Risk Management

The DFCC Group (which in the context of this Report means the Bank and its subsidiary licenced commercial bank, DFCC Vardhana Bank Limited) continued to demonstrate its resilience under the stressed global and local economic conditions by focusing on managing credit risk and liquidity. The Group's operations are primarily associated with credit risk, operational risk, liquidity risk, market risk, business risk, legal risk and reputation risk of which credit risk is predominant. Management is tasked with managing all of these risks prudently to optimise stakeholder value, with oversight from the Board Integrated Risk Management Committee and the Board of Directors.

The Scope of Basel II Application

From January 2008, the Group adopted the simplest approaches of Basel II viz., Standardised Approach for credit risk, Standardised Measurement Approach for market risk and Basic Indicator Approach for operational risk for the quantification of risk for regulatory capital adequacy purposes.

Evolution of the Risk Management Function

During the year, the Group continued to review and upgrade its risk management function in line with the business needs, environmental factors, regulatory requirements and international best practices. An integrated risk management function, independent from risk assuming functions, became operational at the beginning of the financial year. The emphasis was on the management of liquidity and portfolio quality, which subsequently proved to be critical for the overall banking sector in the country. The strategic alignment of lending activities aimed at maintaining the portfolio quality and collection ratios within acceptable parameters, including de-emphasising exposure to higher risk sectors, further supported the liquidity management of the Bank. The Board Integrated Risk Management Committee (BIRMC) commenced oversight of the Group's integrated risk management function under the responsibilities set out in the Board-approved Charter for the BIRMC, which was developed during the year under review. Credit Risk Management was undertaken within the existing policy while three other risk policy frameworks viz., liquidity risk management framework, market risk management framework and new product development policy, were approved by the BIRMC and the Board. These frameworks will underpin the progress towards the implementation of advanced approaches of Basel II. These policy frameworks stipulate the Group's policies, strategies, systems and responsibilities of different parties and processes for the management of relevant risk. A validation of the DFCC Bank's credit rating models based on historical data was performed internally and required improvements to the rating process and the rating models were identified. Probability of Default was computed for the past three-year period as an interim measure with a view to progressing towards a five-year period as required by the advanced approaches of Basel II. This enabled the Group to build internal capacity in rating model development, validation and calibration.

Staff from risk management, business and other service divisions received local and overseas training as part of the on-going capacity building programme. A series of knowledge sharing sessions was conducted across the Group including the regional business units covering the areas of integrated risk management, Basel II, local and international market updates, with a view to promoting a strong risk management culture across the Group.

As an interim measure for capital planning under their Internal Capital Adequacy Assessment Process , regulatory Capital forecast was accommodated in the three-year business plan of the DFCC Bank. This task would support the decision making for business and financing strategies in the light of pricing and adequacy of risk capital. Herfindahl-Hirschman Index for the DFCC Bank's sectoral exposure distribution was computed as a measure of the concentration risk, and could be used as a tool for the management of concentration risk in the future.

Governance Structure for Risk Management

The Group's governance structure for risk management encompasses the concept of 'Three Lines of Defence', and is based on and the four fundamentals of Board and senior management oversight, risk management policies and procedures, risk measurement, monitoring and control, and internal controls and independent audit. The First Line of Defence involves the supervision and monitoring of risk management practices by the business managers, corporate management and executive committees while discharging their responsibilities and accountability for the day-to-day management of business operations. Independent risk monitoring, validation, policy review and compliance by the integrated risk management function, the compliance functions and BIRMC/ Board of Directors constitute the Second Line of Defence. The Third Line of Defence is provided by the independent check and quality assurance by the internal audit and external audit functions.

The Head of Integrated Risk Management Department reports to the BIRMC through the Chief Executive. The Executive Committees such as Asset Liability Management Committee (ALCO), Credit Committee, Investment Committee and Bad Debt Review Committee are guided and operate within risk frameworks and limits set out by BIRMC. The Executive Committees may, depending on circumstances, adopt such further risk parameters as they deem necessary as long as they do not conflict with those stipulated by BIRMC. The Integrated Risk Management Department is vested with the responsibility of measuring and monitoring risk at operational levels on an on-going basis to ensure compliance with the parameters set out by the Board/BIRMC and other Executive Committees. All exceptions are highlighted for corrective action and reported to the BIRMC. This structure for integrated risk management function will further evolve to be in line with the regulatory and Basel II recommendations and best practices over a period of time.

DFCC Group's policies for Integrated Risk Management

Apart from the macro policies and operating frameworks detailed above, the Group adheres to the following key risk management policies. In doing so, it however bears in mind that in the case of DFCC Bank it still has a mandated role to play in sustainable development by supporting private sector entrepreneurship:

- Entering into new business, developing products or adopting new strategy will depend on a detailed evaluation and sign off on risks and availability of adequate internal expertise and capabilities for risk management as has been stipulated in the New Product Development Policy.
- Ensuring that regulatory capital requirements are not compromised and sufficient capital is internally generated to support its normal business activities and internal growth through risk-based pricing.
- Comprehensive, transparent, timely and objective disclosure of the Group's risk exposure is made to the Board, relevant Board sub-committees, corporate management, regulators, shareholders and other stakeholders. Care is however taken to ensure that public disclosures do not compromise the Group's competitive position.
- Continuously assess delivery capabilities, resource requirements and capital requirements, and accommodate them in the Bank's business planning process and new product development process.

of single borrower limits, group limits and sector limits. Risk exposures to high-risk sectors are managed through sector restrictions that require prior high-level clearance before assuming individual risks for even small amounts.

- Regulatory requirements are considered as minimum standards for risk management purposes. The Group focuses on progressively upgrading its risk management function with best practices and Basel II recommendations based on applicability in the Group's context.

Credit Risk

Credit risk is the risk that a loss will be incurred if a counterparty to a transaction does not fulfil its financial obligations in full and in a timely manner. The loss of market value of debt securities of the investment portfolio due to credit rating downgrades or the credit spread widening is also part of credit risk but in the Sri Lankan context only a very small proportion of corporate debt is traded. Counterparty credit risk is the most significant type of risk assumed by the Group, and accounted for 87% of risk-weighted assets as at FYE 31 March 2009.

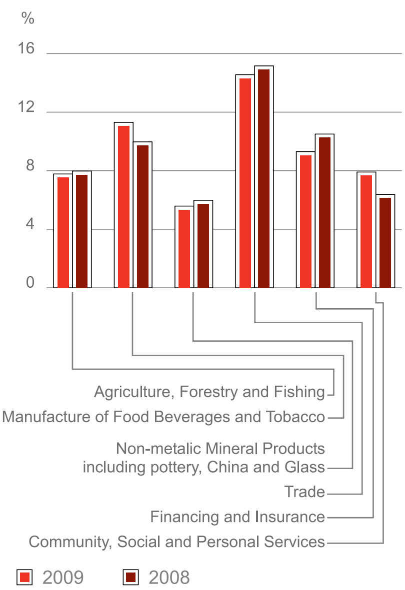
Process for Credit Risk Management

The use of internal rating models and the periodic review of assigned ratings form the basis for risk profiling of borrowers for the purpose of managing credit risk through structuring, pricing, monitoring, restructuring and recovery action. Concentration risk is currently managed and monitored in terms

Trade sector and the Food, Beverage & Tobacco sector, which amount to 14.3% and 11% of total earnings assets, respectively, are the largest sector concentrations in the earning assets of DFCC Bank. However, these sectors have diversity within themselves. In the Group's context, concentration risk arising from these two sectors is further reduced due to a low average exposure per borrower. All other sectors individually account for less than 10% of the total earning assets of DFCC Bank as at 31 March 2009. The individual exposures within the sectors are usually secured by a high level of tangible collateral.

During the year, the advances portfolio was affected by liquidity constraints of borrowers coupled with high interest rates that in turn led to a higher level of non-performing advances. The Leasing Portfolio relating to the Small and Medium Sector was particularly vulnerable to these conditions. BIRMC monitored the steps taken to manage this situation in the context of the difficult economic environment that prevailed and likely to prevail in 2009 and the need for the DFCC Bank to play its statutorily-mandated role as a development finance institution by supporting viable businesses through short-term difficulty.

Distribution of DFCC Bank's Earnings Assets within Selected Sectors*



* *Sectors accounting for 5% or more of the total earnings assets as at FYE 31 March 2009.*

Only six sectors accounted for 5% or more of the total earnings assets of the DFCC Bank as at 31 March 2009, compared to nine sectors, which accounted for a more than 5% of the total earnings assets in the previous year. Of these sectors, gross exposure to Finance and Insurance as a percentage of the total earnings assets declined by 1.2% during the period while the gross exposure to the Food, Beverage & Tobacco sector and the Community, Social & Personal services sector increased by 1.3% and 1.5%, respectively. The Herfindahl-Hirschman Index - a measure of sector concentration, indicated an acceptable and improved level of diversification of the DFCC Bank's earnings assets as at FYE 31 March 2009.

Market Risk

Market risk is the risk of potential losses accruing through the adverse fluctuation in the market interest rates, equity prices and exchange rates. Market risk could impact a bank mainly in two ways; viz., loss of cash flows or loss of economic value. Market risk can be looked at in two dimensions, as traded market risk, which is associated with the trading book and non-traded market risk, which is associated with the banking book. The ALCO, acting through the Group Treasury and the Investment Committee, are mandated to manage both the traded and the non-traded market risk at the operational level. Tools such as supervisory monitoring, exposure limits, stop-loss limits, scenario analysis and marking-to-market are used to manage the market risk exposure.

Interest Rate Risk

Interest rate risk can be termed as the risk of loss in the net interest income (earnings perspective) or the net worth (economic value perspective) due to the adverse changes in the market interest rates. The Group maintains the Trading and Investment portfolios separately with regard to fixed income securities as per the guidelines of the regulator. The Assets and Liability Management Unit continuously assesses the Bank's asset and liability profile in terms of interest rate risk and report to the ALCO for necessary realignment in the asset and liability structure and the pricing mechanism.

As a general rule, medium term fixed rate advances are funded by fixed rate liabilities. Foreign currency assets and liabilities are repriced periodically linked to a benchmark rate.

Equity Prices Risk

Equity prices risk is the risk of losses in the equity trading book, which is marked-to-market due to the decline in the market prices. The Investment Committee is responsible for making investment decisions and monitoring exposure to the equity market. Asset allocation limits are approved by the Board of Directors based on recommendations of ALCO/BIRMC. Rigorous appraisal, proper market timing and exposure limits are used to manage equity prices risk. The Bank's long-term investment horizon for equity investments smoothens out the adverse implications of short-term market volatility. The Group's exposure to equity prices risk through the equity trading and the investment portfolios is nominal as these two portfolios account for 0.6% of the total assets.

Exchange Rate (and country) Risk

Exchange rate risk emerges from adverse changes in exchange rates in terms of foreign currency transactions, assets or cross-border business activities. The Bank is not exposed to exchange rate risk on its foreign currency borrowings made with the concurrence of the Government of Sri Lanka since exchange risk relating to such borrowings is borne by the Government in terms of the DFCC Act No. 35 of 1955. The Bank has extended foreign currency denominated loans to borrowers in Sri Lanka who have the capacity to service these loans from their foreign currency revenue. The total foreign currency assets are less than 4% of the total assets and are substantially matched by liabilities in the same currency.

The Group Treasury actively manages the exchange risk of DVB by applying limits on single dealer, currency, overall open positions, stop-loss and maturity. These limits are conservative and commensurate with the size and capital strength of that unit.

Liquidity Risk

Liquidity risk is the risk of not having sufficient resources to meet financial obligations in time and in full, at a reasonable cost. The Group's liquidity risk management process includes regular analysis and monitoring of the liquidity position and the maintenance of market accessibility. Regular cash flow forecasts, liquidity ratio and maturity gap analysis are used as analytical tools by the ALCO. The Group goes beyond the statutory definition of liquid assets when assessing liquidity. It takes into account the liquidity of each eligible instrument relating to the market at a given point in time as well as undrawn commitments made to borrowers when stress testing its liquidity position. The maintenance of a strong credit rating [AA(lka)] by Fitch Ratings Lanka, unchanged since January 2003] and reputation in the market enables DFCC Bank to access domestic wholesale funds when needed to supplement its traditional funding sources from multilateral and bilateral sources. For short-term liquidity support, the Bank has access to the money market at competitive rates. The diversification of the liability structure is also a key focus of the Group and access to retail deposits is being effected through expanding the reach of DVB. DFCC's risk-based pricing mechanism ensures that residual liquidity risk is duly priced when pricing assets.

The Bank's foreign currency liabilities have a longer maturity than its foreign currency assets, thereby mitigating the foreign currency liquidity risk.

Operational Risk

Operational risk arises from human activities, technology and natural incidents. The sources of operational risks include frauds, staff negligence, management systems failure, technology failure, model failure, technology obsolescence and inadequate internal controls. Segregation of duties with demarcated authority limits, internal and external audit, strict monitoring facilitated by the technology platform and back-up facilities for information are the fundamental tools of operational risk management. Audit findings and management responses are forwarded to the Board's Audit sub-committee for their examination. The Group demands a high level of technical skills, professionalism and ethical conduct from its staff and these serve as insulators for many operational risk factors. The Bank's business recovery plan deals with natural or other catastrophes. The loss of physical assets is mitigated through insurance.

Reputation Risk

Reputation risk is the risk of losing public trust or the tarnishing of the Bank's image in the public eye. It could arise from environmental, social, regulatory or operational risk factors. Events that could lead to reputation risk events are closely monitored, utilising an early warning system that includes inputs from frontline staff, media reports, and internal and external market survey results. Policies and standards relating to the conduct of the Bank's business have been promulgated through internal communication and training. A culture of compliance permeates all levels of the organisation, and the Chief Compliance Officer submits quarterly compliance reports to the Board of Directors.

Business Risk

Business risk is the risk of deterioration in earnings due to the loss of market share, changes in the cost structure and adverse changes in industry or macroeconomic conditions. The Group's medium-term strategic plan and annual business plan form a strategy road map towards continued prosperity. Diversification into related financial services through subsidiaries, associates and joint ventures, continuous competitor and customer analysis, and monitoring of the macroeconomic environment enable the Group to formulate its strategies for growth and business risk management.

Legal Risk

Legal risk arises from unenforceable transactions in a court of law or the failure to successfully defend legal action instituted against the Bank. Legal risk management commences from prior analysis, and a thorough understanding of, and adherence to, related legislation by the staff. Necessary precautions are taken at the designing stage of transactions to minimise legal risk exposure. In the event of a legal risk factor, the Legal Department of the Bank takes immediate action to address and mitigate these risks. External legal advice is obtained when required. The financial statements disclose details of significant ongoing legal disputes involving the Bank.

Regulatory Environment

The Group considers prudential regulatory specifications not a burden but a stimulus for maintaining an effective risk management function. The Group has taken necessary steps to bring its governance structure, policies, processes and procedures to be compliant with the mandatory prudential regulations, which became effective during the year under review. The Group further reviewed the Central Bank's guidelines on integrated risk management, outsourcing and AML risk profiling of customers and have commenced assessing the internal arrangements in the light of those guidelines.

Risk-based Capital Adequacy

DFCC Bank continued to maintain a healthy risk capital position on a solo and group basis computed under the simplest approaches of Basel II. Given the current downturn in global markets and the uncertainty in the local macro conditions, this risk capital buffer over the minimum regulatory requirement has been a strength for the DFCC Bank. The consolidated total regulatory capital base of the Group is lower than the core capital due to the reduction arising from the investment in the associate company, Commercial Bank of Ceylon PLC.

DFCC Group Regulatory Capital Ratios under the simplest approaches of Basel II as at 31 March.

	2009 %	2008 %
Core Capital	21.9	20.4
Total Capital base	19.9	19.0

DFCC Group Regulatory Capital position under Basel II as at 31 FYE March 2009

Allocation of Capital	Amount Rs million
Credit Risk	6,204
Market Risk	198
Operational Risk	706
Minimum Regulatory Capital	7,108
Buffer	7,039
Actual Regulatory Capital	14,147

The Group Risk-Weighted Assets as at FYE 31 March 2009