

RISK MANAGEMENT

MANAGEMENT DISCUSSION AND ANALYSIS

GOVERNANCE STRUCTURE FOR RISK MANAGEMENT

The Governance structure for risk management at DFCC Bank (DFCC) and DFCC Vardhana Bank (DVB), collectively referred to as the DFCC Banking Business (DBB) in this review, encompasses the concept of 'Three Lines of Defence', and is based on the four fundamentals of Board and senior management oversight; risk management policies and procedures; risk measurement, monitoring and controls; 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 day-to-day management of business operations. Independent risk monitoring, validation, policy review and compliance by the Integrated Risk Management Department (IRMD), the Compliance Function and periodic monitoring and oversight by the Board Integrated Risk Management Committee (BIRMC) and the 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.

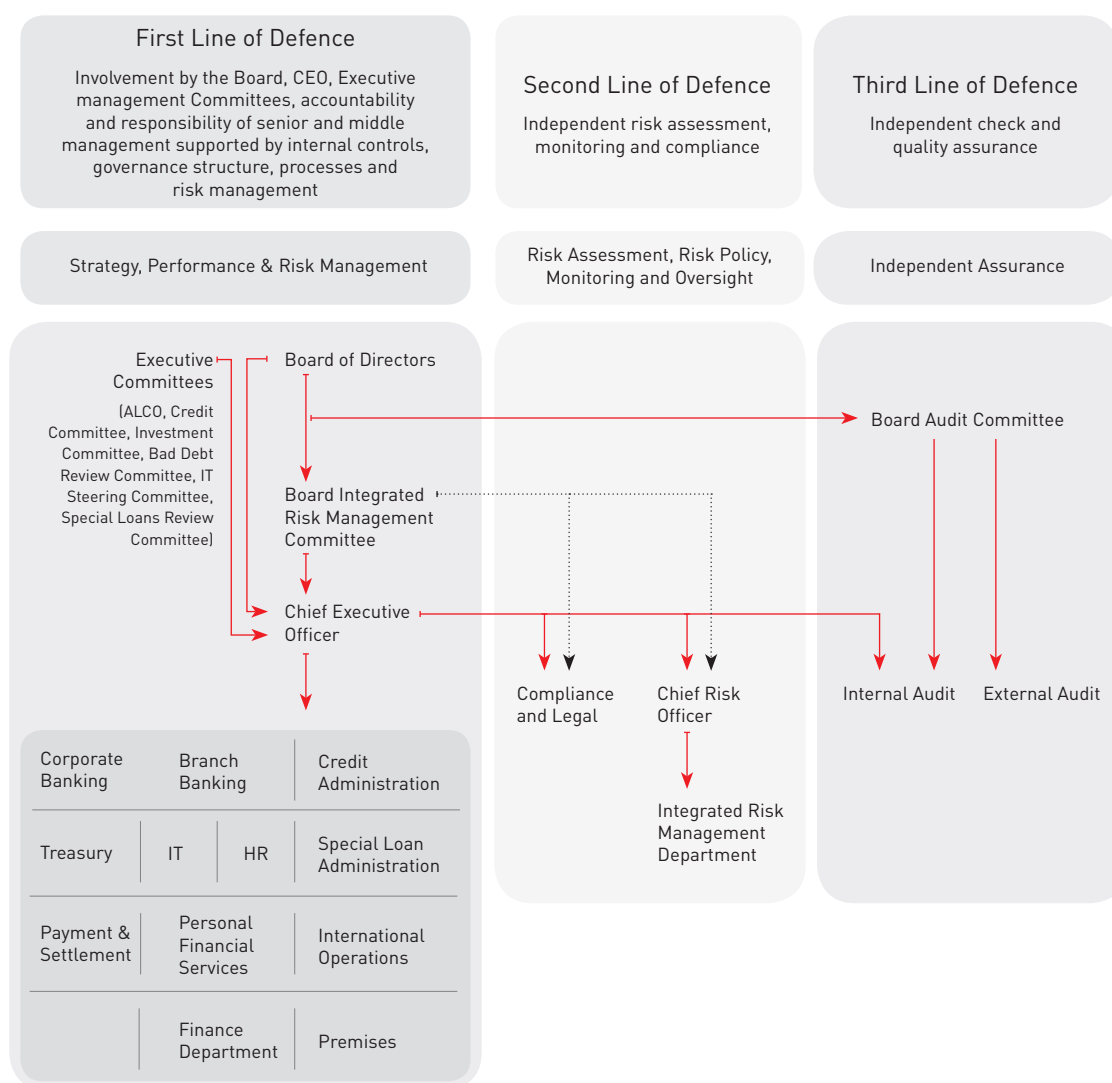
The Chief Risk Officer, who is a Senior Vice-President, has been designated a Key Management Personnel and administratively reports to the Chief Executive but with functional reporting and access to the BIRMC. The BIRMC functions under the responsibilities set out in the Board-approved Charter for the BIRMC, which incorporates corporate governance requirements for Licensed Specialised Banks issued by the Central Bank of Sri Lanka (CBSL). The executive committees such as the Asset Liability Management Committee (ALCO), Credit Committee, Investment Committee, Bad Debt Review Committee and Special Loans Review Committee are guided and operated within risk frameworks and limits set out by the Board and the Board Committees.

BIRMC reviews the adequacy and effectiveness of the executive committees. IRM representatives serve in these committees. Design or redesign of asset and liability products of the DBB involves a structured process set out in the new product development policy, in which the overall risk exposure of the product forms a part of the assessment prior to the product launch. IRMD is responsible for measuring and monitoring risk at operational level on an on-going basis to ensure compliance with the parameters set out by the Board/BIRMC and other executive committees. The structure for the Integrated Risk Management Function is evolving to be in line with the Basel II recommendations.

DEVELOPMENTS

The DBB continued to review its overall risk management and the business functions in line with internal developments, regulatory requirements, industry factors and international best practices. During the year, several new policy frameworks, manuals, guidelines and limits were introduced while amendments were made to the existing

GOVERNANCE STRUCTURE FOR RISK MANAGEMENT IN DFCC BANKING BUSINESS



policies and guidelines. Quantitative measures for risk management were improved and an effective blend of quantitative evidence and expert knowledge was built to facilitate the DBB's operations. The DBB's risk-based pricing and business strategies were re-evaluated more frequently at the relevant executive committees with inputs from the business and IRMD. Key industry sectors were studied to recognise vulnerabilities and opportunities in the light of local and global sources of risk. These studies were communicated across the DBB and were taken into account in strategy formulation and business planning.

The establishment of an independent credit rating review process within the IRMD was a key improvement during the

year to DFCC's credit appraisal process. Credit proposals which are submitted to the Credit Committee go through this rating review process. Independent credit rating review, which had already been adopted by DVB, is in line with the Basel II recommendations for credit risk management. Credit audit activity, which was initiated during the year as a part of Internal Audit, would provide a risk-based post-sanctioning evaluation for credit proposals.

Use of internally developed credit rating models, as a credit risk quantification tool, has been a part of DFCC's risk management practices for nearly a decade. These models warrant periodic reviews and adjustments to improve the discriminatory power in line with the

changes in the Bank's business focus and external factors. Such reviews are a pre-requisite when implementing Advanced Approaches of the Basel II. DFCC's credit rating models were back-tested during the year with an extended data sample. Back-testing results were used to bring about necessary improvements to the credit rating models and the credit appraisal process. Equipped with the study findings, and DFCC's historical borrower data, DFCC commenced realigning its existing credit rating models. Model realignment in DFCC was carried out in two parallel exercises involving support from external experts and mobilising internal expertise. Historical borrower data and expert knowledge from business functions were utilised with particular attention paid to

the Basel II recommendations for model development and usage. DFCC built up a database for historical borrower data, which were used for the model realignment process.

Probability of Default (PD) and Loss Given Default (LGD) were computed for the DFCC's credit portfolio covering an extended data sample. The PD - a credit risk component-based on the borrower rating, was separately assessed for corporate borrowers and the SME borrowers. LGD assessment during the year separately covered the DFCC's lease facility data and the loan portfolio. The resultant LGD values were evaluated in the dimensions of collateral type, region, branch, exposure at default, etc. Findings of this credit risk quantification will be used by the DBB in its future business decisions and risk management practices. Historical loss database constructed through LGD computation will facilitate the impairment loss assessment under the IFRS implementation.

The DBB has now successfully completed the initial phase of capacity building in the risk management and Basel II awareness through local and foreign training, knowledge sharing and increased cadre positions to cater to the scope of the Integrated Risk Management function and organisational needs.

THE DFCC GROUP'S RISK- BASED CAPITAL ADEQUACY

The DBB continued to maintain a healthy risk capital position on a solo and group basis computed under the simplest approaches of Basel II. During the year, the Group's total regulatory capital base grew by 37% to reach Rs20,403 million as at end March 2011 while total risk weighted assets grew to Rs78,897 million by 22.5%. The part divestment of DFCC's investment in Commercial Bank of Ceylon PLC was the

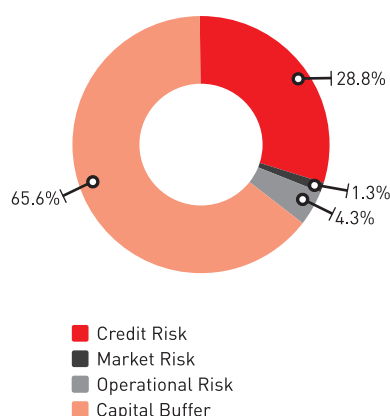
main cause for the growth in the capital base. Increase in on-balance sheet commercial lending, off-balance sheet credit exposure and risk-weighted assets for market risk were the main causes for the growth in total risk-weighted assets of the DBB. The risk capital base of the Group indicated a high level of risk absorption capacity and will enable DBB to increase leverage and exploit the anticipated growth in credit in the medium-term.

DFCC GROUP REGULATORY CAPITAL RATIOS

under the simplest approaches of Basel II as at 31 March

	2011	2010
Core capital	26.7%	26.2%
Total capital base	25.8%	23.1%

THE GROUP'S REGULATORY CAPITAL ALLOCATION AND AVAILABLE CAPITAL BUFFER AS AT MARCH 2011



Stress-testing carried out during the year for DFCC and DVB on a solo basis indicated a healthy capital cushion above regulatory minimum capital requirement even if the worse case scenarios, as per the specification of the CBSL, for all key risk categories crystallised at the same time.

THE DBB'S PROCESSES FOR RISK MANAGEMENT

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 DBB, and accounted for 83.7% of risk-weighted assets as at end of the financial year.

The use of internal rating models and the periodic review of assigned ratings by the DBB form the basis for risk profiling of borrowers for the purpose of managing credit risk through structuring, pricing, monitoring, restructuring and recovery action. A well-structured approval process is in place, guided by the Delegation of Lending and Related Authority limits based on risk categories. No single person can originate and approve the granting of credit. Approval of large value credit exposures is undertaken by the Executive Credit Committee or on its recommendation by the Board of Directors. Concentration risk is currently managed and monitored in terms of single borrower limits, group limits and sector limits. Herfindahl-Hirschman Index (HHI) - an internationally accepted technical measure, indicated a satisfactory granularity of the DBB's credit portfolio among different industry sectors. Of the DBB's portfolio, within the project financing segment and the commercial banking segment, the HHI indices were 0.085 and 0.047, respectively, as at March 2011. DFCC has recognised in its credit policy some sectors as 'Special Clearance' which are considered for

lending only after a special assessment process and 'Negative List' which are not considered for lending. Such sectors or credit products have been categorised based on the country's laws and regulations, DFCC's corporate policies and values and the levels of risk exposure. Information on key sector exposures is given in the section on Operations Review.

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 DBB's exposure to market risk is primarily governed by a Market Risk Management Framework, provisions in the ALCO Charter and risk limits. The ALCO and Investment Committee oversee the management of both the traded and the non-traded market risk. The DBB treasury manages the foreign exchange risk arising in the banking book with permitted hedging mechanisms. Tools such as supervisory monitoring, exposure limits, stop-loss limits, simulation, scenario analysis, stress-testing and marking-to-market are used to manage the market risk exposures. The DBB's foreign exchange assets comprising less than 5% of total assets and liabilities are substantially matched or hedged through various mechanisms. The market risk exposure arising from exchange rate movements is insignificant.

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 DBB maintains the Trading and Investment (held to maturity) portfolios

separately with regard to fixed income securities. The Assets and Liability Management Unit regularly assesses the Bank's asset and liability profile in terms of interest rate risk and reports 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 re-priced periodically linked to a benchmark rate. Statistical methods such as scenario analysis, simulation and stress-testing are used by the DBB in managing interest rate risk.

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 of DFCC is responsible for making investment decisions and monitoring the DFCC's 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. DFCC's long-term investment horizon for equity investments smoothens out the adverse implications of short-term market volatility. Further, the DVB assumes equity price risk indirectly through its margin lending in the event of crystallisation of credit risk of margin borrowers. This indirect equity exposure of DVB is managed through the specific margin trading guidelines under the supervision of the Credit Committee. The DBB's total direct exposure to equity prices risk through the equity trading portfolio and the investment portfolios accounted for 6% of the Group's total assets, inclusive of DFCC's residual investment in Commercial Bank of Ceylon PLC. However, this equity portfolio marked an unrealised capital gain equivalent to several times of its carrying value as at 31 March 2011. DFCC does not engage in active trading of equities; however,

Directions issued by the Central Bank of Sri Lanka necessitate the transfer to a trading portfolio and marking to market of certain residual equity holdings.

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 DBB has a well-set out Framework for Liquidity Risk Management and a Contingency Funding Plan. The liquidity risk management process includes regular analysis and monitoring of the liquidity position and maintenance of market accessibility. Regular cash flow forecasts, liquidity ratio and maturity gap analysis are used as analytical tools by the ALCO. The DBB introduced a scenario-based approach for liquidity risk management in which scenarios are recognised in the light of internal liquidity conditions under the different market liquidity conditions for applicable liquidity risk limits. Whilst comfortably meeting the regulatory requirements relating to liquidity, for internal monitoring purposes, the DBB takes into consideration the liquidity of each eligible instrument relating to the market at a given point in time as well as undrawn commitments to borrowers when stress-testing its liquidity position. The maintenance of a strong credit rating [AA(lka)] assigned by Fitch Ratings Lanka, unchanged since January 2003 and reputation in the market enables the DBB to access domestic wholesale funds when needed to supplement its traditional funding sources from multilateral and bilateral sources. For short-term liquidity support, the DBB has access to the money market at competitive rates. The diversification of the liability structure is also a key focus of the DBB and access to retail deposits is being effected through expanding the reach of DVB as well as sourcing foreign currency denominated funding to complement the base. A substantial proportion of DFCC's funding is from medium to long-term sources. This reduces its liquidity risk in the short-term. If the necessity arises,

DFCC's finance lease portfolio can be securitised to generate liquidity. DFCC's risk-based pricing mechanism ensures that residual liquidity risk is duly priced when pricing assets.

OPERATIONAL RISK

Operational risk arises from human activities, technology and natural incidents. The sources of operational risks include fraud, 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. Effective internal control systems, supervision by the Board, senior management and the line managers form a part of 'First Line of Defence' for operational risk management at DBB. The DBB 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 DBB'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 DBB'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. A Communication Policy that addresses aspects of reputation risk is

in place. Policies and standards relating to the conduct of the DBB's business have been promulgated through internal communication and training. A culture of compliance permeates all levels of the DBB, 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 DBB's medium-term strategic plan and annual business plan form a strategy road map for sustainable growth. Diversification into related financial services through subsidiaries, associates and joint ventures, continuous competitor and customer analysis, and monitoring of the macroeconomic environment enable the DBB to formulate its strategies for growth and business risk management. The DBB's Planning & Plan Implementation Department oversees this process and information technology is used to support the budgeting, planning and variance analysis. Business risk relating to customers is assessed in the credit rating process and is priced accordingly.

LEGAL RISK

Legal risk arises from unenforceable transactions in a court of law or the failure to successfully defend legal action instituted against the DBB. 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 design stage of transactions to minimise legal risk exposure. In the event of a legal risk factor, the Legal Department of the DBB 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 claims on the DFCC.