

Deposit Guarantee Fund

Annual Report 1998

Financial year: 23 May 1998 – 31 December 1998

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Chairman of the Deposit Guarantee Fund's Supervisory Board, Helo Meigas.

For Estonian banking, 1998 was a year of significant rearrangement. In addition to extensive consolidation by way of mergers, three smaller banks went out of business due to insolvency resulting from high risks and tangible changes in the business environment. In the second half of 1998, dynamics in the balance of deposits belonging to resident individuals reflected that despite substantial restructuring, confidence in the banking sector had survived. Retention of trust was unquestionably facilitated by the entering into force of the *Deposit Guarantee Fund Act* on 23 May 1998 and the ensuing deposit guarantee that became applicable as of 1 October of the same year.

A day after the enactment of the deposit guarantee, bankruptcy proceedings were initiated against EVEA Bank and, a few days later, a moratorium was declared on ERA Bank. By the time when the first compensations had to be paid out, the Fund had not yet accumulated sufficient funds for covering its liability to depositors. The required amount was borrowed from the private sector and deposits were compensated following the terms and procedure prescribed by law. To enable depositors to collect compensation with the smallest possible expense and delay, the services of the two largest commercial banks were used.

1998 showed that the newly established Deposit Guarantee Fund was capable of fulfilling its legal obligations.

The Deposit Guarantee Fund helps to increase the stability of the banking sector in the case when the depositors' trust declines. Large-scale deposit outflow may cause liquidity problems even for the most conservative banks. Therefore, prevention of instability is in the interest of the whole banking sector. Deposit outflow does not threaten only weak banks where the loss of trust may indicate an increase in the risks taken by the bank but also strong credit institutions. Thus, deposit guarantee is based on the principle of the banking sector's collective liability.

The funds needed for compensating deposits accrue from the banks' quarterly contributions; the amount of the latter depends on the amount of deposits taken by the bank. Payments to the Deposit Guarantee Fund constitute a term established for the licensing of credit institutions. They secure the compensation of depositors' funds at any credit institution in the legally prescribed extent.

Arrangement of the deposit guarantee assumes assessing the expedient extent of deposit compensation. To allow the market to restrict the taking of unreasonable risks, the principle of the deductible is applied. It is essential that the depositor should be interested in the credit institution's financial position and would decide placement of funds only after evaluating the bank's risks on the basis of public financial statements. Depositors' behavior in placing their funds ought to have a significant effect on the banks' activities.

The present Estonian deposit guarantee level is considerably smaller than the minimum outlined in the European Directive. The reason is that the Estonian standard of living is lower than the EU average. It is also relevant that a higher extent of compensation would assume larger contributions from credit institutions. The law establishes a transition period for gaining the level prescribed by the European Directive (EUR 20,000). The latter ought to be effected from 2010. In 1999, the supervisory board of the Deposit Guarantee Fund is going to focus on establishing a detailed schedule for attaining the level required by the European Union.

Helo Meigas
Chairman of the Supervisory Board

The director general of the Deposit Guarantee Fund has prepared the activity report and the annual financial statements for 1998.

The annual report of the Deposit Guarantee Fund consists of the activity report, the annual financial statements, and the auditor's report.

The annual report was approved by the supervisory board of the Deposit Guarantee Fund on 31 May 1999.

Activity Report

Foundation

Riigikogu (the Estonian parliament) passed the *Deposit Guarantee Fund Act* on 15 April 1998. The act that took effect on 23 May 1998 provides the procedure for guaranteeing deposits taken by credit institutions, the sources and procedure for compensating deposits in the event of the insolvency of a credit institution, and the legal status of the Deposit Guarantee Fund. The act was drawn up consistent with the requirements of the 1994 European Parliament and Council directive that regulates the deposit guarantee system.

Purpose and Management

The Deposit Guarantee Fund (hereinafter "the Fund") is a public legal person founded on the basis of law. The purpose of its activities is to guarantee the deposits placed with credit institutions by depositors in the event of the insolvency of the credit institutions by arranging compensation of deposits consistent with law. The Fund is managed by a five-member supervisory board and director general. Two members of the supervisory board are appointed by *Riigikogu* and one by the Government of the Republic, the Bank of Estonia, and the Estonian Banking Association.

Establishment

Preparations for establishing the Fund began on 7 August 1998 with the first meeting of the supervisory board. The Government of the Republic approved the statute of the Fund on 15 September 1998.

On 18 September 1998, the supervisory board appointed the director general based on the results of a public competition. The director general began working on 28 September 1998.

In October, staff was recruited, office premises were rented, and computers and other office equipment acquired. At the end of the financial year, the Fund had 4 employees. Salaries totalled EEK 199,512 including those of the director general and the members of the supervisory board of EEK 111,739.

Compensation of Deposits

The deposit guarantee provided for in the *Deposit Guarantee Act* became applicable as of 1 October 1998. In the fourth quarter the Fund was to launch the guarantee system by developing regulations and rules of procedure for implementing the act, designing principles and a strategy for investing its assets, etc.

Developments in the banking sector, however, induced a change of plans.

On 2 October 1998, Tallinn City Court initiated bankruptcy proceedings against EVEA Bank. On 7 October, the supervisory board of the Bank of Estonia declared a moratorium on ERA Bank. Thus, the Fund had to begin organizing compensation of the deposits placed with these banks.

The supervisory board resolved that compensation for the deposits placed with EVEA Bank and ERA Bank would be paid through Hansabank and Union Bank of Estonia. With a view to applying the principles prescribed by law, the Fund concluded trilateral agreements with the banks.

To restore the reliability of the banking system and protect the interests of small depositors, the supervisory board extended the guarantee to all deposits denominated in foreign currency. Initially, only DEM deposits had been guaranteed.

Obligatory contributions by credit institutions were not sufficient for paying out the compensation. Therefore, the supervisory board resolved to take a loan of EEK 75 million from Hansabank.

At the end of the financial year, the Fund concluded a considerably more favorable loan agreement with Merita Bank Tallinn Branch. The loan is secured by a state guarantee. In February 1999, the loan received from Hansabank was fully repaid with the loan received from Merita Bank.

Payment of compensation to the clients of EVEA Bank began on 2 November 1998 and ended on 4 January 1999.

Compensation to the depositors of ERA Bank was paid from 6 November 1998 through 8 January 1999.

The aggregate amount of compensation to be paid is EEK 134,255,792 and the number of entitled persons 23,888. As of the expiry of the payment term, 15,175 depositors had been paid EEK 127,871,190.

Basic Directions of Activity for 1999

In 1999, the Fund will continue fulfilling its legal obligations.

The problems arisen on the implementation of the *Deposit Guarantee Fund Act* will be thoroughly analyzed and amendment proposals prepared in co-operation with banks and administrators.

Several implementation acts for regulating the information presented by credit institutions will be drawn up in co-operation with the Banking Supervision Department of the Bank of Estonia. The procedure for submitting the information shall be established by the Bank of Estonia.

Payment of compensation to the depositors of EVEA Bank and ERA Bank will continue. The Fund acts in the bankruptcy proceedings of these two banks as a large creditor.

Repayment of the loan taken from Merita Bank has been scheduled for the end of the year. By that time, the principles and strategy for investing the Fund's assets ought to be developed and ready for presentation to the supervisory board. In addition, the Fund intends to resolve issues related to increasing the extent of compensation for guaranteed deposits.

Madis Kallion

The director general of the Deposit Guarantee Fund

Compensation of Deposits Placed with EVEA and ERA Banks

The deposit guarantee provided for in the *Deposit Guarantee Act* became applicable as of 1 October 1998.

Developments that occurred in the banking sector in October gave rise to a situation where the Fund needed to begin with the actual compensation of deposits.

On 2 October Tallinn City Court initiated bankruptcy proceedings against EVEA Bank and on 7 October the supervisory board of the Bank of Estonia declared a moratorium on ERA Bank.

The supervisory board resolved that compensation for the deposits placed with EVEA Bank and ERA Bank would be paid through Hansabank and Union Bank of Estonia. To apply the compensation principles prescribed by law, the Fund concluded trilateral commission agreements with the banks in question.

Under the law, every depositor's deposits with any credit institution specified in the *Act* are guaranteed to the extent of 90 percent. On the enactment of the law, compensation for guaranteed deposits with a credit institution was limited to EEK 20,000 per depositor. By 1 January 2010, the extent of compensation should reach EUR 20,000. The schedule for attaining the required level will be established by the supervisory board of the Fund.

The Fund does not guarantee the deposits of the state, local governments, insurance companies and financial institutions, credit institutions and commercial undertakings belonging to the same group as the credit institutions. Nor does the Fund guarantee deposits related to money laundering and deposits whose owners cannot be identified.

The deposits of legal persons are guaranteed considering 3 figures: the balance sheet total, annual net sales, and the number of employees. If two of the latter exceed EUR 1 million, EUR 2 million or 50, respectively, the client's deposits will not be guaranteed.

Deposits that are smaller than EEK 10 will not be compensated. Deposits denominated in foreign currency will be compensated in Estonian kroons.

At the enactment of the law, the only guaranteed foreign currency deposits were those denominated in German marks.

To restore the reliability of the banking system and protect the interests of small depositors, the supervisory board extended the guarantee to all foreign currency deposits.

Payment of compensation to the customers of EVEA Bank began on 2 November 1998 and ended on 4 January 1999.

The number of customers entitled to compensation was 15,472 including 13,344 individuals and 2,128 legal persons.

Most depositors (28.3%) were entitled to EEK 10,000 - 20,000.

The percentage of individuals entitled to the largest compensation was 28.9% and that of legal persons 24.5%.

The second-largest group was that of depositors entitled to up to EEK 50 (17.5%). The percentage of individuals falling into this group was 16.2% and that of legal persons 25.7%.

Average compensation payable equaled EEK 6,293; individuals were entitled, on the average, to EEK 6,399 and legal persons to EEK 5,626.

Compensation to the depositors of ERA Bank was paid from 6 November 1998 to 8 January 1999.

The number of customers entitled to compensation was 8,416 comprising 6,245 individuals and 2,171 legal persons (Table 4).

Most depositors (23.5%) - 23.7% of individuals and 22.8% of legal persons were entitled to compensation of up to EEK 50.

The next group (18.4%) was made up of customers entitled to EEK 10,000 to 20,000; 16.6% of individuals and 23.8% of legal persons fell into this group.

Average compensation payable amounted to EEK 4,384; the corresponding figure for individuals equalled EEK 4,034 and that of legal persons EEK 5,390.

Payment of Compensation

Altogether, compensation was paid to 10,624 depositors of EVEA Bank (68.7%) – 9,581 individuals and 1,043 legal persons. Individuals were more active collectors (71.8%); the largest number of compensations claimed fell into the EEK 10,000 - 20,000 category. Compensation of up to EEK 50 was claimed by only 17.1% of depositors.

The interest of legal persons was considerably smaller (49.0%). Most amounts of compensation ranged from EEK 10,000 to 20,000 (97.4% of depositors resolved to collect). Interest in compensation of up to EEK 50 was conspicuously smaller – only 14.2% decided to collect.

Compensation for deposits placed with ERA Bank was claimed by 4,551 customers (54.1%) – 3,631 individuals and 920 legal persons. Compared to EVEA Bank, the customers of ERA Bank were less active. Both individuals (97.3%) and legal persons (88.4%) were mostly interested in claiming compensation of EEK 10,000 – 20,000. Only 6.4% of depositors claimed amounts of up to EEK 50.

Unpaid Compensation

Approximately EEK 3.6 million remained uncollected by the customers of EVEA Bank. Close to a third of all those entitled to compensation (over a quarter of individuals and a half of legal persons) did not collect. Amounts of EEK 500 – 20,000 remained unpaid to 700 customers including 420 individuals. The number of customers not interested in collecting the largest amounts (10,000 – 20,000) was 115.

More than EEK 2.8 million remained unpaid to 3,865 customers of ERA Bank: 41.9% of individuals did not collect over EEK 1 million and 57.6% of legal persons did not claim EEK 1.7 million.

Five hundred and twenty-two customers did not collect amounts of EEK 500 – 20,000; 88 did not claim EEK 10,000 – 20,000.

The supervisory board of the Fund resolved to deposit unpaid compensation with Hansabank (compensation for the deposits of EVEA Bank) and Union Bank of Estonia (compensation for the deposits of ERA Bank).

On 1 March 1999, the Fund began paying compensation to depositors that had not received their compensation.

Depositors have the right to claim compensation from the Fund within 10 years.

Annual Financial Statements

Deposit Guarantee Fund

Balance Sheet

31 December 1998

In Estonian kroons

	Note	31.12.1998
ASSETS		
Current assets		
Cash and bank	2	7,067,137
Accrued income		
Interest receivable	3	150,923
Total		150,923
Prepaid expenses	4	1,628
Total current assets		7,219,688
Non-current assets		
Tangible assets	5	390,380
Accumulated depreciation		-25,992
Total		364,388
Intangible assets		14,150
Total non-current assets		378,538
TOTAL ASSETS		7,598,226
 LIABILITIES AND EQUITY		
Current liabilities		
Short-term loans from credit institutions	6	74,905,018
Accrued expenses		
Interest payable	6	760,847
Total		760,847
Total current liabilities		75,665,865
 Fund (equity) at end of financial year		-68,067,639
TOTAL LIABILITIES AND EQUITY		7,598,226

Deposit Guarantee Fund

Statement of Changes in Fund

1998

In Estonian kroons

	Note	1998
Fund (equity) at beginning of financial year		0
Received from credit institutions	7	54,646,741
Compensation paid to depositors	8	120,810,948
Total interest income		153,053
Interest earned on deposits		153,053
Total interest expense		1,036,045
Interest paid on loans		1,036,045
Net interest income		-882,992
Total administrative expenses		1,020,440
Personnel expenses	9	
Salaries		199,512
Social taxes		65,838
Other administrative expenses	10	728,088
Depreciation and value adjustments	5	27,002
Net result of the fund		-68,067,639
Fund (equity) at end of financial year		-68,067,639

Deposit Guarantee Fund

Cash Flow Statement

31 December 1998

In Estonian kroons

1998

Cash flows from operating activity

Payments received from credit institutions	54,646,741
Compensation paid to depositors	-120,810,948
Operating and personnel expenses	-995,066
Interest expense	-275,198
Net cash used in operating activity	-67,434,471

Cash flows from investing activities

Non-current assets acquired	-405,540
Interest income	2,130
Net cash used in investing activities	-403,410

Cash flows from financing activities

Loans received	74,905,018
Net cash from financing activities	74,905,018

Net increase in cash **7,067,137**

Cash and cash equivalents at beginning of period **0**

Cash and cash equivalents at end of period **7,067,137**

Notes to the Annual Accounts

Note 1 Accounting Policies

General Information

The Deposit Guarantee Fund (hereinafter “the Fund”) is a public legal person without share capital founded under the *Deposit Guarantee Fund Act*, which entered into force on 23 May 1998. 1998 was the first financial year for the Fund.

The purpose of the Fund is to guarantee the deposits placed with credit institutions by depositors in the event of the insolvency of the credit institutions under the terms and in the extent provided by law. Deposit guarantee by the Fund became applicable as of 1 October 1998.

The Tallinn City Court initiated bankruptcy proceedings against EVEA Bank on 1 October 1998 and the supervisory board of the Bank of Estonia declared a moratorium on ERA Bank on 7 October 1998. This made the Fund liable for compensating the deposits of the depositors of the two banks.

Bases of Preparation

The annual financial statements of the Deposit Guarantee Fund have been prepared in accordance with the *Deposit Guarantee Fund Act*, the *Estonian Accounting Law*, and generally accepted accounting principles.

Cash and bank

To receive payments and make settlements, the Fund opened a current account with a credit institution operating in Estonia as required by the *Deposit Guarantee Fund Act*. Payments received by the Fund have to be invested within three working days of their receipt in the account of the Fund using the procedure prescribed by law. The balance of the account shall not exceed the amount required for the continuous activity of the Fund.

The Fund has opened special accounts with two credit institutions to which it has transferred assets needed for compensating the deposits placed with EVEA Bank and ERA Bank. As of the balance sheet date, the balances of these accounts reflect the amounts not yet distributed to depositors. The Fund can use the amounts only for deposit compensation purposes.

Receipts

The Fund’s receipts include single payments made on the foundation of credit institutions, obligatory contributions from credit institutions, income from the investment of its assets, and other receipts. Single payments and obligatory contributions by credit institutions are reported in the *Statement of Changes in Fund* as *Receipts from credit institutions* on cash basis, other receipts are recorded on accrual basis.

Until 1 January 2002, the obligatory quarterly contributions made by credit institutions are to equal 0.125% of the deposits taken by them. Obligatory contributions are calculated as of the end of the quarter and remitted to the Fund by the fifteenth of the second month of every quarter.

Compensation paid to Depositors

Compensation paid to depositors comprises the amount of deposits calculated consistent with the *Deposit Guarantee Fund Act* that has been paid to the depositors of EVEA Bank and ERA Bank. Compensation paid to depositors is recorded on cash basis.

Off-balance Sheet Receivables

When compensation has been paid to depositors, the right to claim from the credit institution in the extent of the compensation transfers to the Fund. The rights to claim have been treated as off-balance sheet receivables because the recoverability of the receivables cannot be assessed with reasonable accuracy. If assets are received from a credit institution, they will be reported as income.

Off-balance Sheet Liabilities

Compensation that had not been paid to depositors as of the balance sheet date but which has to be paid upon claim has been reported as an off-balance sheet liability. Under the law, compensation has to be paid within three months of the date when the deposits became unavailable. Compensation that has not been paid within that term will be deposited and the entitled persons have the right to file a claim against the Fund.

Non-current Assets

Assets whose acquisition cost exceeds EEK 5,000 and estimated useful life extends beyond one year are recorded as non-current assets. Immaterial assets whose acquisition cost is less than EEK 5,000 are expensed as of implementation.

Non-current assets are depreciated in line with their estimated useful lives using the straight-line method as follows:

Plant and equipment	30% per annum
Computer hardware	40% per annum
Buildings	5% per annum
Intangible assets	20% per annum

Depreciation commences from the month of implementation.

Note 2 Cash and Bank

	<u>31.12.1998</u>
Current account with Hansabank	88,042
Current account with the Bank of Estonia	90,043
Special account with Hansabank	3,321,236
Special account with Union Bank of Estonia	3,567,816
Total	<u>7,067,137</u>

Special accounts are used for paying deposit compensation to depositors.

Note 3 Accrued Income

	<u>31.12.1998</u>
Interest receivable from the Bank of Estonia	150,923

Interest calculated on the deposit with the Bank of Estonia as of 31.12.1998. Annual interest rate is 2.5%.

Note 4 Prepaid Expenses

	<u>31.12.1998</u>
Prepayments to employees	279
Prepayments to suppliers	1,349
Total	<u>1,628</u>

Note 5 Non-current Assets

	<u>31.12.1998</u>
Computers	107,128
Car	221,536
Other non-current assets	35,724
Intangible assets	14,150
Total non-current assets at net book value	<u>378,538</u>

Non-current assets are carried at cost less accumulated depreciation. Intangible assets comprise a computer programme. All non-current assets were acquired during the financial year.

	Intangible assets	Computers and other	Car
Acquisition cost			
Balance as at 31.12.1997	0	0	0
Additions	15,160	150,880	239,500
Balance as at 31.12.1998	15,160	150,880	239,500
Accumulated depreciation			
Balance as at 31.12.1997	0	0	0
Increase	1,010	8,028	17,964
Balance as at 31.12.1998	1,010	8,028	17,964
Net book value as at 31.12.1998	14,150	142,852	221,536

Note 6 Short-term Loans from Credit Institutions

31.12.1998

Creditor: Hansabank	
Outstanding balance	74,905,018
Repayment term: 29.10.1998–20.11.1999	
Annual interest rate: 14.73%	
Limit:	80,000,000

Equal quarterly repayments start from 20 February 1999. As of the end of the financial year, interest payable totaled EEK 760,847.

In February 1999 the loan from Hansabank was fully repaid. To refinance the loan taken from Hansabank, the Fund took a loan from Merita Bank Tallinn Branch. The interest rate of the loan is DEM LIBOR + 1.6%. The new loan is to be repaid by the end of 1999. The loan has been secured with a state guarantee issued by the Government of the Republic of Estonia.

Note 7 Receipts from Credit Institutions

31.12.1998

Optiva Bank	4,599,693
Union Bank of Estonia	17,422,889
Hansabank	29,934,747
Estonian Credit Bank	1,140,040
EVEA Bank	796,322
ERA Bank	581,801
Tallinn Business Bank	171,249
Total	54,646,741

Note 8 Compensation Paid to Depositors

	<u>31.12.1998</u>
Compensation has been paid to:	
Depositors of EVEA Bank	91,678,763
Depositors of ERA Bank	29,132,185
Total	<u>120,810,948</u>

Note 9 Personnel Expenses

	<u>31.12.1998</u>
Salaries	199,512
inc. management and supervisory board	111,739
Social security	65,838
Total	<u>265,350</u>

At the end of 1998, the Fund had four employees and the supervisory board had five members.

Note 10 Other Administrative Expenses

	<u>31.12.1998</u>
Rental expenses	22,002
Transport, vehicle maintenance	36,129
Immaterial items	8,530
Information and communication expenses	79,845
Loan agreement fee	405,000
Other operating expenses	176,582
Total	<u>728,088</u>

Note 11 Off-balance Sheet Receivables

As of the balance sheet date, the Fund had compensated EEK 91,678,764 of guaranteed deposits to the depositors of EVEA Bank and EEK 29,132,184 to the depositors of ERA Bank, i.e. EEK 120,810,948, in aggregate.

As of the end of the compensation terms on 4 January 1999 and 8 January 1999, the depositors of EVEA Bank and ERA Bank had been paid EEK 93,778,025 and EEK 34,093,165 respectively, amounting to EEK 127,871,190 in aggregate.

The Fund has the right to claim an amount equal to the compensation paid both from EVEA Bank and ERA Bank. EVEA Bank was declared bankrupt on 5 February 1999 and the Fund has filed a claim for all deposits that were and are to be compensated, totaling EEK 97,361,959.

Note 12 Off-balance Sheet Liabilities

	Deposits to be compensated	Compensation paid in 1998	Deposits not yet compen- sated as at 31.12.1998
Depositors of EVEA Bank	97,361,960	91,678,764	5,683,196
Depositors of ERA Bank	36,893,832	29,132,184	7,761,648
Total	134,255,792	120,810,948	13,444,844

After the balance sheet date, by 4 January 1999 and 8 January 1999, the last days of the compensation terms, the depositors of EVEA and ERA Bank were paid EEK 2,099,261 and EEK 4,960,981, respectively. Deposits that had not been compensated to the depositors of EVEA Bank and ERA Bank by the last day of the compensation term of EEK 3,583,935 and EEK 2,800,667 were deposited and their compensation began again on 1 March 1999.

AUDITOR'S REPORT TO THE SUPERVISORY BOARD OF THE DEPOSIT GUARANTEE FUND

(Translation from the Estonian language)

We have audited the annual financial statements of the Deposit Guarantee Fund presented on pp.8-16, These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements give a true and fair view of the financial position of the Deposit Guarantee Fund as of 31 December 1998, and of the results of its operations for the year then ended in accordance with the Estonian Accounting Act.

Tallinn, 20 May 1999

KPMG Estonia

(signature)

Taivo Epner

Authorised Public Accountant