



Deposit Protection Fund

**ANNUAL REPORT
2006.**



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1. INTRODUCTION

The Deposit Protection Fund (hereinafter: the Fund) was established pursuant to the Deposit Protection Law (Official Gazette of the Republic of Montenegro, no 40/03 and 65/05). With respect to the performance of its main activity, the Fund has been exempt from taxation and any other dues. The Fund commenced its operations with the appointment of the Management Board of the Fund in June 2004.

At end-2005, there were 10 banks operating in the Montenegrin banking system (Atlas Mont Bank AD Podgorica; Euromarket Bank AD Podgorica; Crnogorska Komercijalna Bank AD Podgorica; Hipotekarna Bank AD Podgorica; Komercijalna Bank AD Budva; Montenegro Bank AD Podgorica; Nikšićka Bank AD Nikšić; Opportunity Bank AD Podgorica; Podgorička Bank AD Podgorica, and Pljevaljska Bank AD Pljevlja), of which 8 are members of the Fund.

There have been certain changes as of 2005 with regard to the Montenegrin banking system:

- Euromarket Bank was merged with Montenegro Bank, acting under the name NLB Montenegro Bank as of 1 January 2006.
- A French Societe Generale Bank took over Podgorička Bank.
- During February 2006, Hypo Alpe Adria banka AD started operating after being licensed by the Central Bank of Montenegro.
- In July 2006, a Hungarian OTP Bank bought all shares of Crnogorska Komercijalna Bank.
- At year-end 2006, Pljevaljska Bank AD was privatised by Atlasmont Bank AD and changed its name in Invest Bank Montenegro AD Podgorica.
- Two banks (Hipotekarna Bank AD-Podgorica and Pljevaljska Bank AD-Pljevlja) were still under the measures imposed by the Central Bank of Montenegro, thus not being included in the deposit insurance scheme in 2006.

The aforesaid changes had no significant impact on the Fund's operations in 2006.

At end-2006, 10 banks were operating in the Montenegrin banking system.

2. ACTIVITIES OF THE FUND IN 2006

As a part of its regular activities, the Fund paid special attention to: the monitoring of deposits trends: the collection of the initial and the annual premium, investments of the Fund's assets, the preparation of the required reports for 2005, the round-off of the normative regulations of the Fund by passing new documents (the Investment Policy of the Fund), the signing of the Memorandum of Cooperation and exchange of Information with the Central Bank of Montenegro, the preparation of the Financial and Business Plans of the Fund, the implementation of software for protected cases occurrence, a marketing presentation of the Fund, and the establishment of cooperation with other corresponding Funds and international institutions.

2.1. Analysis of Deposits in 2006

The analysis was prepared on a quarterly basis and presented to the Management Board of the Fund. The information on deposits in 2004, 2005, and 2006 that banks submitted to the Fund show an uptrend in Total deposits in the Montenegrin banking system.

2.1.1. Total Deposits

All deposits have shown dynamic growths in the last three years. As of end-2003 (available data), Total deposits have shown a steady growth, as presented in the following Table:

Table 1: Deposits movement (nominal) (EUR thousand)

Period	Total deposits	Excluded deposits	Protected deposits	Guaranteed deposits
31.12.03.	211.006	69.586	141.420	35.559
31.12.04.	273.195	72.355	200.840	33.376
31.12.05.	472.560	131.738	340.822	52.787
31.03.06.	495.784	152.527	343.256	65.000
30.06.06.	620.485	158.829	461.656	73.768
30.09.06.	789.801	161.722	628.079	98.422
31.12.06.	1.032.465	180.820	851.645	112.506

Table 2 Growth index in deposits, by periods

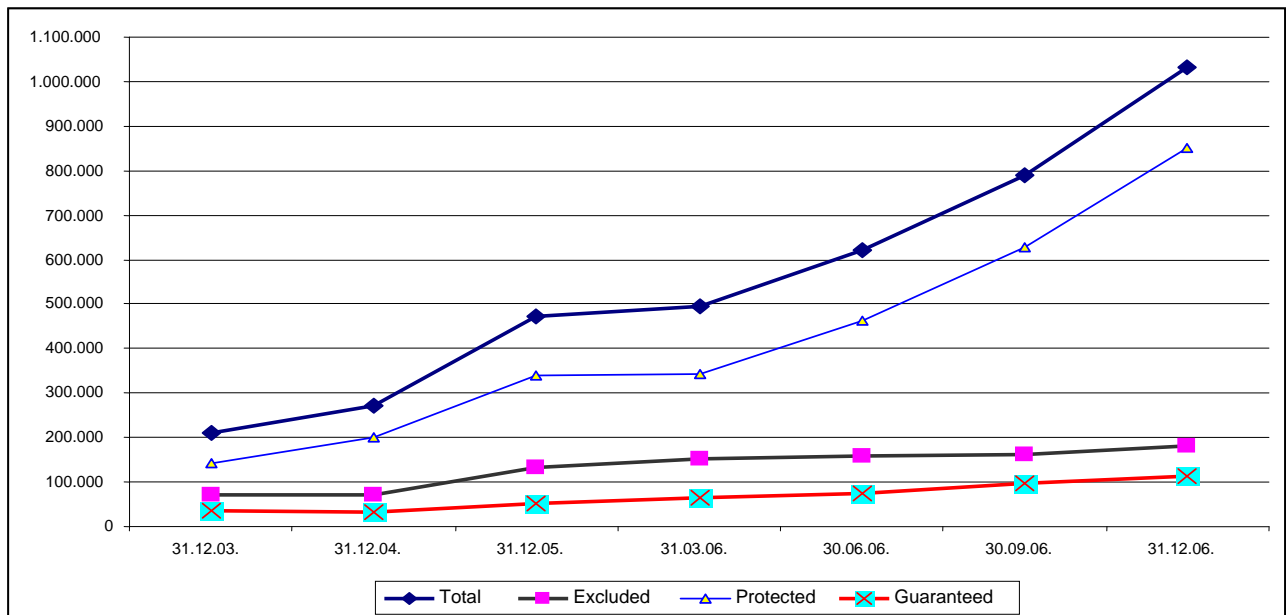
Period	Total deposits	Excluded deposits	Protected deposits	Guaranteed deposits
31.12.04./ 31.12.03.	129	104	142	94
31.12.05./ 31.12.04	173	182	170	158
31.03.06./ 31.12.05.	105	116	101	123
30.06.06./ 31.03.06	125	104	134	113
30.09.06./30.06.06.	127	102	136	133
31.12.06./ 30.09.06	131	112	136	114
31.12.06./ 31.12.03	489	260	602	316
31.12.06./ 31.12.04	378	250	424	337
31.12.06./ 31.12.05	218	137	250	213

The highest increase recorded in Total deposits was in the fourth quarter of 2006, 31%, whereas Excluded deposits showed the highest growth in the first quarter of the year, 16%. Protected deposits rose mostly in the second and third quarters (by 36% in each quarter), while Guaranteed deposits recorded the highest growth in the third quarter of 2006 (33%).

The year-on-year comparison of 2003 and 2006 shows the following increases: Total deposits by 4.9 times, Excluded deposits by 2.6 times, Protected deposits by 2.6 times, and Guaranteed deposits by 3.16 times. A growing trend in Total deposits continued in 2006, being 118.5% higher than at end-2205.

Movements of all types of deposits in the period 31 December 2003 and 31 December 2006 are shown in Chart 1, as follows:

Chart 1 Movement of Total, Excluded, Protected, and Guaranteed deposits



2.1.2. Depositors

An uptrend in the number of depositors, both legal entities and private individuals, continued in 2006. This is partly due to the fact that a private individual or a legal entity holds deposits with more than one bank.

The number of depositors at year-end 2006 is 20% higher than at end-2005 (private individuals by 20.32% and legal entities by 9.75%). The movement in the number of depositors in 2006 is shown in Table 3.

Table 3 Depositors

	Total depositors	Private depositors	Legal depositors
31. 12. 2006.	474.736	443.401	31.362
30. 06. 2006.	405.123	405.231	28.108
31. 12. 2005.	397.093	368.519	28.574

2.1.3. Excluded Deposits

Excluded deposits are those excluded pursuant to the Deposit Protection Law, these being: deposits by legal entities engaged in insurance, deposits by the Budget of the Republic of Montenegro and local authorities, deposits by off-Budget Funds in the meaning of the law governing the Budget of the Republic of Montenegro, deposits by pension funds, deposits by joint investment schemes founded in compliance with the law (privatization funds, investment funds, and the like), deposits by banks, deposits by persons for whom the bank, on their behalf and for their account, acting under their instructions, performs the operations for which the person that provides the money shall bear the risk, deposits by persons holding a bank's shares providing them with more than 5% of votes at the bank's shareholders assembly, deposits by a bank's general manager, members of the bank management board and its standing committees, persons performing the functions of directors, deputy directors and chiefs of departments and other organizational units in the bank, deposits by legal entities in which such persons have 10% or a higher share in capital or voting shares, as well as deposits by their spouses and relatives in the straight or lateral lines of kinship, up to the second degree of kinship, deposits by persons responsible for the audit of a bank's financial reports, deposits against which the legal proceedings have been initiated in order to establish if they originate from or are connected to the transactions or actions that represent money laundering or terrorism financing.

A share of Excluded deposits in Total deposits fluctuated during 2006, showing a continuous downtrend. At end-2005, a share of Excluded deposits in Total deposits amounted to 28%, falling to 18% at the year-end 2006.

In the structure of **Excluded** deposits at end-2005, the main share was of off-Budget deposits, 33%, followed by 26% of deposits by the Budget of RoM, 15% of deposits by banks, and deposits by pension funds with a 13% share. Deposits by legal entities engaged in insurance accounted for a mere 7% and deposits by persons holding more than 5% of bank shares contributed to 1% in Excluded deposits. Other categories of deposits either had a small or no share in Excluded deposits.

At year-end 2006, the situation is much different: deposits by legal entities engaged in insurance accounted for 12%, deposits by the Budget of RoM 29%, deposits by the off-Budget funds with 17%, deposits by pension funds with 13%, deposits by persons holding more than 5% of bank shares accounting for 4%, deposits against which the legal proceedings have been initiated in order to establish if they originate from or are connected to the transactions or actions that represent money laundering or terrorism financing contributing 0.4% of Excluded deposits of member banks of the Fund.

An interesting fact is that deposits against which the legal proceedings have been initiated in order to establish if they originate from or are connected to the transactions or actions that represent money laundering or terrorism financing appear in the structure of Excluded deposits in 2006, which, in a case of bankruptcy proceedings against a bank being identified to have this kind of deposit, would imply the obligation of the Fund to pass a separate decision excluding this deposit.

Some banks did not present deposits by banks' general managers, members of management boards, and their spouses as Excluded deposits in their reports, which are going to be the subject of a targeted examination in cooperation with the Central Bank of Montenegro.

2.1.4. Protected Deposits

Protected deposit represents total deposits of a depositor held with a bank reduced by deposits that are Excluded (Excluded deposits) in line with Article 5 of the Deposit Protection Law.

Protected deposits at end-2006 were 150% higher in comparison with end-2005.

As at 31 December 2006, there were 474,763 depositors having Protected deposits, of which 443,401 depositors were private individuals and 31,362 legal entities. An average amount of a protected deposit per depositor amounted to EUR 1,794, i.e. EUR 1,114 for private individuals and EUR 11,407 for legal entities. Comparing these data with those in 2005, we can see that the number of depositors rose from 397,093 to 474,763 or by 20 %.

Table 4 Protected deposits by quarters, (EUR thousand)

Period	31/12/2006	30/09/2006	30/06/2006	31/03/2006	31/12/2005
Protected deposits by private individ.	493.887	347.582	249.976	195.444	171.087
Protected deposits by legal entities	357.758	280.497	211.680	147.812	169.735

Protected deposits as at December 31, 2006 accounted for 82% of Total deposits, whereas this share at end-2005 was 72%. The ratio of protected deposits by private individuals and legal entities was almost 50%: 50% in 2005, moving to 58%: 42% in favour of private individuals.

Table 5 Net Protected deposits in 2006 (EUR thousand)

NET PROTECTED DEPOSITS	31. 12. 2005.	31. 03. 2006.	30. 06. 2006.	30. 09. 2006.	31. 12. 2006.
Less than 5,000	24.883	30.865	33.424	42.062	45.966
More than 5,000 less than 10,000	15.735	19.037	21.934	30.425	33.820
More than 10,000 less than 20,000	22.993	25.434	28.935	43.100	51.296
More than 20,000 less than 100,000	64.323	70.016	87.045	122.393	156.938
Over 100,000	133.062	133.953	182.705	296.678	424.678
Total	260.996	279.305	354.043	534.658	712.698

Net protected deposits are obtained when every protected deposit is reduced for liabilities certain depositors have with a bank.

At year-end 2006, Net protected deposits were 275% higher than at end-2005. The category Net protected deposits over EUR 100,000 accounted for 59.59% of total Net protected deposits as at 31 December 2006. Depositors with Net protected deposits up to EUR 5,000 accounted for the main share (95.59% and 97.75% at end-2005 and end-2006, respectively).

During 2006, a share of Net protected deposits in Total deposits ranged between 55.23% (at the beginning of 2006) and 69% (at end-2006), whereas their share in Protected deposits in varied between 76.58% (at the beginning of 2006) and 85.13% (end-2006).

2.1.5. Guaranteed Deposits

Guaranteed deposit is a protected deposit, or a part of the protected deposit by a depositor with a bank, the payment of which is made by the Fund in case of an occurrence of the protected event and to the amount defined in Article 7 of the deposit Protection Law (up to EUR 5,000).

Table 6 Guaranteed deposits in 2006 (EUR thousand)

PERIOD	31.12.06.	30.9.06.	30.6.06.	31.3.06.	31.12.05.	31.12.06/ 31.12.05
Guaranteed deposits	112.506	98.422	73.768	65.000	52.787	113

Guaranteed deposits at the end of 2006 were by 113% higher than in the same period a year ago, i.e. more than twofold. Their share in Protected deposits in the reporting year amounted to 13.2%. Corporate guaranteed deposits accounted for 18%, and retail guaranteed deposits for 82% of total guaranteed deposits. Their share in Net protected deposits amounted to 15.79% as at 31 December

2006, while this share at 31 December 2005 was 20.23%. The number depositors of Guaranteed deposits rose by 21.53% in comparison with 2005, of which the number of private individuals increased by 21.10%, and legal entities by 26.86%.

Table 7 Average Guaranteed deposits (EUR)

Date	Private individuals	Legal entities	Total
31. 12. 2006.	333	834	373
30. 09. 2006.	259	933	307
30. 06. 2006.	214	691	245
31. 03. 2006.	197	664	229
31. 12. 2005.	172	360	212

An average Guaranteed deposit as at 31 December 2006 amounted to EUR 373, which is 75.9% more than at year-end 2005.

An average Guaranteed deposit of legal entities amounted to EUR 834 at end-2006, which is 131.7% more than the average as at 31 December 2005.

An average Guaranteed deposit of private individuals amounted to EUR 333 as at 31 December 2006, which is 96.3% more than the average at end-2005. Guaranteed deposits of member banks of the Fund amounted to EUR 112.5 million, which is the total exposure of the Fund towards all member banks.

2.2. Information on Collected Premium in 2006 *was prepared by quarters and the Management Board was informed about the premium collection. Member banks of the deposit insurance system are obliged to pay premiums for the protection of deposits under the conditions and in the manner stipulated by the Law. The premiums are the most important financing source of the Fund. In addition to premiums, the Fund receives income from investments, donations, and other sources.*

The Law prescribes the obligation for banks to pay the initial premium, a regular annual premium, and an extraordinary premium to provide for any lacking funds.

2.2.1. Initial Premium

Banks are obliged to pay to the Fund's account the initial premium of 0.3% of the amount of Total deposits, but not less than EUR 10,000.00, which is the same as for newly established banks. At the beginning of 2006, Euromarket Bank and Montenegro Bank merged, acting as of then under the name NLB (Nova Ljubljanska Bank(Montenegro Bank AD. Since both banks had already paid the initial premium in 2005, this change of their status did not reflect on the payment of the initial premium. The collected premium for a newly established bank, to the amount of EUR 10,000, refers to Hypo Alpe Adria Bank that commenced its operations in February 2006.

2.2.2. Annual Premium

The annual premium is determined by the annual premium rate and the annual premium calculation base, the latter consisting of the average Total deposits as at the last day in each month of the previous quarter, and the annual rate of 0.25% (or 0.0625% pre quarter) was determined in the **Decision on the Establishment of the Annual Premium. Banks** are obliged to pay the annual premium in three-month instalments.

The annual premium diminishes the operating results of bank and is presented in their balance sheets as an expense. There were some initiatives to record this legal obligation as an accrued expense and thus not affect the income statement of banks, but to our knowledge, the Institute of Accountants and Auditors of Montenegro have rejected this initiative.

Most of the member banks paid the annual premium in 2006 within the deadline prescribed by the Law, the total amount being EUR 1,404,500.92.

2.3. Information on Interest Earned on Invested Funds in 2006 was prepared on a quarterly basis. The Deposit Protection Law provides the basic guidelines for investing the Fund's assets in the safest and most liquid securities issued or guaranteed by the Republic, securities issued by a bank, a financial institution, or a country of a high rating assigned by an internationally recognized rating agency, and in deposits with banks of high ratings assigned by an internationally recognized rating agency.

The total amount of funds collected from premiums was invested, i.e. the Fund did not use these funds for covering any operating expenditures but used solely the funds received as technical assistance from the Central Bank of Montenegro and a part of funds earned on interest in 2005 and 2006.

The Fund invested the collected premiums through the Central Bank of Montenegro and received revenues to the amount of EUR 55,604 in 2006. The average interest rate on the invested funds in the reporting year ranged between 1.65% and 3.54%, i.e. 2.9% on average.

2.4. Reports in 2005

Pursuant to Article 19 of the Deposit Protection Law, the President of the Management Board prepared, and the Management Board considered and adopted, three reports.

2.4.1. Annual Report for 2005 was prepared with the assistance of a KfW consultant (the consulting house GBDS – Global Banking Development Solutions). The report covers the activities of the Fund on the preparation of the Amended Deposit Protection Law and its implementation in 2005.

2.4.2. Financial Reports of the Fund for 2005 were prepared in line with the IAS standards. A Bookkeeping unit was organized within the Fund, but due to the insufficient training of employees an accounting/bookkeeping agency was hired in order to assist and supervise the preparation of financial reports.

2.4.3. Independent External Auditor's Report for 2005

was considered and adopted by the Management Board of the Fund. The report was prepared by the auditing house Deloitte. The independent, internationally recognized external auditor is of the opinion that: "the financial reports truly reflect the financial situation of the Fund and were prepared pursuant to the laws of the Republic of Montenegro and the IAS".

2.5. Selection of External Auditor for 2006

Pursuant to Article 17, paragraph 1, item 9 of the Deposit Protection Law and Article 13 of the Fund` By-Law, the Management Board of the Fund selected the External Auditor for 2006. There are three registered internationally recognized audit houses in Montenegro: Deloitte, KPMG, and Pricewaterhouse Coopers. The Management Board decided to entrust the audit house Deloitte with the auditing of the annual financial statement and reports of the Fund for 2006, as in the previous year.

2.6. Memorandum on Cooperation and Exchange of Information between Central Bank of Montenegro and Deposit Protection Fund

was signed in August 2006. This document regulates the basis of cooperation between these two institutions, the exchange of information, and the system of informing. The Central Bank is obliged to inform the Fund about: issuing and revoking licenses to banks; passing a decision on the initiation of bankruptcy proceedings and the appointment of the trustee in bankruptcy; results of examination findings, when measures have been imposed against a bank and the implementation of these measures in accordance with deadlines prescribed by the Central Bank; credit rating of banks based on risk assessment that shall serve the Fund as the basis for the collection of the annual premium at differential rates. The Fund is obliged to inform the Central Bank about: the proposal for the amount of all premiums, including a

possibility of reducing or canceling the premiums; the initiated payments to depositors of a bank under bankruptcy proceedings; monthly amount of paid Guaranteed deposits per depositor of a bank under bankruptcy; banks` failure to fulfill their obligations towards the Fund; any other information required by the Central Bank.

2.7. Normative Activities

With regard to normative activities, the Fund prepared, and the Management Board adopted, three documents: the Memorandum of Cooperation and exchange of Information between the Central Bank of Montenegro and the Deposit Protection Fund, the Investment Policy of the Deposit Protection Fund, and the Decision on the Amount of the Annual Premium for 2007.

2.7.1. Investment Policy represents a strategic document of the Fund. It gives the basic guidelines for the passing of investment decisions, allocation of funds, the manner of asset management, and the manner of reporting. This document was prepared during the first and the second quarters of 2006, with the assistance of the KfW consultant. With a view to providing thorough information and basis for the preparation of the Investment Policy, the Fund and the German consulting house GBDS organised working meetings with four respectable investment funds (Deutsche Asset Management GmbH; Allianz GI Europe; Cominvest, and Pioneer Investments). The working meetings were held in Berlin, 27 -29 May 2006. The Fund presented a draft Investment Policy at the meetings, and the aforesaid investment funds presented the possibilities of asset management. In accordance with experiences of other deposit insurance funds, KfW recommendations, and consultations with domestic experts, the Management Board adopted this document in December 2006.

2.7.2. Decision on Annual Premium for 2007

Pursuant to the Deposit Protection Law, the Management Board of the Fund passed a **Decision on the Amount of Annual Premium for 2007.**

This decision prescribes the annual premium rate of 0.25% of Total deposits of member banks. The rate remains the same as in 2006 because the conditions for its change specified in Article 27 of the deposit Protection Law have not been fulfilled.

2.8. Business and Financial Plan of the Fund is also one of the important documents adopted by the Management Board of the Fund. It defines duties of the Fund in 2006 and 2007 and the required funds for the implementation of this plan, as well as the projections for the following three years, i.e. the period in which KfW is involved in this project. The aim of this plan in the next three years is to improve the know-how of the Fund's employees through their continuous training and education, raise the eligibility of the Fund in asset management and internal procedures in order for the Fund to be fully eligible to serve its purpose at the end of this period.

2.9. Software to be used for the payment of Guaranteed deposits in case of initiating bankruptcy proceeding in some of the member banks, was installed and tested, and employees were trained to use it. Also, instructions for the use of this software were also prepared.

2.10. Guaranteed Deposit Payment Procedure

With a view to making the Fund fully prepared for "protected event" occurrence, the Fund worked on the preparation of documents and procedures for the payment of Guaranteed deposits, as well as the document to serve as the basis for the selection of the payment bank.

2.11. Donation Agreement with the German Government

In 2003, during the preparation of the Deposit Protection Law proposal, potential benefactors were contacted to provide assistance to this project. The German Government expressed its willingness to participate in the implementation of this project through its development

bank KfW. During 2004 and 2005, a protocol was signed which, inter alia, as a part of the financial cooperation with Montenegro, provides a grant of EUR 3,000,000 for the Deposit Insurance Project in Montenegro. The proposal of the financing agreement to the amount of EUR 3,000,000 was prepared by KfW. This Agreement stipulates several conditions that the Fund had to fulfil before the funds are disbursed to the Fund. A part of the funds, EUR 500,000, are provided as a grant for financing a consultant to provide technical assistance to the Fund in the period of three years after the signing of the agreement. Another share of the funds, EUR 250,000 is also given as a grant to improve the financial stability of the Fund. In December 2006, the conditions were met to sign these Agreements (the Montenegrin Government enacted a decision on giving a guarantee to KfW for the donation amount) and all open issues regarding KfW and the Fund were settled.

2.12. Marketing Activities

With a view to timely inform and educate the public on the deposit insurance system in Montenegro, the Fund paid a lot of attention to marketing activities.

In order to inform the public in Montenegro, the Fund prepared an Info Flyer in 2006 and distributed sufficient copies to the newly established bank (Hypo Alpe Adria), together with all additional propaganda material (pens, stickers, posters, holders). Also, posters and stickers with the Fund's sign were distributed to all member banks of the Fund in order for them to inform the public on deposit insurance in all their branches.

A TV commercial, which promotes the Fund's sign and logo in a simple and acceptable manner, was broadcasted on two TV networks during two months.

We gave three interviews in printed media and one interview on the national television during the reporting year. Printed media published on several occasions the Fund's announcements and information on deposit insurance system.

In order to inform a broader domestic and international public, we regularly updated our website at the address www.fzdcg.org all information on the Fund's activities are available to the public.

2.13. International Cooperation

In October 2004, the Fund became a member of the European Forum of Deposit Insurers (EFDI) which represents the association of European funds on a voluntary basis, and enables the exchange of ideas and experiences about deposit insurance in Europe.

The EFDI organised two seminars and the annual meeting in 2006, where the achievements in the field of deposit protection in EU countries and countries in transition were presented. At the seminar in Tirana, Albania, possible solutions for the determining of the amount of the guaranteed deposit were presented, as well as the procedure for establishing the annual premium rate that banks pay to the Fund.

In September 2006, the Fund organised the presentation of software for monitoring "protected events" for the purposes of the Albanian Deposit Insurance Fund. The presentation was prepared in cooperation with the agency that had prepared software for our Fund ("Dialog" from Osijek, Croatia). The presentation was attended by the general manager and 11 employees of the Albanian fund. This also gave us the opportunity to discuss problems our two institutions encounter during our work.

With a view to preparing a quality Investment Policy of the Fund, KfW and the GBDS organised the presentations to be given by the four aforesaid European investment funds on investment opportunities for the Deposit Protection Fund.

3. IMPORTANT EVENTS AFTER THE BUSINESS YEAR-END

On 4 January 2007, the Fund, the Montenegrin Ministry of Finance and the Central Bank of Montenegro signed Agreements with KfW on the financial assistance to be provided by the German Government with a view to improving the financial stability of the Deposit Protection Fund, and technical assistance to improve the Fund's eligibility in the next three years. This Agreement envisages the disbursement of EUR 2.5 million for capitalisation of the Fund and EUR 0.5 million as technical assistance to the Fund.