

# Management Information

## Chief Executive's Report

The financial year ended 31 March 2010 proved to be an year of contrasting challenges. At this time in 2009 the global economy was still fragile and Sri Lanka was still facing the challenge of rebuilding its depleted foreign currency reserves in a sustainable manner. On the positive side, there was great hope because the Government had for the first time in several decades, taken control of the entire land mass, sea and airspace of Sri Lanka after crushing terrorist violence that had caused more than 700,000 deaths and claimed several times that number as victims in various ways. This unprecedented opportunity was expected to serve as a springboard for catapulting Sri Lanka firmly into the ranks of a middle income country.

Much has happened in the last 12 months, both globally and in Sri Lanka. In April, the IMF predicted global economic growth for 2010 to reach 4.2% on a purchasing power basis, up from the forecast of 3.2% six months previously, driven mainly by large emerging economies such as China, India and Brazil. Despite the looming threat posed by the debts of the so called 'PIIGS' countries and the recent battering of the Euro, there is some exuberance built around the world economy compared with the uncertainty that prevailed a year earlier. In Sri Lanka, the recently concluded elections resulted in the country having a strong Government for

the first time in many years. Economic activity in the country including the North and East showed slow but sure signs of improvement. However, the fiscal deficit remained untamed and in fact widened. These phenomena posed a different set of challenges as we ended the last financial year.

### Profit increased but core business affected...

In an year of contrasting challenges, the performance of the Bank was mixed. Profit at the Bank and Group level showed healthy increases to Rs1,713 million and Rs2,684 million up by 26% and 30% respectively from the previous year. However, the core advances portfolio comprising loans and finance leases suffered a contraction for the second consecutive year at a rate somewhat above the banking sector average. This was understandable since during an economic downturn and a high interest rate environment, the normal contraction of the amortising term loan portfolio is compounded by a lower demand for new medium and long term project loans whereas the revolving working capital finance which forms a significant proportion of the assets of the commercial banking sector, may not be affected as much.

The portfolio quality too continued to be adversely affected, with the non-performing asset ratio increasing due to the contraction in advances, but on the positive side the quantum of non-performing assets, which peaked in May 2009, reduced every month thereafter and showed a slight reduction year on year. The Bank focused on containing the non-performing portfolio through proactive management of customer advances rather than reducing the ratio through seeking to aggressively grow the credit portfolio in the relatively high risk environment that prevailed for much of the year. However, the Bank provided significant liquidity support to many stressed borrowers, especially in the small and medium enterprise sector, by restructuring and rescheduling debts under both Government sponsored schemes and using the Bank's own resources. Although gross provisions for delinquent debts naturally increased in this scenario, recovery of previously provided advances also showed a fair improvement.

The decline in interest income from loans and leases was partly offset by the interest earned on investments in Government Securities held to maturity. Net interest income showed a growth due to the reduction in funding costs. Dividends from group companies

"One must not underestimate the role that has to be played by the financial services sector led by the banking sector, which is the predominant provider of funding to the private sector. Achieving the growth objective of the Government will require bank lending to more than double to Four Trillion Rupees in the next five years."



increased, as did income from the sale of shares, with a significant component of this income being derived from the divestment of subsidiary Lanka Ventures PLC (LVL) to the investment banking joint venture, Acuity Partners (Pvt) Limited.

Special attention was paid to managing cost, including employment related expenses and the success of our efforts is reflected in the low cost/income ratio of 26% for the Bank.

## DFCC Vardhana Bank makes further progress...

Despite the challenging environment, the commercial banking unit, DFCC Vardhana Bank Ltd (DVB) recorded a better performance. The investment in the distribution network whereby DVB now has 44 branches and 30 outlets in post offices contributed to DVB growing its customer deposits by 16 %. DVB also benefitted from the declining cost of funds and the interest earned from high yielding government securities held to maturity. Profit before and after tax for the year grew to Rs598 million and Rs268 million recording increases of 77% and 141% respectively for the year. The slowdown in economic activity resulted in a deterioration in the asset quality of DVB as well and steps are being taken to address this issue.

## Entering the North and East...

The DFCC Group made its entry to the North and East by setting up branches in Batticaloa, Ampara and Jaffna. Opening of two further full branches and several post office units of DVB are planned for this year which will enable the DFCC Group to play its development role in the post war reconstruction of these regions.

## Group companies steady...

LVL which recorded a loss in the previous year due to a prior year tax charge, returned to profitability. It ceased to be a subsidiary on 18 January 2010. Lanka Industrial Estates Limited (LINDEL) recorded a steady year. Acuity Partners (Pvt) Limited commenced full scale operations from one location and both the government securities trading and stock broking businesses made positive contributions while commencing work on several corporate finance mandates. The information and communication technology subsidiary Synapsys Limited which undertakes the ICT operations of the Bank and DVB made a small loss but continued to build capacity to produce products for the financial services sector and implement solutions for non-group companies. It recently launched its mobile banking platform MBanx which is now deployed in DVB. The Bank is committed to investing new capital in Synapsys to enable it to expand its reach overseas. National Asset Management Limited (NAMAL) launched the first listed close ended fund in the country's fund management history. Commercial Bank of Ceylon PLC (CBC) had a fair year and made a significant contribution to the Group profit. The market value of this investment has increased significantly in recent times although the synergy benefits envisaged at the time of investment did not materialise.

## The new challenges...

The new challenges that I referred to earlier relate to the repositioning of Sri Lanka to achieve the Government's objective set out in its policy programme

Mahinda Chintana - *Idiri Dakma* (Vision for the future) of doubling the per capita GDP to above USD 4,000 in the next 6 years by leveraging the peace dividend and the rebounding global economy. Continuing the policies of the past may not get us there and a paradigm shift may be called for. The Government may therefore wish to re-examine and change where necessary, any policy that does not affect national security (in an era of peace, not war), sovereignty or personal freedoms, in its attempt to reach the goal. Bold new policies, but more importantly, implementation will be the key to success. The Government and the private sector now have a golden opportunity to propel Sri Lanka to its full potential.

A good start has been made with the cabinet of ministers being pruned down by almost half which, should help to streamline the administrative machinery. A recent public pronouncement that it is Government policy to allow overseas universities to operate campuses in Sri Lanka is a welcome development to help build the talent pool that the country needs to support the growth objective.

## Make doing business easy...

Targeted foreign direct investment will need to be attracted at an unprecedented level to complement domestic investment. In doing so, it is time for us to move away from the three traditional carrots, viz, cheap labour, tax holidays, and protection from competition that have been offered to investors both local and foreign in the past, although it is recognised that the last two may still need to be used sparingly and in a time bound manner for major projects. Instead, the Government can focus on improving the ease of doing business in the

country in general. In the latest study in this regard conducted by the World Bank Group, Sri Lanka was ranked 105 out of 183 countries surveyed. While the country ranked well when compared with SAARC countries, we badly lagged many ASEAN countries. Sri Lanka did particularly poorly in the areas of construction permits, enforcing contracts, employing workers, paying taxes and speedy reforms in these four areas could help to push Sri Lanka into the top 50 within a short time although reaching the top 25 should be the medium term goal. The private sector will have to play its part and become more innovative and efficient but the Government will have to provide the enabling environment for this to happen. Although this issue has already attracted the attention of the Government, best results may be achieved by setting up a high level task force along the lines of the Presidential Commission on Taxation involving both the public and private sectors, to speedily come up with specific recommendations and action plans.

### **Banks have to be ready to play a big role...**

One must not underestimate the role that has to be played by the financial services sector led by the banking sector which is the predominant provider of funding to the private sector. Achieving the growth objective of the Government will require bank lending to more than double to Four Trillion Rupees in the next five years. Only part of the required resources will be available from domestic sources. The domestic banks will have to tap international capital markets for the balance requirements. The impending

introduction of new accounting standards on fair value accounting and impairment measurement in 2011 may have an adverse impact on profitability of banks. All of these developments will dictate that banks be strongly capitalised and upgrade their risk management practices with special emphasis being paid to risk based pricing. The DFCC Group for its part has made significant progress in this regard by investing in building technical and human capacity in its Integrated Risk Management department and is using external expertise for implementing the new accounting standards in the financial year commencing 01 April 2011.

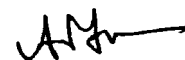
There is much global criticism of the performance of the banking sector with calls for greater regulation. In the case of Sri Lanka, apart from isolated cases of governance and control failure, private sector banks, that have recorded strong growth in the last decade, have discharged their fiduciary responsibility to depositors and other stakeholders quite well over the years without recourse to schemes funded by tax payers. While continuous improvement in regulation is important, policymakers should be mindful that regulation has both direct and indirect costs, sometimes arising from unintended consequences. Thus, striking the right balance between regulation and the need to permit the banking and financial service sector to support the growth strategy of the country will need to be carefully considered especially in the context that unlike global players, the domestic banking sector is not significantly exposed to complex derivatives and securitisation. If I may make a specific reference to the often referred to need for a deposit insurance scheme, it is hoped that any scheme that is introduced will not increase moral hazards by requiring soundly managed institutions to subsidise the weak.

### **Supportive Board of Directors, Employees, Central Bank and Government...**

DFCC is fortunate to have a Board of Directors with diverse skills and experience who are able to constructively challenge management whilst being supportive and who spare no effort to meet their responsibilities to shareholders and other stakeholders. My management team and employees always gave of their best to produce the results and I thank them. The Bank also received encouragement and support from the Central Bank of Sri Lanka and the Government for which I am thankful.

### **The future...**

The country is uniquely placed to leap forward and the DFCC Bank is very conscious of the role that it is mandated to play by supporting development to which we remain committed. However, the ground situation today is very much different to the situation that prevailed when the Bank was set up in the aftermath of World War II. Sustainability of the Bank requires it to be in a position to offer a wide range of services to its clients. In the coming year we will focus on the challenge of delivering on our development banking mandate while ensuring that our business model will ensure value addition to all our stakeholders.



**Nihal Fonseka**  
*Chief Executive*

26 May 2010