

CHIEF EXECUTIVE'S REPORT

MANAGEMENT INFORMATION

The financial year that commenced on 1 April 2010 held out great promise, while also posing some challenges that had to be faced. Good progress was made overall that positioned DFCC Group to reap the benefits of the post-war resurgence that gathered momentum during the year. A key event during the year under review was the disposal of part of the equity stake in a former associate company, Commercial Bank of Ceylon PLC (CBC), in which the ownership was reduced from 27% to 14%. With this change of ownership status, DFCC Bank (DFCC) will now focus on its subsidiary, DFCC Vardhana Bank Limited (DVB), to expand its commercial banking business. The successful TV reality quiz show "MindStar" and the larger foot print created with the help of our 75 post office outlets are effectively delivering this message.

DFCC will continue to concentrate on project lending and development financing activities, while DVB will further leverage the DFCC customer base and develop new relationships to provide working capital finance while also implementing strategies to increase its penetration of personal financial services, financing of international trade and payment services that are not catered to by DFCC. The necessary regulatory approval has been received for DFCC and DVB to go forward on the

basis of a single economic entity and to reinforce this concept the combined operations of DFCC and DVB will be referred to as the DFCC Banking Business (DBB) in this Report. Further, consistent with our accounting policy, the 'year under review' for DVB is the financial year ended 31 December 2010, while the corresponding period for DFCC is financial year ended 31 March 2011.

RECORD PROFIT BOOSTED BY A ONE-OFF GAIN

The DFCC Group recorded its best ever consolidated profit after tax of Rs5,171 million in the year under review, boosted by the capital gain derived by divesting part of the equity stake in CBC. This contributed an exceptional profit after tax of Rs5,361 million to DFCC, and a reduced amount of Rs3,001 million to the DFCC Group due to consolidation adjustments.

After eliminating gains from disposals of subsidiaries and associates, DFCC recorded a profit after tax of Rs1,776 million, an increase of 19.6% over the comparable profit of the previous year. Likewise, the combined profit after tax of DBB after normalising for one-off gains was Rs1,990 million, an increase of 15% over the previous year.

The key drivers of profitability of a banking business are credit growth, leverage, interest spread, credit quality, non-funds based income, cost/income management and taxation. These components are examined below in relation to the performance of DBB, DFCC and DVB.

HIGH CREDIT APPROVALS... WITH SIGNIFICANT DISBURSEMENTS YET TO COME

On-balance sheet credit facilities granted by the DBB recorded a modest increase of 16%, driven mainly by the credit growth in DVB which recorded an



increase of 30% that came largely from working capital and trade financing. Although the approval of new medium and long-term credit facilities by DFCC increased by 117% to Rs33,484 million, disbursements, especially those relating to larger projects, tended to lag and began to pick up only in the last quarter. This lag is normal due to the time taken for various preliminary steps that have to be completed before loans are drawn down. However, in the Small and Medium Enterprises (SME) sector that is catered to by our branch network, approvals and disbursements recorded increases of 113% and 98% respectively. The SME sector constitutes a significant proportion of total credit exposure of DBB. We continued to support this sector to promote equitable regional development, particularly the acceleration of economic growth outside the Western Province through employment creation and poverty reduction. A noteworthy feature is that our newly established business units in the Northern and Eastern Provinces

have provided credit facilities to local entrepreneurs well in excess of the deposits raised from those areas. This is at variance with the norm where banks generally use less developed areas for deposit mobilisation.

LOW LEVERAGE PROVIDES OPPORTUNITY FOR AGGRESSIVE GROWTH

From the perspective of generating an adequate return on capital, the large increase in regulatory capital following the reduction in our ownership of CBC proved to be challenging in the short-term. DFCC distributed part of the exceptional profit component as an interim dividend. The availability of some surplus capital at this juncture is an opportunity and DBB is embarking on strategies to increase leverage and grow the loan book more aggressively to the corporate and personal sectors.

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INTEREST SPREAD UNDER PRESSURE BUT CREDIT GROWTH WILL HELP

The progressive reduction in the Rupee interest rates during the financial year coupled with the high level of liquidity that prevailed in the banking system put significant pressure on lending rates since there was a time lag in re-pricing time deposits. Surplus funds of DFCC were deployed in relatively low yielding short-term Government Securities. The expected switching of these funds to customer loans & advances and the planned increase in leverage are expected to have a favourable impact on net interest income. DFCC also took steps to shed high priced customer and wholesale liabilities, while DVB was successful in increasing the share of lower costing savings accounts in its interest bearing deposits mix. Strategies

to further increase this ratio are being implemented, which will help DVB to progressively reduce its funding cost over the next few years.

CREDIT QUALITY IMPROVED, BUT IT IS STILL WORK-IN-PROGRESS

I am happy to report that concerted action taken during the year to improve credit quality have been successful. Non-performing credit exposure of DBB reduced from Rs5,682 million to Rs4,474 million during the year and the ratio improved from 10% to 6.6%. Although the ratio is somewhat higher than the average for commercial banks, it should be seen in the context of the dominant component of the DBB credit portfolio being the higher risk project finance related to development banking activities of DFCC. Further, a conscious decision was taken by DBB to continue to support the SME sector, where the non-performing loan ratio exceeded 20% at its peak in 2009. The approach has been to restructure these loans and assist the affected enterprises to return to financial viability. While this strategy continues to have a temporary adverse impact on the ratio, it is our belief that with the improving economic conditions, it will be more beneficial to DBB and its customers, as opposed to aggressively pursuing asset recovery. The non-performing loan ratio in the corporate banking portfolio was less than 1%. Provision cover ratio for DBB improved to 57% and the unprovided exposure as a percentage of equity improved to less than 4% from 13%. The Integrated Risk Management department has collected and analysed a significant amount of information relating to the performance of our credit portfolio in recent years and are in the process of refining the DBB risk appraisal models as part of the effort to continuously improve the management of credit risk.



GROWING FEE-BASED INCOME FROM CORE BANKING ACTIVITIES A PRIORITY

At DFCC and at the consolidated Group level the contribution made by 'Other Income' (excluding gains from disposals of subsidiaries and associates) improved significantly. DVB's trade finance and treasury operations benefited from Government's economic stimulus delivered through the reduction of duties and levies on imports, especially passenger cars. Finance of foreign trade has been identified as a key growth area for DVB. Fee income from personal financial services and payment services are still low but strategies to progressively grow the contribution by leveraging the recent investments made by DVB in expanding the branch network and technology are being implemented.

The DFCC Group is a significant player in the domestic investment banking space. Investment banking services are offered through an equally-owned joint venture, Acuity Partners (Pvt) Limited and its subsidiaries. It is a full spectrum investment bank with corporate finance, fund management, stock broking, primary dealership in Government Securities and private equity capabilities. The Acuity Partners Group returned an excellent performance in its financial year ended 31 December 2010, with a profit of Rs301 million compared to Rs84 million in the previous year, half of which is included in the consolidated income of DFCC Group.

COST MANAGEMENT LEADERSHIP

DFCC has always been the best in class in managing its cost to income ratio. This has been extended to the DBB, which posted a cost/income ratio of 37.5%, the lowest among domestic private banks operating in Sri Lanka. This was achieved through reaping synergies and shared services between DFCC and DVB. In fact, it is the first domestic banking business to hive off the entire spectrum of managing its Information Technology to a separate group entity.

This arrangement has allowed DBB to focus better on IT costs and optimise the return on IT investments.

REDUCED TAXES WILL IMPROVE FUTURE PROFITABILITY

The national budget proposals presented in November 2010 proposed far reaching steps to reform the tax structure in the country. The measures included a reduction in the standard corporate tax rate from a regionally high level of 35% to 28% and more importantly for banks, the reduction of the financial services value added tax rate from 20% to 12%. The latter was effectively an additional income tax, about which banks had made repeated representations over several years. These measures did not have a significant impact on the year under review but will benefit DBB going forward.

CONVERGENCE WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS

Of particular significance to banks is the impending adoption of Financial Instruments Standards and full convergence with International Financial Reporting Standards (IFRS) and International Accounting Standards effective from the financial year commencing 1 April 2012 in the case of DFCC. Further information is given in Notes to financial statements.

As regards fair value accounting, the concept of 'marking to market' certain financial instruments and all derivatives assumes the existence of deep and liquid markets which is not the case in Sri Lanka. According to some analysts the failure of markets to determine prices for instruments even in well developed markets exacerbated the global financial crisis. It is therefore important that adequate safeguards are adopted to reduce the risks and unintended consequences in the implementation of these global standards in Sri Lanka.

The policy of full convergence with IFRS by Sri Lanka may not necessarily be suitable for an emerging economy of our size. For instance it is understood that India, one of the largest emerging economies, has announced specific carve-outs with IFRS in the national interest. Appropriate amendments to tax legislation will also need to be undertaken as an integral part of the proposed convergence.

However, in view of the approaching deadline, DFCC Group is working with input from external consultants on this initiative and is on target to make the transition.

COST AND COMPLEXITY OF REGULATION CONTINUE TO INCREASE

A consequence of the global financial crisis of 2008 was the tightening up of regulations governing banking and capital markets and Sri Lanka is no exception in this regard. A mandatory deposit insurance scheme for banks and deposit takers became effective in October 2010. Although an added cost, it is encouraging that the premium payable was linked to the level of capital adequacy. It is hoped that a more refined differential cost structure based on financial strength will be progressively introduced to reduce moral hazard.

Although there is a fair amount of dialogue between the regulator and regulated, the hidden cost of regulations does not appear to be getting sufficient attention. These arise, for instance, from the same entity coming within the purview of multiple regulators requiring duplication and overlap of compliance and disclosure requirements. The Inter Regulatory Institutions Council can be a useful forum for greater interaction among regulators to reduce such overlap. The dispensation given to banks by the Colombo Stock Exchange from complying with its own corporate governance rules and disclosures taking into account the mandatory Directions on Corporate Governance applicable to banks, is an example of the benefit arising from dialogue.

There is an increasing trend in recent times to shift from principles based to rules based regulations and the latter do appear to be more effective in Sri Lanka. Although prudential requirements have to be specified by rules, consideration should be given to formulating regulatory frameworks in respect of operational and oversight aspects in a manner that provides flexibility depending on the risks associated with business models, scale of operations and the capital cushion.

THE WAY FORWARD

The development plans for the country are ambitious but achievable if there is a concerted effort and a unity of purpose. The financial services sector too has an important role to play here, as credit disbursed by the banking sector will need to more than double in the next 5 years. This will require banks to significantly increase their capital and risk management capabilities. The DFCC Group is well placed on both counts. Capital formation in the private sector will also be an essential ingredient to undertake this development journey. DFCC has over the past 55 years played an integral role in this aspect and remains committed to do so in the next wave of development as well, through a sustainable business model serving the interests of all its stakeholders.

THE TEAM EFFORT

The Chairman and Directors including those who relinquished office during the year were very supportive and looked after the interests of stakeholders. My colleagues in the Management Team and employees worked tirelessly and I express my sincere gratitude to them. I also acknowledge with appreciation the support provided by the Government and the Central Bank of Sri Lanka for our various initiatives.



Nihal Fonseka
Chief Executive

30 May 2011