management. The Bank's portfolio of loans and advances to customers is monitored on an ongoing basis and the relevant management bodies, including the Board of directors and the Risk Committee, are kept informed on a regular basis of developments in the credit portfolio, any non-performing loans and other relevant information.

2. Credit risk - continued

2.2 Credit risk management

The granting of a credit facility is based on the Bank's insight into the customer's financial position, which is reviewed regularly to assess whether the basis for the granting of credit has changed. Furthermore, the customer must be able to demonstrate, in all probability, the ability to repay the debt.

In order to measure its principal risk exposures, the Bank compiles risk assessment reports, which include references to external reviews of the primary borrowers and their guarantors carried out by agencies such as Moody's or their equivalents.

The Bank's Operations Department is responsible for undertaking and managing credit risk with respect to the Bank's lending activities, which covers all the stages within the lending cycle, from credit proposal to credit recovery procedures. The Bank manages, limits and controls concentrations of credit risk arising from loans and advances wherever they are identified – in particular, to individual corporate customers, to industry sectors and to geographical locations. Hence, the Bank structures the levels of credit risk it undertakes by placing limits on the amount of risk in relation to one borrower, or groups of borrowers, to industry segments and to different countries. Such risks are monitored on an ongoing basis and subject to review as considered necessary. Limits on the level of credit risk by industry sector and country are approved by the Board of directors. Limits to individual borrowers are approved by the Risk Committee and ratified by the Board. Actual exposures against limits are monitored on a regular basis.

In order to minimise the credit risk undertaken in examining a counterparty's creditworthiness, country risk, quantitative and qualitative characteristics, as well as the industry sector in which the counterparty operates are considered. The Bank has also set limits of authority and has segregation of duties in place so as to maintain impartiality and independence during the approval process and to control new and existing credit facilities. Credit review procedures are designed to identify at an early stage exposures which require more detailed monitoring and review. The Bank's principal credit risk exposures reflecting the maximum exposure to credit risk before collateral held or other credit enhancements in accordance with the regulatory information submitted to the MFSA are as follows:

	2016 Year end exposure value €
Central Government or central banks	3,536,778
Institutions	6,512,483
Corporates	42,627,343
Other items	780,432
	53,457,036

The exposures set out in the preceding table are based on the sum of on-balance sheet exposures and off-balance sheet exposures adjusted for the credit conversion factors stipulated within Article 166(10) of the CRR. The off-balance sheet exposures comprise guarantees issued by the Bank in favour of third parties.

2. Credit risk - continued

2.2 Credit risk management - continued

Credit risk exposures analysed by residual maturity

	Within one month	Within three months but over one month	Within one year but over three months	More than one year	Total
	€	€	€	€	€
As at 31 December 2016					
Central Government or central banks	-	-	-	3,536,778	3,536,778
Institutions	1,502,911	5,009,572	-	-	6,512,483
Corporates	317,343	40,810,000	1,500,000	-	42,627,343
Other items	550	779,882	-	-	780,432
Total	**1,820,804**	**46,599,454**	**1,500,000**	**3,536,778**	**53,457,036**

2.3 Concentration risk

Concentration risk arises as a result of the concentration of exposures within the same category, whether it is geographical location, industry sector or counterparty type. These risks are managed through adherence to Board approved lending criteria.

The Bank has a significant concentration of credit risk with respect to its loans and advances to customers since €40,000,000 (2015: €Nil) of the total loans and advances are due from shareholders. However, residual credit risk is mitigated as the €40,000,000 shareholder loans are repayable by direct capital reduction set-off. As at 31 December 2016, apart from these shareholder loans, there were no other loans and advances to customers that were deemed to be large exposures for regulatory reporting purposes in accordance with the requirements the CRR.

Exposures analysed by location/geographical region

The Bank monitors concentrations of credit risk by location. The geographical concentration of the Bank's exposure classes as at the end of the reporting period is analysed in the following table. For the purposes of this table, the Bank has allocated exposures classes to regions based on the country of domicile of the counterparties or customers.

2. **Credit risk** - continued

2.3 **Concentration risk** - continued

As at 31 December 2016	**Malta**	**Other EU countries**	**Rest of world**	**Total**
	€	**€**	**€**	**€**
Central Government or central banks	3,536,778	-	-	3,536,778
Institutions	138,815	6,373,668	-	6,512,483
Corporates	40,000,000	2,310,611	316,732	42,627,343
Other items	47,945	732,482	5	780,432
Total	**43,723,538**	**9,416,761**	**316,737**	**53,457,036**

Exposures analysed by industry

The following is an analysis of the industry concentrations relating to loans and advances to corporate customers:

At 31 December 2016	**Total**
	€
Electricity, gas, steam and air conditioning supply	**316,732**
Financial and insurance activities	**40,000,611**
Manufacturing	**810,000**
Wholesale trade	**1,500,000**
	42,627,343

None of the Bank's exposures constitute exposures to SMEs (small and medium-sized enterprises).

As outlined previously, the Bank monitors these exposures on an individual basis throughout the different stages of the cycle from approval upon origination to ongoing monitoring until maturity. The Bank focuses on the compilation, together with ongoing and event-driven updating, of credit review analyses taking cognisance of actual account developments, repayment history, ability to meet commitments and collateral measurement.

Counterparty banks' risk

The Bank runs the risk of loss of funds due to the possible delay in the repayment of existing and future obligations by counterparty banks. Within its daily operations the Bank transacts with banks and other financial institutions which are pre-approved and subject to a limits framework. In the normal course of business, the Bank places deposits and enters into foreign exchange derivative contracts with credit institutions of international repute. By conducting these transactions the Bank is running the risk of losing funds due to the possible delays in the repayment to the Bank of the existing and future obligations of the counterparty banks. The positions are checked against the limits on a regular basis.

2. Credit risk - continued

2.3 Concentration risk - continued

Country risk

The Bank runs the risk of loss of funds due to the possible political, economic and other events in a particular country where funds have been placed or invested with several counterparties. Countries are assessed according to their size, economic data and prospects and their credit ratings from international rating agencies. Existing country credit risk exposures are monitored and reviewed periodically.

2.4 Use of External Credit Assessment Institutions

The Bank uses an External Credit Assessment Institution ('ECAI') in calculating its risk-weighted exposure amounts for Central governments or central banks, Institutions and Corporates for which a credit assessment is available. The credit quality of such exposures is determined by reference to credit ratings applicable to issuers published by Moody's. The Bank maps Moody's ratings to the credit quality steps prescribed in the CRR as required by CEBS publication *'Standardised approach: Mapping of ECAIs' credit assessments to credit quality steps'*.

The following table represents the exposure values for which an ECAI is used:

At 31 December 2016	Credit quality step	Central governments or central banks	Institutions	Corporates	Total
		€	€	€	€
A1 to A3	2	3,536,778	1,502,911	-	5,039,689
Baa1 to Baa3	3	-	5,009,572	-	5,009,572
Not rated		-	-	42,626,732	42,626,732
Total		**3,536,778**	**6,512,483**	**42,626,732**	**52,675,993**

2.5 Credit quality of the Bank's financial assets

Loans and advances to customers

The Bank's Operations Department monitors loans and advances to customers on an individual basis throughout the different stages of the cycle, from approval upon origination until maturity. As highlighted previously, the Bank focuses on the compilation, together with ongoing and event-driven updating of credit review analyses taking cognisance of actual account developments, repayment history, ability to meet commitments and collateral measurement.

With respect to loans and advances to customers, the Bank reviews and grades loans and advances in accordance with internal credit gradings. The Bank's internal credit system is based on a number of different asset quality criteria, namely:

- financial strength, profitability
- servicing of interest
- market position, dependence and industry environment
- other criteria e.g. management organisation, access to capital markets/other financing

2. Credit risk - continued

2.5 Credit quality of the Bank's financial assets – continued

Loans and advances to customers - continued

In addition to the above, the Bank also grades its loan and advances portfolio into two main external reporting categories: 'Performing' and 'Non-performing'. 'Performing' customers represent those customers with exposures which are less than 90 days past due, whilst 'Non-performing' customers are those customers with exposures which are past due by 90 days or more. The 'Performing' category is further sub-divided into sub-categories based on (a) past due days and (b) renegotiated loans

Loans are considered past due when a counterparty has failed to make a payment when contractually due. Past due but not impaired loans comprise loans and advances where contractual interest or principal payments are past due, but the Bank believes that impairment is not appropriate on the basis of the level of security available and/or the stage of collection of amounts owed to the Bank.

As at 31 December 2016, loans and advances to corporate customers were deemed to be fully performing. As at 31 December 2015, loans and advances to customers included €961,246 fully impaired loans. These were subsequently liquidated in 2016. The Bank did not hold any renegotiated financial assets as at the end of the reporting period.

Impaired loans and advances to customers represent those advances which are either more than 90 days past due, or for which the Bank has determined that it is probable that it will be unable to collect all principal and interest due as prescribed within the contractual terms of the loans and advances agreement(s). During the period under review, the Bank has written off loans and advances to customers amounting to €404,054.

Financial investments

As part of its treasury management activities the Bank invests in debt instruments issued by local government as well as a portfolio of debt securities issued by high quality foreign institutions. All such instruments are listed and accordingly the quality of these assets is monitored through the use of external ratings (see note 2.4 above). These transactions are also monitored through the practical use of exposure limits. At the end of the reporting period, the Bank had no past due or impaired financial assets within this category.

2.6 Credit risk mitigation techniques

The Bank's approach when granting credit facilities is based on the customer's capacity to repay rather than placing primary reliance on credit risk mitigants. Notwithstanding, as part of the Bank's credit risk mitigation techniques, the Bank holds collateral against loans and advances to customers, the nature and level of which generally depends on the amount of the exposure, the type of facility provided, the term of the facility and the level of credit risk involved. Collateral utilised to secure loans and advances generally includes guarantees and the assignments of receivables.

As at 31 December 2016, the collateral eligible value in terms of CRD IV collateral eligibility requirements on the total customer loan exposure of €41,126,732 was €Nil (2015: €202,076 on total customer loan exposure value of €961,246). Shareholder loans amounting to €40,000,000 out of the total loan exposure of €41,126,732 was repayable by a direct capital reduction set-off that took place after year-end.

3. Market risk

Market risk for the Bank consists of the following elements:

- Interest rate risk, which is the risk of losses because of changes in interest rates; and
- Foreign exchange risk, which is the risk of losses on the Bank's positions in foreign currency because of changes in exchange rates.

3.1 Interest rate risk

Cash flow interest rate risk is the risk that the future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Fair value interest rate risk is the risk that the value of a financial instrument will fluctuate because of changes in market interest rates.

The Bank's exposure to interest rate risk is analysed in the table below:

	Floating rates	**Fixed rates**	**Total**
	€	**€**	**€**
At 31 December 2016			
Financial assets	6,829,215	44,346,778	51,175,993
Net exposure	**6,829,215**	**44,346,778**	**51,175,993**

The Bank's Senior Management is responsible for the management of interest rate risk and for actively monitoring the interest rate risk measures used by the Bank, by reporting on a regular basis to the Board. Responsibility for day-to-day interest rate risk management is allocated to the Treasury function. The Bank's risk oversight function provides oversight with respect to the interest rate risk management process, by ensuring its design is appropriate and functioning properly.

Financial instruments issued at fixed rates potentially expose the Bank to fair value interest rate risk. Loans and advances to customers and to banks, and amounts owed to customers are measured at amortised cost and are therefore not subject to fair value interest rate risk.

The Bank's instruments that are fair valued comprise debt securities classified as available-for-sale. A significant proportion of the Bank's investments in debt securities are subject to floating interest rates. The remaining debt securities subject to fixed interest rate risk consist of investments in debt securities issued by the Government of Malta.

The Bank manages interest rate risk by utilising sensitivity analysis based on modified duration, which measures the potential loss in market value arising from a 200 basis-point upward parallel shift in yields. The estimated impact of an immediate 200 basis point increase in yields as at 31 December 2016 amounts to a loss of €0.39m (2015: loss of €0.63m).

The Bank is exposed to cash flow interest rate risk principally in respect of certain financial instruments which were subject to floating interest rates. Financial assets and liabilities issued at variable rates expose the Bank to cash flow interest rate risk. Cashflow interest rate risk is measured and monitored by reference to a sensitivity analysis in respect of interest rate changes in relation to the Bank's net floating rate assets or liabilities.

3. Market risk - continued

3.1 Interest rate risk - continued

At the end of the reporting period, if interest rates had increased by 1% (assuming a parallel shift of 100 basis points in yields) with all other variables held constant, in particular foreign currency rates, the post-tax result for the year would increase by €0.53m (2015: increase by €0.78m).

The following table summarises the Bank's exposures to interest rate risk. It includes the entity's financial instruments at carrying amounts, categorised by re-pricing dates, taking cognisance of the instruments' interest rate terms. For the entity's interest bearing assets and liabilities that are mainly subject to fixed interest rates, the re-pricing periods are generally equivalent to the remaining period to maturity.

	Within one month	Within three months but over one month	Within one year but over three months	More than one year	Total
	€	€	€	€	€
As at 31 December 2016					
Financial assets	1,819,643	45,819,572	-	3,536,778	51,175,993
Interest rate gap	**1,819,643**	**45,819,572**	**-**	**3,536,778**	
Cumulative gap	**1,819,643**	**47,639,215**	**47,639,215**	**51,175,993**	

3.2 Currency risk

The Bank takes on exposure to the effects of fluctuations in the prevailing foreign currency exchange rates on its financial position and cash flows. Foreign exchange risk is the risk to earnings and value caused by a change in foreign exchange rates. Foreign exchange risk arises when financial assets or liabilities are denominated in currencies which are different from the Bank's functional currency.

The Bank manages its currency risk on an ongoing basis by ensuring that foreign currency liabilities are utilised to fund assets denominated in the same foreign currency thereby matching asset and liability positions as much as is practicable. When it is not possible to match the asset and liability currency positions, the Bank normally hedges its open foreign exchange exposures arising from customer loans by entering into forward foreign exchange contracts with terms which match those of the hedged items, with a view to reducing exposures within a limit management framework.

The Bank's Treasury function is responsible for the effective management of foreign exchange risks, ensuring exposures to foreign currencies are maintained within the limits set by the Bank's Board. The Board sets these limits on the level of exposure by currency and in aggregate for both overnight and intra-day positions, which are actively monitored and reported on a regular basis. The Bank's risk oversight function provides oversight with respect to the foreign exchange risk management process, by ensuring its design is appropriate and functioning properly.

3. Market risk - continued

3.2 Currency risk - continued

The following table summarises the Bank's exposure to foreign currency exchange rate risk at 31 December. Included in the table are the Bank's financial instruments at carrying amounts, categorised by currency.

	EUR	Other currencies	Total
	€		€
As at 31 December 2016			
Financial assets	51,416,739	539,686	51,956,425
Financial liabilities	287,702	180,467	468,169
Net on balance sheet position	51,129,037	359,219	
Off-balance sheet net notional position	1,500,000	(317,169)	
Net currency exposure	**52,629,037**	**42,050**	

4. Liquidity risk

Liquidity risk is the risk that the Bank is unable to meet its payment obligations associated with its financial liabilities when they fall due and to replace funds when they are withdrawn. The consequence may be the failure to meet obligations to repay depositors and fulfil commitments.

The Bank manages this risk by maintaining a strong base of shareholders' capital. The Bank manages its asset base with liquidity in mind, and monitors future cash flows and changes in available liquidity on a regular basis.

The Bank holds a diversified portfolio of cash and high-quality highly-liquid securities to support payment obligations and contingent funding in a stressed market environment. The Bank's assets held for managing liquidity risk comprise:

- short term placements with other banks; and
- unencumbered debt securities amounting to €7,847,457 (2015: €8,890,118) that are readily acceptable for refinancing operations within the Eurosystem's open market operations.

4. Liquidity risk - continued

Liquidity is managed by the Bank's treasury function and the Bank's liquidity management process, and includes:

- day to day funding managed by monitoring future cash flows to ensure that requirements can be met including plans for replenishment of funds as they mature;
- maintaining a portfolio of highly marketable assets that can easily be liquidated as protection against any unforeseen interruption to cash flow;
- monitoring the liquidity ratios against internal and regulatory requirements; and
- managing the concentration and profile of debt maturities.

Moreover, sources of liquidity are regularly reviewed by the treasury function to maintain a wide diversification by provider, product and term. Monitoring takes the form of cash flow projections for the next day, week and month respectively, as these are key periods for liquidity management.

In this light, reporting of measures of liquidity risk and liquidity ratios to the Board is effected on a regular basis. The Bank's risk oversight function provides oversight with respect to the liquidity risk management process, by ensuring its design is appropriate and functioning properly.

Analysis by residual maturity

The following table discloses financial assets and liabilities at the end of the reporting period by remaining period to maturity.

	Within one month	Within three months but over one month	Within one year but over three months	More than one year	Total
	€	€	€	€	€
As at 31 December 2016					
Financial assets	1,870,193	46,775,532	300,000	3,536,778	52,482,503
Financial liabilities	34,759	433,410	-	-	468,169
Maturity gap	**1,835,434**	**46,342,122**	**300,000**	**3,536,778**	
Cumulative gap	**1,835,434**	**48,177,556**	**48,477,556**	**52,014,334**	

4. Liquidity risk - continued

The following table analyses the Bank's principal undiscounted cash flows payable under non-derivative financial liabilities into relevant maturity groupings based on the remaining period at the end of the reporting period to the contractual maturity date.

	Within one month	Within three months but over one month	Within one year but over three months	More than one year	Total	Carrying amount
	€	€	€	€	€	€
Financial liabilities						
As at 31 December 2016	**34,759**	**433,410**	**-**	**-**	**468,169**	**468,169**

5. Operational risk

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. The Bank's Board of directors is primarily responsible for the development and implementation of policies and procedures to ensure that operational risks are managed effectively. The Bank mitigates the possibility of impact risk events through the implementation of a business continuity plan, which encompasses risk mitigation achieved through back-up information security infrastructures, back-up disaster recovery sites and insurance covers over particular business risks. Such systems enable the Bank to operate on an ongoing basis and limit losses in the event of severe business disruption.

The Bank's management of operational risk relies on a framework of policies and procedures implemented across the Bank's operational functions through transaction processing and business execution. The implementation of these policies and procedures is overseen by the Bank's risk oversight function. Regular reporting of operational risk events to the Board of directors is carried when required.

The Bank currently uses the Basic Indicator Approach to assess the operational risk capital requirements and accordingly allocates 15% of average gross income for a three year period in accordance with regulatory requirements. The operational risk regulatory capital requirement as at December 2016 amounted to €856,488, based on the preceding three financial years 2013, 2014 and 2015 (2015: €3,829,857 based on the preceding three financial years 2012, 2013 and 2014).

6. Capital risk management

The Bank's objectives when managing capital, which is a broader concept than the 'equity' as disclosed in the statement of financial position, are:

- to comply with the capital requirements set out in the CRD and the CRR;
- to safeguard the Bank's ability to continue as a going concern so that it can continue to provide returns for shareholders and benefits for other stakeholders; and
- to maintain a strong capital base to support the development of its business.

Capital adequacy and the use of regulatory capital are monitored on an ongoing basis by the Bank's management, employing techniques based on the guidelines developed by the Basel Committee, European Union Regulations and Directives, as implemented by the MFSA for supervisory purposes. The Bank's capital risk management is based on the regulatory requirements established within the CRR and by local regulations which are modelled on the requisites of the CRD rules.

The Bank's Senior Management is primarily responsible for the Bank's capital risk management process. Capital adequacy ratios together with the level and quality of own funds are reported on a regular basis to the Board of directors by the Finance function.

In terms of its MFSA banking licence conditions, the Bank is required to maintain at all times a minimum ratio of total regulatory capital to risk-weighted assets ("Capital requirements ratio") of 12%.

The minimum capital requirements are calculated for credit, market and operational risks. During the year, the Bank utilised the Standardised Approach for credit risk, the Basic Indicator Approach for operational risk and the Basic Method for foreign exchange risk in order to calculate the Pillar 1 minimum capital requirements. For credit risk, under the standardised approach risk weights are determined according to credit ratings provided by internationally recognised credit agencies such as Moody's or their equivalents and by using the applicable regulatory risk weights for unrated exposures. The Basic Indicator Approach requires that the Bank allocates capital for operational risk by taking 15% of the average gross income, while the Basic Method requires the Bank to allocate 8% of its overall net foreign exchange position to calculate the capital requirement for foreign exchange risk.

6.1 Own funds

The level of Own funds represents the Bank's available capital and reserves for the purposes of assessing capital adequacy from a regulatory perspective. The total capital ratio is a measure of the long-term financial strength of a bank, usually expressed as a ratio of its own funds or capital to the measure of the Bank's assets. The Bank has processes to ensure that the minimum regulatory requirements in relation to own funds are met at all times, through the assessment of its capital resources and requirements. During the financial period ended 31 December 2016, the Bank has complied with all the externally imposed capital requirements to which it was subject.

In July 2013, the European Banking Authority ('EBA') issued its final draft Implementing Technical Standards ('ITS') on own funds disclosures. The disclosure requirements of these technical standards have been integrated within the Bank's disclosures set out below.

For regulatory purposes, the Bank's capital base is composed solely of Common Equity Tier 1 ('CET1') capital. The Bank's CET1 capital includes ordinary share capital, retained earnings and other regulatory adjustments relating to items that are included in equity but treated differently for capital adequacy purposes, including deductions relating to intangible assets and transitional adjustments relating to the fair value reserve on available-for-sale financial assets. The Bank does not maintain a Reserve for General Banking Risks, since it does not have loans and advances which are classified as "Non-performing".

6. Capital risk management - continued

6.1 Own funds - continued

(a) Share capital

The Bank's share capital as at 31 December 2016 is analysed as follows:

	2016 No. of shares	2016 €
Authorised		
500,000,000 Ordinary shares of €1 each	**500,000,000**	**500,000,000**
Issued and fully paid up		
50,000,000 (2015: 100,000,000) Ordinary shares of €1 each	**50,000,000**	**50,000,000**

The holders of 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. All shares rank equally with regard to the Bank's residual assets.

In August 2016, the shareholders of the Bank requested formal approval from the MFSA to reduce the issued share capital of the Bank to €10,000,000 and concurrently grant a loan to its shareholders of €40,000,000. The said loan and capital reduction amounts would then be offset after the expiration of the three-month statutory notice period.

MFSA approval was granted on 20 October 2016. The formal capital reduction process was then initiated via an extraordinary shareholders' resolution dated 27 October 2016 by virtue of which the issued share capital of the Bank was reduced by 40,000,000 shares of €1 each to 10,000,000 shares of €1 each. The capital reduction and corresponding shareholder loan was then implemented on 9 February 2017.

(b) Retained earnings

The retained earnings represent earnings not paid out as dividends.

Retained earnings form part of Own funds only if those profits have been verified by the Bank's independent external auditor. As the Bank did not have in place such verification as at 31 December 2016, the retained earnings included in Own Funds do not include current year profits.

(c) Fair value reserve

This represents the cumulative net change in fair values of available-for-sale assets held by the Bank.

6. Capital risk management - continued

6.1 Own funds - continued

As described in the CRR published by the European Commission, banks are required to present a transitional disclosure template during the phasing in of regulatory adjustments from 1 January 2014 to 31 December 2017. The transitional disclosure template is set out below.

	As at 31 December 2016 €
Common Equity Tier 1 (CET1) capital	
Common Equity Tier 1 (CET1) capital: instruments and reserves	
Share capital	**50,000,000**
Investment fair value reserve	**216,270**
Retained earnings	**514,763**
CET1 capital before regulatory adjustments	**50,731,033**
Common Equity Tier 1 (CET1) capital: regulatory adjustments	
Intangible assets	(43,671)
Regulatory adjustments relating to unrealised gains and losses pursuant to Articles 467 and 468	(86,508)
CET1 capital	**50,600,854**
Total capital / own funds	**50,600,854**
Total risk weighted assets	**57,059,876**
Capital ratios	
CET1 capital	88.68%
Tier 1 capital	88.68%
Total capital	88.68%

The Bank has excluded the impact of current year profits from the above analysis.

6. Capital risk management - continued

6.2 Capital requirements

The Bank's policy is to maintain a strong 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 allocation of capital between specific operations and activities is, to a large extent, driven by optimisation of the return achieved on the capital allocated. The amount of capital allocated to each operation or activity is based primarily upon the regulatory capital, but in some cases the regulatory requirements do not reflect differing risk profiles, subject to the overall level of capital to support a particular operation or activity not falling below the minimum required for regulatory purposes. The process of allocating capital to specific operations and activities is undertaken independently of those responsible for the operation.

Although maximisation of the return on risk-adjusted capital is the principal basis used in determining how capital is allocated within the Bank to particular operations or activities, it is not the sole basis used for decision making. Account is also taken of synergies with other operations and activities, the availability of management and other resources, and the fit of the activity with the Bank's long-term strategic objectives. The Bank's policies in respect of capital management and allocation are reviewed regularly by the Board of directors.

As outlined previously, minimum capital requirements are calculated for credit, market and operational risks. The Bank utilises the Standardised Approach for credit risk, the Basic Indicator Approach for operational risk and the Basic Method for foreign exchange risk in order to calculate the Pillar 1 minimum capital requirements. As disclosed previously, for credit risk, under the standardised approach risk weights are determined according to credit ratings provided by internationally recognised credit agencies such as Moody's or their equivalents and by using the applicable regulatory risk weights for unrated exposures. Capital charge for foreign exchange risk using the Basic Method is calculated at 8% of the higher of the sum of all the net short positions and the sum of all the net long positions in each foreign currency. The Basic Indicator Approach requires that the Bank allocates capital for operational risk by taking 15% of the average gross income.

The total capital ratio is calculated using the definition of regulatory capital and risk-weighted assets. As required by the CRR, the minimum level of the Capital Requirements Ratio stands at 8%. The Capital Requirements Ratio expresses own funds as a proportion of risk weighted assets and off-balance sheet items, together with notional risk weighted assets in respect of operational risk and market risk. Total risk-weighted assets are determined by multiplying the capital requirements for market risk and operational risk by 12.5 (i.e. the reciprocal of the minimum capital ratio of 8%) and adding the resulting figures to the sum of risk-weighted assets for credit risk. In terms of its banking licence conditions, the Bank is required to maintain at all times a minimum capital ratio of 12%.

The Bank will be fully implementing the CRD IV capital requirements with effect from January 2019. In this respect, Banking Rule BR/15: 'Capital Buffers of Credit Institutions authorised under the Banking Act, 1994', will require additional buffers, namely the 'capital conservation buffer', the 'countercyclical buffer', 'other systemically important institutions (O-SII) buffer' and the 'systemic risk buffer'. Automatic restrictions on capital distributions apply if the local group's CET1 capital falls below the level of its CRD IV combined buffer.

The Bank will be required to maintain a capital conservation buffer of 2.5%, made up of CET1 capital, on the risk weighted exposures of the Bank as from 1 January 2019. This buffer will be phased in over the period from 1 January 2016 to 31 December 2018.

6. Capital risk management - continued

6.2 Capital requirements - continued

CRD IV contemplates a countercyclical buffer in line with Basel III, in the form of an institution-specific countercyclical buffer and the application of increased requirements to address macro-prudential or systemic risk. This is expected to be set in the range of 0-2.5% of relevant credit exposure RWAs, whereby the rate shall consist of the weighted average of the 'countercyclical buffer' rates that apply in the jurisdiction where the relevant exposures are located.

The O-SII buffer is also institution specific and may be set at a maximum of 2% of a systemically important institution's total risk exposure amount. Given the Bank's position as a non-core domestic bank, in terms of its systematic relevance to the financial system in Malta, it is unlikely that the Bank will be required to maintain an O-SII buffer.

In addition to the measures above, CRD IV sets out a 'systemic risk buffer' for the financial sector as a whole, or one or more sub-sectors, to be deployed as necessary by each EU member state with a view to mitigating structural macroprudential risk. The 'systemic risk buffer' may range between 0% and 5%. There are currently no indications that the Bank will need to maintain a systemic risk buffer.

Additionally, since the Bank advances loans to borrowers in different geographical regions, it may be required to maintain a 'countercyclical buffer'. This is expected to be set in the range of 0-2.5%, whereby the rate shall consist of the weighted average of the 'countercyclical buffer' rates that apply in the jurisdiction where the relevant exposures are located.

The Bank's capital requirements and total capital ratio computation are as follows:

At 31 December 2016	**Exposure value €**	**Risk weighted assets €**	**Capital required €**
Central governments or central banks	3,536,778	-	-
Institutions	5,009,572	1,001,914	80,153
Corporates	41,126,732	41,126,732	3,290,139
Short-term claims on credit institutions	1,502,911	751,456	-
Other	1,449,049	1,448,049	115,844
Total on balance sheet exposures	52,625,042	44,328,151	3,486,136
Off-balance sheet items	3,000,000	1,500,000	120,000
Total credit risk	**55,625,042**	**45,828,151**	**3,606,136**
Foreign exchange risk		525,625	42,050
Operational risk		10,706,100	856,488
Total capital required		**57,059,876**	**4,504,674**
Own funds			
Common Equity Tier 1 capital			**50,600,853**
Total own funds			**50,600,853**
Total capital ratio			**88.68%**

6. Capital risk management - continued

6.3 Internal Capital Adequacy Assessment Process (ICAAP)

The Bank considers the Internal Capital Adequacy Assessment Process (ICAAP) embedded in Pillar II as a tool that ensures a proper measurement of material risks and capital and allows better capital management and an improvement in risk management. Therefore it facilitates a better alignment between material risks and regulatory capital in order to have better capital deployment and improvements in the risk management and mitigation techniques adopted by the Bank. The ICAAP as required by the MFSA Banking Rule 12 is performed on an annual basis.

Therefore ICAAP is a process that the Bank utilises to ensure that:

- there is adequate identification, measurement, aggregation and monitoring of the Bank's risks;
- adequate internal capital is held by the institution in relation to its risk profile; and
- the Bank uses sound risk management systems and there is the intention to develop them further.

The Board and the Bank's Executive Team take overall responsibility for the conceptual design and technical details of the ICAAP document. Apart from the responsibility for the conceptual design, the Board discusses, approves, endorses and delivers the yearly ICAAP submission. The Bank's independent risk oversight function is involved in the ICAAP with a view to ensuring that the process reflects and takes cognisance of the Bank's risk management activities and processes.

The ICAAP is a revolving management tool which starts with defining risk strategy, identifying, quantifying and aggregating risks, determining risk-bearing ability, allocating capital, establishing limits and leads to ongoing risk monitoring. The individual elements of the tool are performed with varying regularity. All the activities described in the circuit are examined at least once a year to ensure that they are up to date, adequate and also adjusted to current underlying conditions when necessary.

The process involves a quantitative assessment of individual types of risk and an assessment of the existing methods and systems for monitoring and managing risk (qualitative assessment). The risk assessment concept is used as a scoring procedure, thus providing a comprehensive overview of the risk profile of the Bank.

The basis for the quantitative implementation of the ICAAP is the risk bearing capacity calculation which demonstrates that adequate capital is in place at all times to provide sufficient cover for risks that have been entered into and which also ensures such cover is available for the future. The Bank's ICAAP is based upon a "Pillar 1 Plus" approach whereby the Pillar 1 capital requirement for credit and operational requirements is supplemented by the capital allocation for other material risks not fully addressed within Pillar 1. The risks considered for ICAAP include concentration, liquidity, reputational and strategic risks, interest rate risk in the banking book, and risks arising from the macroeconomic environment.

The Bank's ICAAP contains three year projections as well as the capital plan, and the Board monitors that there are adequate capital resources to support the corporate goals contained within the plan and the associated risks.

The Bank covers the Pillar 2 capital requirements through stress testing processes to forecast the Bank's projected capital requirements and resources in a range of stress scenarios. This enables the Bank to guarantee that it can meet its minimum regulatory capital requirements in a stressed environment.

7. Remuneration policy

The Bank has an established Remuneration Policy that is implemented and managed by the Remuneration Committee. The Committee is composed of three non-executive directors and meets at least four times a year or more often as deemed necessary.

Independent non-executive directors of the Bank, in their capacities as directors of the Bank, are entitled to fixed remuneration fees from the Bank. The Bank has one director that is employed as the Chief Executive Officer of the Bank. The Bank's senior management, including the CEO, are entitled to receive an annual discretionary bonus based on an assessment of one's overall performance, together with the level annual financial results of the Bank, during the previous financial year.

The Board of directors considers that the packages offered to senior management ensure that the Bank attracts and retains management staff that is capable of fulfilling its duties and obligations. Furthermore, it is the Bank's policy to engage its senior management staff on the basis of indefinite contracts of employment after a period of probation, rather than on fixed term contracts. Accordingly, the applicable notice periods, after probation, are those provided for in the relevant legislation.

Share options and profit sharing do not feature in the Bank's processes and the individual contracts of employment of employees within the Bank do not contain provisions for termination payments and/or other payments linked to early termination other than as determined by Law. Currently no pension benefits are payable by the Bank.

As required in terms of the framework for prudential supervision established by EU Directive 2013/36/EU, the Bank is required to identify individuals that are considered as Material Risk Takers ('MRTs') based on qualitative and quantitative criteria set out in the Regulatory Technical Standard EU 604/2014 that came into force in June 2014. In addition to the Non-Executive directors, the Bank's MRTs consist of five senior management staff members including one Executive Director.

Senior management is not entitled to contractual annual salary increases. An annual bonus is payable based on an assessment of one's overall performance, together with the level of annual financial results of the Bank, during the previous financial year. Bonus payments do not exceed 25% of the fixed component of the total remuneration for each individual. In addition, the total amount of performance related payments should not exceed 15% of the total staff costs of the Bank.

Total emoluments received by senior management, including the Executive Director, during the period under review are as detailed below:

Fixed Remuneration	Variable Remuneration
€482,163	€62,050

Total Non-Executive directors' fees attributable for the financial year ended 31 December 2016 amounted to €167,747 (2015: €27,960).

8. Leverage

The CRR introduced a new regulatory supervisory tool which requires credit institutions to calculate a non-risk based leverage ratio, supplementing the risk-based capital requirements discussed above. This tool has been introduced to deter any possible build-up of excessive leverage, a main factor during the banking crisis in 2008. The leverage ratio measures the relationship between the Bank's capital resources and its total assets.

The leverage ratio is calculated on a three-month average of capital as a proportion of total exposures. Capital is defined as Tier 1 capital in line with Article 25 of the CRR, whilst total exposure relates to the total on and off balance sheet exposures less the deductions applied to Tier 1 capital.

The current leverage ratio regime considers initial implementation as a Pillar II measure. In this light, the Commission is expected to submit by 31 December 2016 a report on the impact and effectiveness of the leverage ratio to the European Parliament and the Council, with a view to introduce the leverage ratio as a binding measure as of 2018. In the meantime, the Bank is abiding by the minimum 3% Tier 1 leverage ratio, based on fully-transitioned Basel III standards.

The following is the Bank's estimated leverage ratio, determined in accordance with the requirements stipulated by implementing regulation EU 2016/200.

	2016
	€
Tier 1 capital	50,600,853
Total exposure measure for the purposes of the leverage ratio	54,081,371
Leverage ratio	**93.56%**

The total exposure measure for the purposes of the leverage ratio has been determined as follows:

	2016
	€
On-balance sheet exposures	
On-balance sheet items	52,625,042
Asset amounts deducted in determining Tier 1 capital	(43,671)
On-balance sheet exposures	**52,581,371**
Off-balance sheet exposures	
Off-balance sheet exposures at gross notional amount	3,000,000
Adjustments for conversion to credit equivalent amounts	(1,500,000)
Off-balance sheet exposures	**1,500,000**
Total exposure measure for leverage ratio purposes	**54,081,371**

8. Leverage - continued

The following table provides a reconciliation of accounting assets and leverage ratio exposures.

	2016 **€**
Total assets as per published financial statements	52,625,042
Adjustment for off-balance sheet items	1,500,000
Other adjustments:	
Deduction for intangible assets	(43,671)
Leverage ratio exposure	**54,081,371**

The table below shows the different on balance sheet exposures in relation to the calculation of the leverage ratio.

	2016 **€**
Total on-balance sheet exposures (excluding intangible assets), of which:	**52,581,371**
Exposures treated as sovereigns	3,536,778
Institutions	6,512,483
Corporates	41,126,732
Other exposures	1,405,378

9. Other directorships

According to the 'Guide to banking supervision' issued by the European Central Bank in November 2014, a credit institution will be considered significant if any one of the following conditions is met:

- the total value of its assets exceeds €30 billion or – unless the total value of its assets is below €5 billion – exceeds 20% of national GDP;
- it is one of the three most significant credit institutions established in a Member State;
- it is a recipient of direct assistance from the European Stability Mechanism; or
- the total value of its assets exceeds €5 billion and the ratio of its cross-border assets/liabilities in more than one other participating Member State to its total assets/liabilities is above 20%.

MFC Merchant Bank Limited does not meet any of the above criteria, and therefore is currently not considered significant by banking supervisors. Accordingly, the Bank is exempt from the requirements of article 91 of CRD IV.

9. Other directorships - continued

The number of other directorships held by the members of the Bank's Board of directors are listed in the table below:

Director	Position	Number of other directorships held
Christian Farrugia	Chairman	17
Otto Karasek	CEO & Executive Director	-
Samuel Morrow	Non-executive director	1
Ferdinand Steinbauer	Non-executive director	4
Friedrich Hondl	Independent Non-executive director	1

For the purpose of the above disclosure, the number of other directorships held within the same group are counted as a single directorship.

10. Asset encumbrance

The disclosure on asset encumbrance is a requirement introduced in Banking Rule 07 transposing the provisions of the EBA Guidelines on Disclosure of Encumbered and Unencumbered Assets (EBA/GL/2014/03).

The objective of this disclosure is to facilitate an understanding of available and unrestricted assets that could be used to support potential future funding and collateral needs. An asset is defined as encumbered if it has been pledged as collateral against an existing facility, and as a result is no longer available to the Bank to secure funding, satisfy collateral needs or be sold to reduce the funding requirement.

The disclosure is not designed to identify assets which would be available to meet the claims of creditors or to predict assets that would be available to creditors in the event of a resolution or bankruptcy.

Encumbered and unencumbered assets

	Carrying amount of unencumbered assets 2016 €	Fair value of unencumbered assets 2016 €
Debt instruments	8,546,350	8,546,350
Other assets	44,078,692	44,078,692
	52,625,042	**52,625,042**

There are no encumbered assets held by the Bank as at reporting date.

10. **Asset encumbrance** - continued

The unencumbered assets disclosed in the above table under 'Other assets' include loans and advances to banks, loans and advances to customers, property, plant and equipment, intangible assets and other assets.

11. Recruitment and diversity policy

The Bank is aware that a vigorous and professional approach to recruitment and selection of prospective members of the Board of directors and management or other employees within the Bank helps it to attract and appoint those individuals having the necessary skills and attributes compatible with achieving the Bank's overall objectives. Thus, the Bank ensures that appointments at all levels made within the Bank are based on each individual's knowledge, skills, expertise and merit, as required by Maltese legislation and in line with policy.

The Bank undertakes a rigorous selection process for all prospective members of the Board and management together with other employees, bearing in mind the key activities, tasks and skills required for the vacant position. As part of the selection process, multiple interviews are conducted, during which the individual's knowledge, experience, skills and competency are evaluated against those of other individuals.

Bearing its objectives in mind, the Bank endeavours to appoint directors with diverse skills and expertise that allow the Board to create value for shareholders by ensuring that the specific risks pursued by the Bank in trade finance as well as risks that are intrinsic to banking business in general are appropriately managed and mitigated within the Board's approach. The Bank will continue to promote this diversity by recruiting the ideal individual for the vacant position, regardless of the individual's gender, race, family, disability, sexual orientation, identity or preference.

5 Year Summary

Statement of financial position

	2016	2015	2014	2013	2012
	€	€	€	€	€
ASSETS					
Cash and cash equivalents	1,000	1,000	1,000	519,832	424,784
Financial assets designated as at fair value through profit or loss	-	2,694,500	159,631,274	209,607,812	328,264,149
Financial assets classified as available-for-sale	8,546,350	6,329,900	23,562,498	82,348,144	-
Financial assets classified as loans and receivables			88,477,393	39,582,686	-
Financial assets classified as held-to-maturity	-	-	-	-	45,971,846
Loans and advances to banks	1,502,911	77,820,821	5,336,837	1,831,777	60,307,442
Loans and advances to customers	41,126,732	-	71,328,256	94,430,330	81,215,800
Shares in subsidiary undertakings	-	-	595	411,176,270	412,659,036
Derivative financial instruments	611	-	-	26,326	-
Property, plant and equipment	97,257	85,554	77,962	42,174	64,541
Intangible assets	43,671	-	-	13,562	27,125
Deferred tax assets	-	-	-	2,607,671	4,390,733
Accrued income and other assets	1,306,510	160,708	4,546,701	6,787,901	4,853,520
Total assets	52,625,042	87,092,483	352,962,516	848,974,485	938,178,976
EQUITY AND LIABILITIES					
Equity					
Share capital	50,000,000	100,000,000	100,000,000	500,000,000	500,000,000
Other reserve	-	-	-	-	50,000,000
Fair value reserve	216,270	280,837	244,037	205,715	-
Retained earnings /(accumulated losses)	1,940,603	(13,402,460)	(13,917,223)	(21,038,987)	(34,105,120)
Total equity	52,156,873	86,878,377	86,326,814	479,166,728	515,894,880
Liabilities					
Derivatives	-	-	4,324,121	911,268	2,125,686
Amounts owed to banks	-	-	258,832,880	363,904,992	360,832,547
Amounts owed to customers	59	-	2,134,808	2,633,484	55,590,100
Other liabilities	468,110	214,106	1,343,893	2,358,013	3,735,763
Total liabilities	468,169	214,106	266,635,702	369,807,757	422,284,096
Total equity and liabilities	52,625,042	87,092,483	352,962,516	848,974,485	938,178,976
MEMORANDUM ITEMS					
Commitments	1,606,022	15,769	2,115,000	29,077,685	53,823,696

Income statement

	2016	2015	2014	2013	2012
	€	€	€	€	€
Interest income	1,110,820	4,510,079	11,950,250	9,785,152	9,626,842
Interest expense	(57)	(1,299,799)	(3,899,362)	(4,110,371)	(6,382,389)
Net interest income	1,110,763	3,210,280	8,050,088	5,674,781	3,244,453
Fee and commission income	861,762	27,224	46,628	306,724	959,985
Fee and commission expense	(21,907)	(22,067)	(184,325)	(582,742)	(3,166,555)
Net fee and commission income	839,855	5,157	(137,697)	(276,018)	(2,206,570)
Dividend income	-	-	-	1,687,247	4,195,097
Net trading losses	(263,438)	(474,060)	225,903	2,823,814	20,082,863
Gains on disposal of available-for-sale financial assets	408,666	48,193	(82,217)	31,132	-
Gains/(losses) on disposals of other investments	-	-	-	(102,853)	-
Fair value gains/(losses) on shares in subsidiary undertakings	-	-	3,727,906	(1,482,763)	36,041,775
Other operating expenditure	(14,004)	(288,000)	(324,453)	(101,318)	(251,911)
Operating income	2,081,842	2,501,570	11,460,330	8,254,022	61,105,707
Net reversal of impairment charges/(impairment charges)	652,235	(913,709)	(347,138)	8,539,727	(3,905,086)
Administrative expenses	(1,308,236)	(1,073,098)	(1,351,651)	(1,976,660)	(2,557,246)
Profit before tax	1,425,841	514,763	9,761,541	14,817,089	54,643,375
Tax expense	-	-	(2,639,777)	(1,750,956)	4,754,406
Profit for the year	1,425,841	514,763	7,121,764	13,066,133	59,397,781

Statement of cash flows

	2016 €	2015 €	2014 €	2013 €	2012 €
Cash flows from operating activities					
Interest and commission income received	1,875,576	6,230,298	14,318,794	12,925,202	11,265,815
Interest and commission expense paid	(597,931)	(199,922)	(3,481,108)	(4,079,624)	(7,158,495)
Net expense on foreign exchange transactions	(641,956)	-	-	-	-
Cash payments to employees and suppliers	(1,337,697)	(1,033,258)	(1,332,256)	(2,989,704)	(6,695,828)
Cash flows (used in)/generated from operating activities before changes in operating assets and liabilities	(702,008)	4,997,118	9,505,430	5,855,874	(2,588,508)
Changes in operating assets and liabilities:					
Net decrease/(increase) in loans and advances to customers	(41,126,732)	72,218,931	19,261,141	2,942,079	26,613,171
Net increase/(decrease) in reserve deposit with Central Bank of Malta	-	-	518,982	(95,048)	(71,047)
Net increase/(decrease) in amounts owed to customers	59	(2,134,808)	(498,675)	(52,956,617)	27,849,113
Net (decrease) in amounts owed to banks	-	(211,537,600)	(2,080,684)	(47,979,763)	(16,143,372)
Net (decrease)/increase in other liabilities	(13,329)	2,377	(110,841)	(133,451)	(40,980))
Net cash used in from operating activities	(41,842,010)	(136,453,982)	26,595,353	(92,366,926)	35,618,377
Cash flows from investing activities					
Purchase of securities	(50,015,187)	-	(153,042,668)	(219,823,452)	(28,063,098)
Proceeds from disposal and maturity of securities	50,974,045	269,327,338	222,898,170	257,248,649	14,594,174
Proceeds from disposal in subsidiary undertaking	-	595	414,021,066	-	-
Dividend received from subsidiary undertaking	-	-	-	1,370,888	3,408,516
Purchase of property, plant and equipment	(46,641)	(31,165)	(57,451)	(2,090)	(60,947)
Net cash generated from investing activities	912,217	269,296,768	483,819,117	38,793,995	(10,121,355)
Cash flows from financing activities					
Reduction in share capital	(36,082,778)	-	(400,000,000)	-	-
Repayment of capital contribution	-	-	-	(50,000,000)	-
Advances to shareholders	-	-	316,358	470,223	-
Loan advanced to subsidiary undertaking	-	-	-	-	(306,430)
Net cash (used in) from financing activities	(36,082,778)	-	(399,683,642)	(49,529,777)	(306,430)
Net movement in cash and cash equivalents	(77,012,571)	132,842,786	110,730,828	(103,102,708)	25,190,592
Cash and cash equivalents at beginning of year	77,821,821	(46,797,678)	(149,912,184)	(38,926,209)	(64,829,070)
Effect of exchange rate changes on cash and cash equivalents	694,661	(8,223,287)	(7,616,322)	(7,883,267)	712,269
Cash and cash equivalents at end of year	1,503,911	77,821,821	(46,797,678)	(149,912,184)	(38,926,209)