

Financial Review

Despite this challenging environment the Bank was able to post a modest growth of 3% in post tax profit due to proactive measures taken by the Bank to maintain profitability and a high level of liquidity. These measures included:

■ Profitability

The Group profit after tax in the financial year under review (referred to in this report as current year) was Rs2,068 million a decrease of 8% from Rs2,247 million in the previous financial year (referred to as previous year). The unconsolidated profit after tax of the Bank in the current year was Rs1,360 million a 3% increase over Rs1,318 million in the previous financial year.

The difficult economic environment that prevailed and the impact on portfolio quality have been dealt with elsewhere in this Annual Report. The higher level of non performing loans and leases led to the specific provisions for bad and doubtful loans net of recoveries to increase to Rs326 million in the current year compared to Rs84 million in the previous year.

The banking sector continues to be subject to discriminatory higher taxation in the form of financial services VAT. The operating profit of the Bank before financial services value added tax and income tax was Rs2,563 million in the current year, a 6% increase over Rs2,418 million in the previous year. This increase of 6% was reduced to 3% increase at the post tax profit level due to the higher burden of taxes.

i. Maintenance of net interest income margin

Net interest income of Rs2,905 million in the current year was a 9% increase over Rs2,676 million in the previous year despite the contraction in credit portfolio. This was achieved by a higher investment in high yielding Government securities.

ii. Diversification of other income sources

The Bank pursued alternative avenues of income to augment the net interest income in an environment non-conducive to credit growth. This included contribution to capital gains realized through the sale of shares and income from a higher level of Treasury bill repurchase operations reaping benefits from the high interest rate environment.

iii. Containment of personnel cost

The personnel cost of Rs544 million in the current year is a modest 4% increase over the previous year.

iv. Containment of other operating expenses

The establishment and other overhead expenses in the current year was Rs483 million being only a 2% increase over the previous year despite a very high inflationary environment during most of 2008.

v. Maintenance of solvency

The Bank was able to use funds released from the declining portfolio amounting to Rs4,791 million during the current year by repaying borrowing, reducing new borrowing and increasing the liquidity cushion of the Bank.

Although the Bank profit after tax recorded a modest increase of 3% the Group profit after tax of Rs.2,068 million in the current year was a 8% decline over the previous year. The primary reason was the one off loss by Lanka Ventures PLC (LVL) due to additional income tax expense in relation to prior years, which crystallised as a liability in the current year due to the company's appeal against the assessment in the Court of Appeal being decided in favour of the revenue authorities and a subsequent settlement reached in the appeal made to the Supreme Court. As a result, LVL which posted a profit before tax of Rs50 million

in the current year ended up with a post tax loss of Rs91 million compared to post tax profit of Rs80 million in the previous year; a net change of Rs171 million. A further contributory factor to the decline was the lower profit after tax contribution from DFCC Vardhana Bank Limited (DVB), the commercial banking subsidiary amounting to Rs106 million in the current year compared to Rs146 million in the previous year. The lower profit of DVB is largely due to higher specific provisions for non-performing credit facilities. Synapsys Limited a fully owned subsidiary of the Bank providing information technology services recorded a post tax loss of Rs19 million in the current year compared to Rs13 million post tax profit in the previous year.

Loan Quality

The gross non performing loans (NPL) and finance leases was Rs3,783 million on 31 March 2009, increased from Rs2,891 million an year ago. However the infected exposure net of provisions and the realisable value of tangible collateral is only Rs302 million on 31 March 2009. This as a percentage of the equity on 31 March 2009 was only 3.5%.

Loans constitute 82% of the non-performing credit portfolio.

The composition of NPL by age of arrears indicates that Rs1,300 million (36% of the total gross non performing loans of Rs3,783 million) was over 18 months on 31 March 2009, increase from 29% in the previous year's non-performing loans in the same arrears category.

Analysis of NPL by industry sectors indicates six sectors accounted for 67% of the non-performing loans on 31 March 2009. The broad sectors in descending order of non-performing loans were, agriculture forestry & fishing, trade & finance, insurance, real estates & business services, manufacture of food beverage & tobacco, construction industries, transport storage & communication. Within these broad sector exposures to SMEs property, tea, construction, tourism and commercial transport were the prominent sub-sectors.

Investment in Joint Venture Company

During the current year the Bank invested in a new joint venture company partnering with an established private sector commercial bank, Hatton National Bank PLC. The joint venture partners contributed

to the initial capitalisation of Rs500 million equally. The Bank's investment was funded by a cash investment and transfer of shares in the fully owned subsidiary of DFCC Stockbrokers (Pvt) Limited to the joint venture. This transaction yielded a profit on disposal of approximately Rs85 million. The consolidated profit however, has recognised only 50% of Rs85 million attributable to the transfer of ownership to the other joint venture partner.

Investment in Commercial Bank of Ceylon PLC

The Group Profit after tax of Commercial Bank of Ceylon PLC was marginally lower in the current year due to the impact of higher effective rate of income tax and higher provisions.

Dividend Distribution and Solvency

The Directors have recommended a first and final dividend of Rs5 per ordinary share, which will amount to a payment Rs654 million. The total dividend pay out as a percentage of Bank's own profit after tax for year to 31 March 2009 is 48%. This year's proposed dividend is the same as the dividend paid for the previous year.

Companies Act No. 7 of 2007

The provisions of the Companies Act do not apply to the Bank where the DFCC Bank Act No. 35 of 1955 or its Regulations have express provisions on the subjects covered by the Companies Act. Thus the financial statements of the Bank prepared under the DFCC Bank Act No. 35 of 1955 has retained the concept of par value of shares and the share premium whereas the Companies Act No. 7 of 2007 has abolished the concept of par value and share premium. The total of paid up capital and the share premium disclosed in the balance sheet is the equivalent of stated capital in the financial statements of companies, which have complied with the Companies Act.

The Bank however has voluntarily followed some of the requirements of the Companies Act as regards dividend distribution and certification as a matter of prudence.

Capital and Liability Structure

The Total equity of the Bank was Rs14,491 million on 31 March 2009.

Total interest bearing liabilities was Rs42,016 million with a gearing of 75% debt to 25% equity which is similar to the gearing in the previous year. The capital adequacy ratio on consolidated basis was 19.9% on 31 March 2009 (19% on 31 March 2008).

Combined Operations of the Bank and its Commercial Banking Subsidiary DVB

DVB is 96% owned subsidiary of the Bank with an investment of Rs2,286 million.

The combined non-interest expense (excluding provisions and financial services VAT) to operating income ratio of the Bank and its commercial banking arm DFCC Vardhana Bank Limited (DVB), the cost income ratio was 33.3% in the current year compared to 34.4% in the previous year.

DVB with 43 branches and extension offices as at 31 December 2008 will reach its target of maximum branch network during 2009, which will enable it to compete effectively in the commercial banking sphere consolidating its past gains and thereby improve profitability. The success of this strategy will however depend on the macro economic environment globally and domestically in the foreseeable future.