

Chief Executive's Report

It was a Tough Year all Round...

The global economic crisis, which emerged with the sub-prime crisis in the USA quickly spread to Europe turning into a full-blown financial tsunami. It initially struck the developing economies in the form of a cross-border funding crunch and then their real economies, as they began to feel the downturn in consumer demand for goods and services in the USA and Europe.

The Sri Lankan economy was not spared the stress caused by the global conditions. While the Sri Lankan banks proved to be more robust than some familiar global names, the failure of some large unregulated deposit takers in late 2008 threatened to undermine the domestic financial system. Prompt regulatory intervention contained the contagion threat but further action may be required to restore full confidence especially in the non-bank financial institutions sector.

Tight monetary policy imposed by the Central Bank to bring inflation under control during 2008 made credit very expensive and resulted in many businesses facing serious liquidity problems, arising from

the longer working capital cycles. Several sectors such as tourism, tea, construction, industrial exports as well as domestic retail trade were affected to varying degrees with the Small and Medium Enterprises bearing the brunt of the problem. This in turn led to higher non-performing advances in the Sri Lanka banking sector and lower risk appetite for new lending even when monetary policy was eventually relaxed in 2009 with inflation coming down. Thus, the year under review was one of immense challenge not only for the banking and financial sectors in Sri Lanka but also for the economy in general.

Profit Steady at DFCC Bank but Balance Sheet Contracts; Group Profit Drops...

The foregoing had a mixed impact on the performance of the DFCC Bank and DFCC Group. At the Bank level, profit was steady, slightly ahead of the previous year. However, demand for new project loans declined with both approval of loans and disbursements falling behind the previous year. The Bank was also compelled to take a much more cautious approach to the expansion of credit, especially the granting of fixed rate finance leases, due to clear signs of stress in that segment. Net interest income on customer advances was

affected by the contraction of the portfolio through the year as well as higher non-performing loans and leases. However, judicious allocation of assets to high-yielding Government Securities countered this decline. Capital gains on disposal of mature equity investments and emphasis on cost control despite the high average inflation that prevailed, helped to negate the adverse impact of higher provisions for possible credit losses.

The Bank redeemed its Floating Rate Notes totalling USD 65 million issued in 1998 that had been listed on the Luxembourg exchange. However, there was no adverse impact on liquidity due to the sinking fund assets that had been built up to meet this obligation.

The Group profit after tax of Rs2,068 million was 8% lower than the previous year due to reasons explained later.

Internal Processes and Risk Management Improved...

The Bank also used the downturn to upgrade its internal processes. The Integrated Risk Management function was greatly enhanced and significant investment was made in training staff both in the division and in the business lines.



**EVERYONE'S FOCUS
IS ON THE GLOBAL FINANCIAL CRISIS...
AND RIGHTLY SO...
YET DFCC'S GAZE IS ON THE RENAISSANCE
THAT IS UNFOLDING IN SRI LANKA...
AND THE VITAL ROLE WE WILL PLAY IN THIS EXCITING ERA...**

with the Ministry of Education, to introduce into selected schools a programme to equip school children with the discipline and attention to order that would be helpful for their future development and success.

A project was commenced to collect data and further expand as well as refine the credit-related databases and credit risk appraisal models. The aim is to progress to the advanced internal ratings approaches of Basle II in a few years, thereby improving capital efficiency. Plans were also drawn up for extracting further synergies from the operational activities of the Bank and its commercial banking subsidiary DFCC Vardhana Bank Limited (DVB) to be given effect to in 2009. The Management and the Boards of Directors are working on selecting the best option for the longer-term relationship between the two banks.

The Bank opened a new branch in Galle and has also completed the relocation of all its branches other than the Kandy branch to modern spacious premises providing greater visibility and customer convenience. Expansion into the East in 2009 and subsequently to the North is under active consideration as part of the future expansion strategy. The Bank also did not ignore its responsibility to the community and commenced a programme, in collaboration

DFCC Vardhana Bank Expands Distribution but Higher Provisions Reduce Profit...

At the Group level, DVB was also affected by the difficult credit climate although it was able to grow its customer advances due to the higher working capital requirements of businesses. Nevertheless, it too had to cope with a worsening of credit quality with higher non-performing advances and provisions.

DVB also bore the costs relating to the expansion of its distribution network since a conscious decision was taken to continue with this strategy for the medium-term benefit. It was also affected by the high funding cost in the first half of the year due to the absence of legacy low cost savings account balances that have accumulated over time in mature banks. DVB has added 20 branches during 2007 and 2008 that are still in their break even phase pending the build up of critical mass. It also entered into an agreement with Sri Lanka Post to set up

low cost distribution points. Five locations were operational as at March 2009 and another 25 are planned which, together with the branches to be opened will bring the network to about 50 branches and 30 postal units by the end of 2009. It is planning to join both the Global Visa network and the domestic payment gateway that is under development and the significant enhancement to the distribution network that all of these initiatives will lead to, will enable it to enter the personal financial services market when the economic environment is conducive.

Subsidiary, Lanka Ventures PLC Suffers Loss due to Prior Year Tax Charge but Settles Tax Dispute ...

The venture capital subsidiary Lanka Ventures PLC, had a steady year at the operational level but a prior year tax charge of Rs137 million relating to a refund that had been received in 2004 under the subsequently repealed tax amnesty resulted in a significant loss for the year. This long outstanding dispute was settled in court recently without the payment of any penalties that had been claimed by the Inland Revenue.

Other Subsidiaries, Joint Venture and Associates

Lanka Industrial Estates Limited (LINDEL) that owns and operates an industrial estate in a Colombo suburb recorded a profit after tax exceeding Rs100 million for the first time, a slight increase from the previous year.

The recently established information technology subsidiary, Synapsys Limited, recorded a loss due to expenses incurred in building capacity to enter foreign markets. It has entered into service partnerships with several technology majors and is pursuing initiatives aimed at providing business solutions domestically and overseas in the financial services, healthcare and retail sectors.

DFCC consulting (Pvt) Limited made only a nominal contribution in the absence of new overseas assignments.

The new investment banking joint venture, Acuity Partners Private Limited, became fully operational and moved to one location in early 2009. Although the environment under which this business operated was very challenging due to the virtual drying up of domestic corporate debt markets and the sharp downturn in the equity market, the Acuity brand has now been established

as a one-stop investment bank. DFCC Stockbrokers now re-branded as Acuity Stockbrokers, made its mark when it handled the largest ever equity sale in the history of the Colombo bourse during the year.

Associate company, Commercial Bank of Ceylon PLC performed well although it had to make significant provisions for certain disputed oil hedging transactions with a state owned enterprise. Capital gains arising from the disposal of an associate leasing company helped profit after tax to be maintained at prior year level. National Asset Management Limited, increased its revenue by increasing its funds under management but its contribution remained small.

Exporting Expertise

The Bank successfully bid to provide consultancy services to Oman Development Bank, a development finance Institution that is in the process of broad basing its funding. This could prove to be a stepping stone to providing expertise to other DFIs that are re-engineering themselves for sustainable growth whilst continuing to be involved in development banking.

Global Outlook Uncertain but Opportunities for Sri Lanka

Experts still differ widely on how the global economy will unfold. Most agree that 2009 will be difficult for trade and growth. There are those who contend that 2010 will see a sustained recovery and yet others who believe that the turnaround will only occur later. Even in a weak global scenario, Sri Lanka should be able to record 3% GDP growth in 2009 but domestic developments may help Sri Lanka to perform better.

A key factor that could drive a stronger positive outcome is the vesting of all territory in the North and the East under the writ of the Government after almost 25 years, after a bold and concerted effort at fighting terrorism. However, immediate follow on action to arrive at a lasting political settlement and significant investment to rebuild devastated infrastructure and livelihoods of the affected and displaced people will be needed, if we are to reap the peace dividend. The goodwill and partnership of the international community will be essential for this since the Government has insufficient fiscal space to allocate funding for this mammoth task. Furthermore, inflation has been tamed and interest rates

are on a downward trend and businesses will again be able to afford medium-term investments and also participate in the development of the North and the East.

A key export earner, apparel, and, private inward remittances have so far held up and the much lower oil prices will also help improve the balance of payments, but concerted and quick action needs to be taken to rebuild the depleted foreign exchange reserves by accessing funds from the International Monetary Fund (IMF) or other non-commercial long-term funding sources.

Equally important would be to ensure the continued stability of the domestic financial system. While commendably swift and decisive action relating to a failed bank taken by the Central Bank averted a crisis in the banking sector at the end of 2008, the non-bank financial sector may require further assistance to restore confidence.

The Government and the Central Bank have provided some support to regulated deposit taking companies that are illiquid by offering schemes to buy underlying collateral relating to delinquent loans and leases. While this is a good start, any sustained flight of deposits from these institutions may require the

Central Bank to provide limited and time-bound support for deposit liabilities as well. Such action, although normally frowned upon by Central Banks, have proved to be effective in other countries, where non-bank financial institutions (including insurers) experienced liquidity problems.

The adverse global environment and contraction of some domestic business sectors also present a window of opportunity for strong local companies to retain and build their human talent pool while employment opportunities abroad remain limited.

High Taxation continues to Inhibit Capital Formation in Banks...

Much has been said and written about taxation over the years. The basis for computing the Financial Services Value Added Tax was changed at the beginning of 2008 that resulted in the effective tax rate increasing by a further three percentage points. While recognising that the Government needs to increase its revenue in proportion to GDP, it should not be forgotten that banks need adequate capital if they are to carry out their role of intermediation and support the Government's efforts to stimulate the

economy. Continued discriminatory taxation of banks makes the sector less attractive to capital providers while at the same time making self-capitalisation through internally generated capital to support loan growth very difficult.

The need to formulate a sound policy framework for taxation for sustained economic development was identified as a need in the last budget presented by the Government. It is hoped that this key issue will be speedily addressed through the budget proposal relating to the setting up of a Taxation Commission.

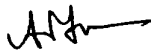
Supportive Board, Employees, Government and Central Bank...

The Chairman and the Board of Directors were a tower of strength to management during a very tough year and they have conscientiously looked after the interests of shareholders and other stakeholders. All my colleagues in the management team and the employees also put their best foot forward, and I express my sincere gratitude to all of them. I also acknowledge with appreciation the support received from the Government and the Central Bank of Sri Lanka in our various endeavours.

■ Optimism Warranted...

While it is easy to adopt a negative approach and wait for everything to become right, the better course for businesses, and indeed banks in Sri Lanka, is to realise that stimulating the economy is in their own interest. While we cannot influence the world economy, until such time as regional and global opportunities re-emerge, we must use whatever internal opportunities we have to get ahead in the recovery curve.

Sri Lanka has shown resilience in dealing with adversity over a long period and at DFCC Bank, we remain optimistic that the advantage of being a small and flexible economy will stand us in good stead to meet the challenges ahead. For its part, DFCC Bank will continue to abide by its mandate to support Sri Lanka's development to the full extent of its capabilities.



Nihal Fonseka
Chief Executive
27 May 2009