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No. of Pages = 28

The Institute of
Chartered Accountants
of Sri Lanka

MULTIDISCIPLINARY CASE STUDY EXAMINATION
MAY 2010

ADVANCE INFORMATION

Derana - Brink

VC consults Holmes Coal successfully!

You are Dinesh Chandraratne, working as a final-year student for the Chartered Accountancy practice of Sanath Dayananda, a national firm with offices in Colombo, Galle and Kandy. Your firm is the Sri Lankan member of 'Vision Capital', a UK based corporate consulting group. Vision Capital UK is headed by a globally recognized author on Strategic Management. You are based in the Colombo office and are currently working for Ms. Sandani Gamage, a senior manager working for Mr. Jon Lloyd- the UK representative and the head of the Business Advisory department of the firm. In the past few years Ms. Sandani Gamage has been increasingly successful in obtaining work as advisors in the whole arena of business development : Initial Public Offers, Investments, Risk Management, Governance, Due Diligence, Restructuring and many other advisory assignments. The expertise acquired can now cover all aspects of client advisory work from financial, through legal to public relations, at all stages of any business development. You have a B.Sc. in Management from a leading Sri Lankan University. You began working in the audit and assurance division before moving into the business advisory department twelve months ago. Your recent work has included assisting Ms. Sandani Gamage in an investment advisory assignment for a UK based client, Holmes Coal & Studland PLC who invested $ 100 mn in convertible debentures of Domestic Energy PLC (as recommended in the report compiled by your division). Domestic Energy PLC was successful in the Initial Public Offer subsequent to the investment by Holmes Coal. You were involved in the analysis and review of the coal power project proposed by Domestic Energy PLC and in the assessment of market conditions in order to advise the UK investor.

Derana Bank PLC

Derana Bank (DB) was founded in July, 1979 under the new economic policy implemented by the then government of Sri Lanka. By far the most significant event in the past two - year period for DB was the bankruptcy of Sisil Group, one of the bank's largest borrowers. The legal actions against DB created a customer panic and the price of DB stock plummeted. End of 2009, Mr. Milton Meegoda (MM), Chairman of DB was reflecting on the last two chaotic years, by far, the most challenging years in the 30-year history of Derana Bank. However, what was uppermost in Mr. MM's mind were the many problems that DB had to face, even in the absence of the crisis, most notably, the exposure of DB to Sisil Group, whose bankruptcy in 2008 threatened the very existence of DB. Not only was DB's exposure to Sisil disproportionately large, but also this large exposure was allegedly funnelled by large commissions received by the previous CEO of

DB. The CEO of DB was arrested early 2008 for his involvement in the case. Was this issue something that DB would be able to disassociate itself from and move forward, or was this something that would linger and might manifest itself in a different way in the future? Were there other types of operational risk that the bank had yet to identify? What could the Sri Lankan government or the regulators have done differently, so that DB would not have reached this crisis? (Exhibit 1 – (Tables 1 to 7)shows some of the relevant financial information). The DB as a licensed commercial bank was always under the supervision of the Central Bank. There was a fundamental problem with the finances of the bank, a possible liquidity problem owing to a possible run on the bank due to panic among customers. The following table shows the drop in Market share in terms of Deposits for DB.

	Market Share of Deposit Products		
	Current Accounts	Savings Accounts	Fixed Deposits
2005	7.44%	6.63%	7.09%
2006	5.97%	6.54%	7.58%
2007	6.81%	5.90%	7.22%
2008	5.69%	5.41%	6.52%
2009	4.86%	4.58%	5.31%

The estimated exposure of DB to Sisil Group was about Rs. 16 billion. Sisil was established in 1980 as a construction company by Ms. Sisil Kirillawala, who took advantage of her government contacts to obtain scarce bank capital from state-controlled banks. Sisil expanded into other unrelated businesses acquiring a pharmaceutical company in 1993, and a mutual savings and finance company in 1994 and a real estate development company in 1997. The debt to equity ratio of Sisil Group shot to 1600 percent. Analysts were puzzled by the lending of billions by Sri Lankan banks without a feasibility study of the Group projects and without securing adequate collateral for the loans. It was obvious that the banks did not pay any attention to the government restrictions on excessive lending. Sisil has had a very close relationship with DB, its main creditor. In 2003, when a big construction company, Commercial Property Developers (CPD) Limited, went into bankruptcy and was a serious risk to DB on account of non- performing loans and earnings, Sisil acquired CPD to decrease DB's exposure. In 2005, four former executives of DB were sued for negligence in the Sisil Group loan case, believed to be the first such lawsuit in Sri Lanka. Two former executives of the bank who were mentioned in the lawsuit were already convicted for accepting bribes from Sisil for the grant of such loans. A picture of DB as reflected by its stock price during 2002- 2009 is shown in Exhibit 1 (Table 2) in a **two scale graph**, along with the Sri Lankan All Share Price Index for comparison. Mr. MM was wondering whether the credit policies of DB were in need of complete overhaul so that DB would never again experience any such threat to its existence as the one that originated with Sisil. He was wondering whether the asset base was sufficiently diversified or whether there were hidden risks.

Banking Industry in Sri Lanka

The banking sector is one of the most dynamic and vibrant sectors of the economy, with developments taking place during the last decade in terms of institutions, instruments, range of services, and the geographic coverage. Financial sector reforms have been introduced to improve the efficiency and stability of the financial sector and further reforms are under way. Commercial banks, development financial institutions, merchant/ investment banks, finance companies, leasing companies, mortgage banks, venture capital companies, savings banks and pension funds are the system contributors. The Central Bank is the apex institution in the financial system of Sri Lanka. At present there are 22 commercial banks in operation in the country. Eleven of these are locally incorporated and the balance are branches of foreign banks. Two of the local commercial banks are state owned. Rapid technological advancement including an automated cheque clearing house that clears cheques from most part of the country within three days, ATMs, credit cards, electronic funds transfer facilities and several financial derivatives are evidence of this. 2009 reports revealed the following data.

ATMs per 100,000 persons	9.6
Credit cards in use per 100,000 persons	4,110
Banking density: No. of commercial bank branches per 100,000 persons	10.8

Several banks have introduced tele-banking and electronic business banking and many have extended banking hours with some services being made available 24 hours a day through automation. Almost all commercial banks have established Foreign Currency Banking Units. The development financing institutions, in Sri Lanka are the Development Finance Corporation of Ceylon (DFCC) and the National Development Bank (NDB).They provide medium and long-term project finance, especially to the export sector. Merchant/ Investment banks offer a wide array of services including identification and financing of projects, leasing, bill discounting, underwriting share issues, margin trading facilities, loan syndication, bridging finance, participation in project equity, other forms of project finance, managing private share issues /placements, financial and management consultancy services etc. Finance companies engage primarily in short-term lending and hire purchase activities. Activities of finance companies are monitored by the Central Bank. Leasing companies specialising in lease finance mainly for commercial vehicles and equipment purchases are in operation in Sri Lanka.

Other financial institutions such as commercial banks, merchant banks and finance companies too provide leasing facilities.

The State Mortgage and Investment Bank (SMIB) provides long term finance primarily for housing purposes. In addition SMIB provides other loans for agricultural purposes. The state owned National Savings Bank (NSB) is the leading savings bank in Sri Lanka. Its primary activities are accepting various savings deposits from the public, investing in government securities, and investing in long-term debt instruments.

The regulatory and supervisory framework for banks is specified in the Banking Act, Monetary Law Act and the Exchange Control Act. The Central Bank issues banking licenses for two categories of banks, Licensed Commercial Banks (LCB) and Licensed Specialised Banks (which are savings and development banks). The main difference between a Licensed Commercial Bank and a Licensed Specialised Bank, is that the former is permitted to accept demand deposits from the public (operate current accounts for customers) and is an Authorised Dealer in foreign exchange which entitles it to engage in a wide-range of foreign exchange transactions, whereas the latter is not. The regulatory and supervisory function relating to banks licensed by the Monetary Board is carried out by the bank supervision department of the Central Bank. The supervision of banks is based on the internationally accepted standards for bank supervision set out by the Basel Committee for Banking Supervision. Under the off-site surveillance system, the financial condition of Licensed Commercial Banks and Licensed Specialised Banks is monitored on the basis of periodic information provided by banks on their operations. The periodic information includes weekly interest rates of deposits and advances; monthly returns on selected financial information, assets and liabilities and statutory liquid assets; quarterly returns on income and expenditure, capital adequacy, non-performing advances, classified advances and provisioning for bad and doubtful advances, investments in shares, accommodation granted to bank directors, their close relatives and concerns in which a director has a substantial interest and interest spreads; half-yearly return on share ownership of the banks and annual audited financial statements. In terms of the provisions of the Banking Act and the Monetary Law Act, all Licensed Commercial Banks and Licensed Specialised Banks are subject to statutory examinations, at least once in two years. A new approach to on-site supervision has now been adopted - the risk based examination process, which focuses on identification of banking risks, the management of these risks and the assessment of adequacy of resources to mitigate these risks. This is supplemented by examination based on the internationally accepted CAMEL model (Capital Adequacy, Asset Quality, Management, Earnings, and Liquidity). In addition, a bank's compliance with statutory requirements, applicable laws and regulations, internal controls and the standards of corporate governance are assessed. Matters relating to non-compliance with prudential requirements and any weaknesses and deficiencies in the financial condition, controls and systems of a bank are brought to the notice of its Board of Directors, by the Central Bank to ensure that corrective action is taken by the bank. Licensed Commercial Banks and Licensed Specialised Banks are also required to publish their quarterly and annual audited financial statements, including key performance indicators, in the newspapers, in all three languages, within two months of the end of each period.

The banking sector in Sri Lanka, dominates the financial system and accounts for about Rs. 3 trillion (58%) of total assets of the financial system. Exhibit 2 – (Tables 1 & 2) indicates the performance of the sector and companies for the past five years. In terms of the asset base and the magnitude of services provided, the LCBs are the single most important category of financial institution within the banking sector. Sri Lankan banking sector too was not exempt from the credit crunch that resulted due to the effects of the US sub –prime mortgage market crisis. The drying up of liquidity in some banks was witnessed during the past couple of years though locally operated banks did not have direct exposure to the US mortgage linked securities. According to the Central Bank annual report -2008 the domestic financial system also came under stress due to liquidity problems faced by commercial banks and failure of some unauthorized finance businesses during 2008. The much-publicized collapse of finance companies in 2008 had focused on deposit-taking financial institutions. As the public rapidly lost confidence in the financial system, many depositors had scrambled to safeguard their money amid rumours of lengthy queues at many deposit-taking institutions. As a result of sudden and substantial withdrawals, many of these entities faced liquidity pressures. However, well-rated and/or prudently managed financial institutions had been able to withstand the pressures better than others. The finance leasing industry also has been playing an important role in the Sri Lankan economy since the early 1980s. The Finance Leasing Act provides for safeguarding the interests of the parties involved in finance leasing transactions and also for registration, regulation and supervision of the institutions engaged in finance leasing business by the Central Bank. Central Bank mentions in the monetary and financial policy;

> *"We plan to further strengthen our payment and settlement systems (PSS) in 2010. Accordingly, to ensure the operational reliability of PSS, we will continue our business continuity policy in 2010 and submit an annual inspection report on Business Continuity Plans (BCP) and Disaster Recovery Sites (DRS) of LankaClear and all LankaSettle participants. We will continue to supervise and oversee the compliance of the participants with the regulations imposed on credit/debit cards and mobile payments and submit an annual examination report on card based payment operations. At the same time, we intend to submit a half yearly inspection report on Lanka Financial Services Bureau (LFSB) in 2010 to ensure smooth operations of SWIFT system with availability of prime connectivity and fall back option for mitigating operational risk from failure of SWIFT services. Based on the results of the on-going survey on cheque realisation under the T+1 rule, which is scheduled to be finalized by end January 2010, further corrective measures are expected to be implemented to ensure that all banks fully adhere to the T+1 rule. In 2010, we intend to expand the Know Your Customer (KYC)/Customer Due Diligence (CDD) cover to money changes,*

primary dealers, the leasing industry and the gem and jewellery sector. We also intend to enhance institutional capacity building and carry out an assessment of money laundering and terrorist financing risk of the country. Continuing the current efforts, we would take further steps to enhance international cooperation in exchanging financial intelligence."

The 'Pramuka' –The 'First' Collapse

Pramuka Savings & Development Bank (PSDB) had an employee strength of 160 personnel with 15,000 account holders at the time of liquidation. This was one of the few specialised 'savings' banks which commenced operations in Sri Lanka with savings schemes, deposit schemes, other services and credit facilities for its customers. PSDB, being the first Specialised Bank, has approached poor borrowers in the villages, through the establishment of agencies at village level and the use of incentive payments for agents. According to reports, within the first five years the bank has grown steadily having total assets exceeding Rs. 3,700 million. Pramuka Bank collapsed in October 2002 with 'bad debts' amounting to Rs.2.2 billion. It has been revealed that PSDB's Non-Performing Advances (NPA) amounted to Rs.1.27 billion. The amount of interest recognized as revenue on these facilities amounted to Rs.93.6 million. The NPA ratio which was initially at 25% has risen to 50% overnight and at the time of collapse it was at 80%. Central Bank (CB) confirms that as a result of bad debts, PSDB stood to lose Rs. 419.7 million, resulting in a ***negative net-worth*** position of Rs. 230.6 mn as at 30 September 2002. PSDB was unable to maintain the minimum statutory liquid asset ratio of 20%. The bank invested 13.9% of the capital funds (which stood at only Rs. 251.8 million), in Pan Asia Bank whereas the CB allowed only 10% of capital funds in the equity of a single unquoted company. The bank also violated directions issued on the single borrower limit when it had authorized 22.5%, of PSDB's capital funds to be lent to Vanik Incorporation Limited, which was financially unstable. The Pramuka Bank Restructuring Committee (PBRC) had proposed to convert 50% of the deposits into share capital or debentures which would improve the 'Capital Adequacy" status. A proposal submitted by Asia Capital Ltd., on the restructuring of PSDB, has suggested to converting 50% of the larger deposits into share capital at a premium of Rs. 5/- and to write-off part of the borrowings. The auditors drew attention to the involvement of 15 related parties in the bank, and had also qualified the controversial investment of staff provident fund monies which were drafted into the bank's own shares and unsecured debentures.

Sampath National Bank PLC

Sampath National Bank (SNB) was the third largest financial service institution in 2009 rankings. SNB was regarded by many as one of the most innovative bank. Their annual report said,

> "…dream 2010, committed us to expand from commercial banking into investment banking and wealth management for private clients, and to expand internationally. At the same time, it committed us to move out of corporate banking activities where there were lower yields and higher costs…."

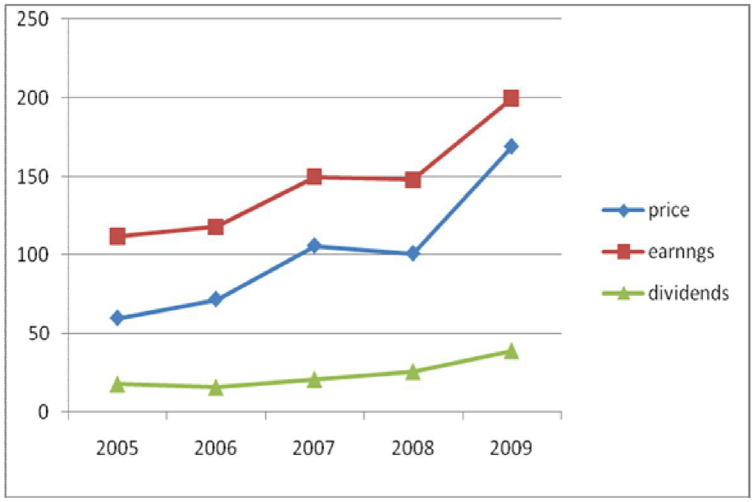
This involved creating a number of new management instruments and processes that were necessary to measure the sources of profitability and promote greater performance orientation. According to its Medium-Term Strategic Goals and Guidelines, the core businesses are;

- Asset Management for Private and Institutional Investors
- Investment Banking
- Retail & Commercial Banking

In the core businesses, the bank wants to be among the leading top quality banks. In selected areas, the bank is a trendsetter. The bank's aims as published in the annual report are:

- To capitalize on business opportunities and systematically exploit potential for improvement in order to achieve a minimum of 12% p.a. increase in the shareholder value of the SNB
- To achieve a balanced risk/return ratio through well diversified earnings streams with annual volatility in net profit of under 30%
- To focus the resource allocation and corporate financial management processes on providing cost-efficient equity to the business activities, to avoid excessive equity surpluses and achieve a medium-term after-tax return on equity of 15%
- To achieve a fair market value for the businesses through wide-ranging disclosure of specific business strategies and results
- To uphold bank's premier ratings on the financial markets by applying a prudent risk policy
- To keep the net costs of corporate management as low as possible through a Corporate Center dedicated to adding value

SNB operates through 109 branch offices in Sri Lanka. Fitch Rating Lanka Limited has affirmed National Long Term Rating of AA- (lka) to SNB. SNB has 68,887,628 ordinary shares in issue, 15,000,000 Unsecured Subordinated Debentures of Rs.100/- each - 2006/2011 (Listed) & 2007/2012 (Listed). The market behaviour and other information of the bank are illustrated in the figure below.



Kahatota Investments Limited (KIL).

In May 2007, SNB announced an agreement to acquire KIL for Rs. 160 million. KIL was an investment bank specializing in advisory work and the underwriting of debt and equity offerings. By acquiring KIL, SNB aimed to leverage the firm's 'blue-chip' brand name with other corporates, and thereby help to strengthen its corporate finance business locally and globally.

Exhibit 2 (Tables 4 & 5) gives the recent income statements extracts and the balance sheets respectively of SNB.

Resource Bank PLC

Resource Bank (RB), provides banking and related services in Sri Lanka and internationally. The company's corporate banking services and products include working capital/operational finance, trade finance, project lending, lead financing for syndicate loans, standby letter of credit/bank guarantees, leasing, custodian services, and various forex/treasury products. Its activities also include offshore banking, mortgage financing, lease financing, corporate financing, dealing in government securities and quoted equities, pawn broking, stock broking, providing life and general insurance services, property development, credit card facilities, personal financial services, foreign currency operations, trade services, investment banking, development banking, rural finance, remittances and foreign currency related services, project finance, and other financial services. RB was founded in 1988 and is headquartered in Colombo, Dr. Fernando, an economist and the Chief Financial Officer of RB did a presentation at a national conference recently. The power point slides of the presentation included the following slides.

Global Financial Services Industry

- *Further deregulation was the norm in developed countries:*
  - *financial markets are self correcting, and*
  - *financial innovation is required to minimize risks*
- *Rapid expansion of debt was facilitated by the shift from traditional 'buy and hold' financial model to 'securitization' model*
- *Much faith on the Information Revolution by IT that risks can be overcome and prevent bubbles from causing disruptions in the financial market*
- *global financial instability will prevail from time to time*

Sri Lankan Scenario

- *Domestic financial sector is not sophisticated; it is at early stages of development and due to regulatory failures, SL faced a homegrown financial problem.*
- *Banking system dominates the financial system*
  - *13% of financial assets controlled by the Central Bank,*
  - *58% by other commercial banks*
- *Venture capital, unit trusts, etc. are negligible in terms of controlling financial assets*
- *The bond market is dominated by debt securities of the government; the corporate bond market is relatively underdeveloped, with the corporate sector relying on bank credit*
- *Securitization remains at the early stages of development*
- *Contractual savings (including insurance and provident and trust funds) account for 21% of total financial assets*

Recent Instability

- *SL financial structure is governed by*
  - *Banking Act, Securities and Exchange Commission Act, Insurance Act, etc.*
- *They are sound in paper, but there are challenges when it comes to enforcement and there are legal loopholes*
- *Homegrown problems of the financial sector were due to a regulatory failure.*
- *There were voluntary codes of corporate governance put into effect by the SEC and ICASL in 2002 and the CSE for listed companies in 2007.*
- *The regulation and supervision of financial conglomerates are becoming increasingly complex due to systemic risks that arise from the inter-related nature of their activities. Large number of cross-shareholdings, common directors, and inter-company transactions are areas that need attention because conflict of interest and abuse of power are not conducive for financial stability*
- *Non-disclosure of related party lending.*

Exhibit 2 (Tables 4 & 6) gives the recent income statement, extracts and the balance sheets respectively of RB.

Business Bank PLC

Business Bank (BB) recorded solid compounded annual growth rates in the past 5 years: Gross Income 29%, Profit Before Tax and Profit After Tax 24% and 20%, Assets 15%, Return on Average Shareholders' Funds 15%. Healthy Tier I and Tier I & II Capital Adequacy Ratios in the past 5 years, over the minimum percentages stipulated by the CBSL. The Bank has 181 delivery points and 346 ATMs. It has invested over Rs. 3 Bn in state-of-the-art technology in the last 10 years. It is accessible to anyone with an Internet connection, 24 hours a day 365 days of the year. On-line banking now allows a wide array of transactions at the click of a mouse. Apart from several accolades won in Sri Lanka, BB was able to manage Bangladesh operations as one of the best rated banks in a space of 5 years. All of these have been achieved in the midst of volatile macroeconomic conditions. The bank's strategy is: to be robust and resilient; to expand international operations and widen global presence; to enhance delivery channels and product range; to look at new market segments and to reduce risks and costs and maintain high service standards. All this while building on high performance work and ethics culture and continuing to discharge larger responsibilities as a modern corporate citizen. BB places considerable importance on maintaining the stability of its Current, Savings and other core deposits and aims to minimise reliance on interbank or other wholesale funding which is mainly price driven. The Assets and Liabilities Committee headed by CEO of the bank carefully monitors funding concentrations and has succeeded in ensuring that these are satisfactorily diversified.

Stability depends on maintaining the high level of depositor confidence that BB has achieved through fair, competitive and transparent deposit pricing policies. BB closely monitors advances to deposit ratio as a key indicator of liquidity risk and limits growth of lending portfolio to be commensurate with growth of reliable core deposits. Exhibit 2 (Tables 5 & 6) gives the recent income statement extracts and the balance sheets respectively of BB.

Public Development Bank PLC

Public Development Bank (PDB) was among the top 10 Sri Lankan companies, selected by the leading business magazine "Business Today". PDB is a dynamic entity that offers a broad range of services and products in the fields of corporate and retail financing. In 2001, PDB entered the commercial banking arena. The bank was recognized among the top ten companies resulting from an 84% growth in profits of the PDB Group. PDB has 40 branches supporting various business areas: corporate banking, project financing, SME lending, retail banking, investment banking and insurance. PDB plays a vital, unique part in the nation's finances at home and abroad and is widely regarded as an integral element in the landscape of Sri Lankan business and finance. PDB took steps towards its plans for local and regional growth through the purchase of shares owned by Peoples Bank of Ceylon in the Capital Venture Company Plc. Fitch Ratings Lanka also reaffirmed the bank's national long-term rating of "AA (lka)" reflecting the bank's "strong financial profile in terms of its high capital base, good profitability and asset quality". PDB Bank is one of the strongest capitalized local banks in Sri Lanka with a high capital adequacy of 18%. The bank's efficiency is reflected positively by its return on assets ratio that stands at 1.4% (profit after tax) compared to the industry ratio of 1%. PDB's cost income ratio is 45%, which is below the industry average. With a quality portfolio and an efficient risk management process PDB Bank records a gross Non-Performing Loans ratio of 3%, the lowest in the industry among local banks. PDB Securities (Private) Limited provides a full range of service needs across a wide customer base. Recently, PDB merged with Bird Insurance PLC, creating a better future potential. With a mission to be dominant in the financial services sector, creating superior long-term shareholder value and contributing to economic development in Sri Lanka by exploiting regional opportunities and delivering innovative solutions, with best-in-industry service excellence, through an inspired team - PDB is firmly on track to achieve its vision to be a World-Class Bank.

The Global Financial Services Industry

After a year of deep recession in major advanced economies, the global economy is now rebounding and conditions in international financial markets have improved markedly. Growth in China and India is expected to hold up at 8.5 per cent and 5.5 per cent respectively. However, the wide-ranging public intervention policies by central banks including large interest rate cuts and liquidity injections and by governments such as major fiscal stimulus programmes, as well as capital injections and guarantees to banks in advanced and emerging economies, have resuscitated global financial markets and the economic activity. Equity markets worldwide have made substantial gains and corporate risk spreads have declined considerably. According to the latest estimates by the International Monetary Fund (IMF), the global economy is forecast to grow by about 3 per cent in 2010 and average about 4 per cent growth in the next three years. The prospects for world trade are also improving and it is expected that international trade will increase by about 3 per cent next year.

The global financial services industry had at least five segments:

- Corporate banking provided senior debt financing to corporate borrowers.
- Investment banking provided securities underwriting to corporations and brokerage services to individuals and institutional investors.
- Private banking offered banking and investment advisory services to high net worth individuals.
- Institutional asset management. This segment provided investment management services to institutions such as pension funds.
- Insurance.

Most surveys, suggest that, following the ravages experienced by this sector in the last quarter of 2008 and into 2009, financial institutions, for the most part, are cautiously optimistic about the road ahead. Deloitte Global Financial Services Industry Outlook, finds that the forecast for financial services is mostly positive. Much of the optimism and dynamism in this sector is driven by exciting prospects in new markets – particularly in emerging markets and in the Asia Pacific – and as financial services companies pursue the opportunities described below, this will certainly create growth in demand for bi-national and multinational meetings:

• In Europe, the political, regulatory and cultural obstacles that blocked European mergers of financial services companies in the past are finally disappearing, and, consequently, an imminent surge in cross-border mergers and acquisitions – driven by the need to grow earnings and by the appeal of economies of scale – is anticipated.

• Offshoring of certain functions of financial services' operations will increase significantly, as firms recognise the improvement in quality they can realise through scaling up their operations overseas, particularly in areas like India, the Philippines, Malaysia, China and other markets in Asia Pacific. Firms will offshore not only ICT services, but also other back-office functions such as actuarial services and human resources.

• China, in particular, will transform the financial services industry for years to come as growth opportunities slow in Japan and the West. Western banks and securities firms that have already acquired substantial stakes in China's four national banks have started to invest in mid-sized banks as well. A high savings rate, growing middle and wealthy classes and a shortage of healthcare and pension systems make China a highly attractive market for major asset management firms and insurance companies.

However, even if the volume of meetings in this sector may reasonably be expected to rise, there will be a high degree of public and press scrutiny of such events, on the lookout for any evidence of extravagance and abuse, against a background of widespread concern over the return of bankers' bonus payments – particularly in the case of institutions that were bailed-out with public funds. Analysts of the global financial services industry believed that competition was intense and subject to changes in national and regional economies, and to fluctuations in foreign currency exchange rates. A wave of mergers and acquisitions in the U.S. financial services sector was prompting firms headquartered elsewhere to reconsider their traditional attitudes toward independence. Especially in Europe, where FSIs enjoyed tacit protection and strong loyalties in the local markets, mergers had been relatively rare.

But today, the global financial services sector had confronted a series of changes and events that called into question conventional wisdom about FSI growth and competition:

Globalization: Large institutions had expanded beyond national and regional borders, in response to the global needs of their customers. It was less relevant to discuss competition in merely local terms.

Integration of markets: Financial and product markets had become regionally and globally integrated. This reflected both the rise of regional trade groups (NAFTA, Mercosur, and the European Union) and the emergence of global trading of foreign currencies and some securities on a 24-hour basis. Integration meant that performance in one country market would spill into others.

Deregulation: The mood among governments worldwide had swung in the direction of easing laws and regulations that bound competition within the financial services industry.

Harmonization: In commercial banking, the Basel accord committed banks to retain a minimum threshold of capital against risky assets in proportions that would apply across the globe. In theory, this would prevent banks and their local regulators from seeking local advantage from local regulators—but in practice local regulators still had wide leeway in enforcing the Basel accords.

Technological innovation: The rise of new information technologies raised the level of information transfer on a global basis, and there by created a need for increased IT investment in the financial industry. To be a global player, an FSI needed a global information platform. This would put extra demands on the capital bases of the firms.

Innovation in financial markets: The design of new financial instruments permitted even small and privately held firms to access the capital they needed to transform themselves and to hedge risks they faced. These new markets offered new opportunities to compete for profits, for instance, in derivatives and high-yield debt. These new instruments were highly influential in the rise of leveraged buyouts, and both private equity and debt financing. Hedge funds proliferated to trade in these new instruments and exploit market inefficiencies. More ominously for FSIs, the new products threatened older markets (e.g., for bank loans) with new lower-cost substitutes.

Rising customer sophistication and expectations: Reflecting these changes, the FSIs had begun to perform at higher levels of customer service. Simultaneously, customers learned to expect higher service from their suppliers. Therefore, many executives believed it was not possible for an FSI to ignore continuous improvement in service—doing so committed the firm to slow erosion in business as clients sought better value elsewhere.

Demographic change: Changes in the make-up of the population affected the competitive strategy and industry structure. Such changes included immigration and aging.

Contagion : The growing linkages among markets and economies and the spread of round-the-clock trading meant that manias and panics would spread faster than before. The intervention of global institutions such as the IMF and World Bank had been influential in stemming the panics. But this represented the dark side of globalization and integration of markets: rather than quelling volatility, these linkages seemed to amplify it.

Economic outlook

The last year was a most challenging year not only for Sri Lanka but for the global economy. Sri Lanka faced extraordinary challenges; controlling inflation; managing reserves at a time of great uncertainty; dealing with the pressure on the exchange rate; dealing with capital flight as a consequence of the financial crisis; dealing with the fallout of the conflict and countering misconceptions. The economy grew by 2.6 per cent in the first three quarters of the year. Although the economy grew at a slower pace during the first half of 2009 due to the negative impact of the global economic crisis, economic activity picked up in the second half of the year with the end to the decades long conflict in May 2009 and the consequent improvement in economic prospects. The per capita at (current prices) shows a continuous growth, it is expected to grow further in the post war era. (See some economic indicators in Exhibit 3.) August 2009, the IMF approved a general allocation of Special Drawing Rights (SDRs) equivalent to US dollars 250 billion to provide liquidity to the global economic system by supplementing Fund's member countries' foreign exchange reserves. Accordingly Sri Lanka received SDRs 306 million (equivalent to US dollars 480 million) which is about 74 per cent of the existing quota with the IMF. Further on 9 September 2009, Sri Lanka received a special allocation of SDR 18 million (equivalent to US dollars 28 million). A stable exchange rate was observed since May, 2009. Since then the exchange rate has remained at a relatively stable level of Rs.114.50, with marginal fluctuations. The All Share Price Index (ASPI) and the Milanka Price Index (MPI) recorded a growth of about 125 per cent and 136 per cent, respectively, in 2009. The ASPI moved up to 3,385.6 points, its highest ever close, on the 30th of December 2009. Market capitalisation, which exceeded Rs.1,000 billion for the first time on 8 October 2009, improved further to Rs. 1,092 billion by end December. The Colombo Stock Exchange (CSE) surpassed the highest ever turnover recorded for a given year in November 2009. In view of these developments, the CSE was recognised as one of the best performing markets in the world in 2009.

Exhibit 1

Table 1: Financial information of DB

(Figures in Rs. '000)

	2009	2008	2007	2006
Assets	132 768 872	154 041 245	143 500 353	130 306 108
Liabilities	122 166 198	147 026 234	136 464 118	123 937 830
Income	23 048 481	25 246 209	21 079 885	23 154 529
Net Income	7 216 593	7 210 978	6 784 126	7 215 981
Core capital adequacy ratio	9.69	5.74	7.49	7.01
Total capital adequacy ratio	11.74	8.06	10.98	9.89
Nonperforming loans	25491.07	15905.54	16345.32	13950.66
Return on average assets	0.38	0.1	0.65	0.61
Profitability	543 301	155 241	923 189	888 068
Price earnings ratio	8	31	12	10
Dividends per share (Rs.)	0.5	0	1.5	1.5

Table 2

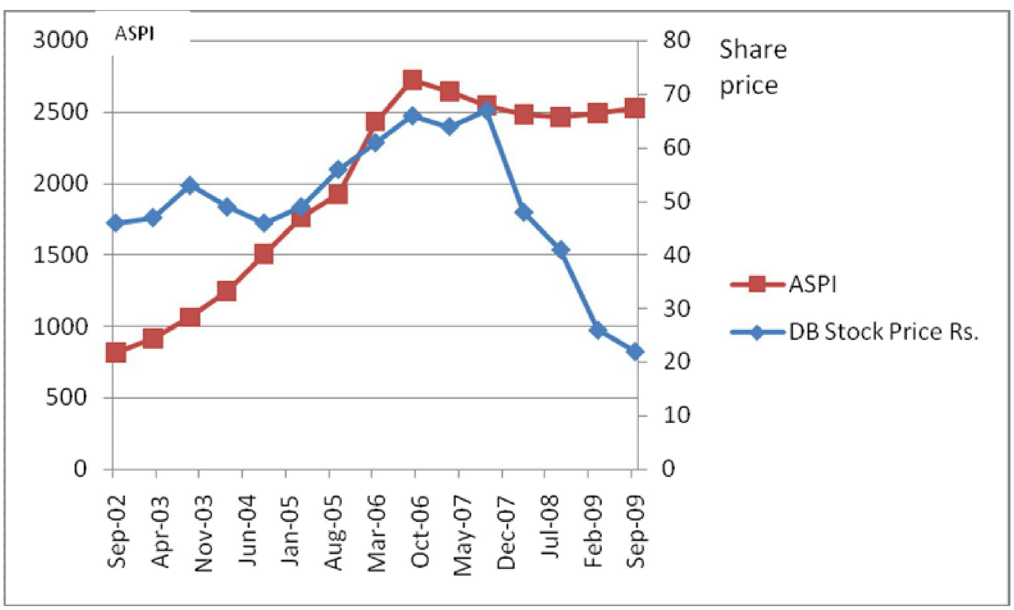


Table 3: Derana Bank PLC: Income Statement Extracts

	2009 RS. Mn.	2008 RS. Mn.
Income	23,048	25,246
Interest Income	20,708	21,572
Interest expense	(13,492)	(14,361)
	7,216	7,211
Other income	2,340	3,674
	9,556	10,885
Personnel expenses	2,385	3,405
Premises, equipment & establishment expenses	1,608	1,559
Other expenses	2,535	3,258
Appreciation in values of investments	(47)	0
Impairment loss	0	41
Provisions for doubtful debts and contingencies	2,183	2,467
Taxes	349	0
	9,013	10,730
Profit / loss for the period	543	155

Table 4: Derana Bank PLC: Summarised Balance Sheet

	Rs. Mn. 2009	Rs. Mn. 2008
Assets		
Cash & other liquid assets	4,683	5,511
Balance with Central Bank	5,084	6,857
Money market placements	34,039	27,634
Loans and advances to banks	-	623
Loans and advances to customers	76,038	97,746
Mortgage lending	2,925	4,935
Investments in related companies	1,668	948
Investment property	521	521
Property, plant & equipments	3,324	4,073
Other assets	4,487	5,193
Liabilities	132,769	154,041
Money market liabilities	1,878	14,516
Due to banks	3,055	7,105
Due to customers on savings	104,815	107,939
Medium term notes	9	1,524
Long term debt	4,230	4,057
Accrued expenses	-	631
Other liabilities	8,173	11,255
Equity		
Reserves	507	480
Stated capital	5,567	2,542
Retained profits	4,535	3,992
	132,769	154,041

Table 5: Maturity Analysis - Interest Earning Assets

	up to 3 months	**3 to12** Months	**1 to 3 years** 5	**3 to 5 years** Years	**more than** 5 years	**total**
Bills of exchange	1,120	149	54	0	0	1,323
Loans & Advances	19,802	18,026	12,585	5,756	19,070	75,239
Lease receivable	678	921	1,180	138	2	2,919
Balances with banks	371	0	0	0	0	371
Short-Term funds	45	0	0	0	0	45
Commercial paper	0	325	0	0	0	325
Treasury bills	119	2,735	14,237	10,489	1,522	29,102
Securities purchased under resale agreement	2,952	0	0	0	0	2,952
Others	714	0	13	0	0	727
	25,801	22,156	28,069	16,383	20,594	113,003

Table 6: Stated Capital of DB

	Rs. Mn	No. of Shares
Ordinary Shares-voting	4,298	130,000,000
Ordinary Shares - non voting	1,235	123,560,000
Preference Shares		
non redeemable, non- convertible	34	3,390,100
	5,567	

Table 7: Credit Risk Management Frame Work in DB

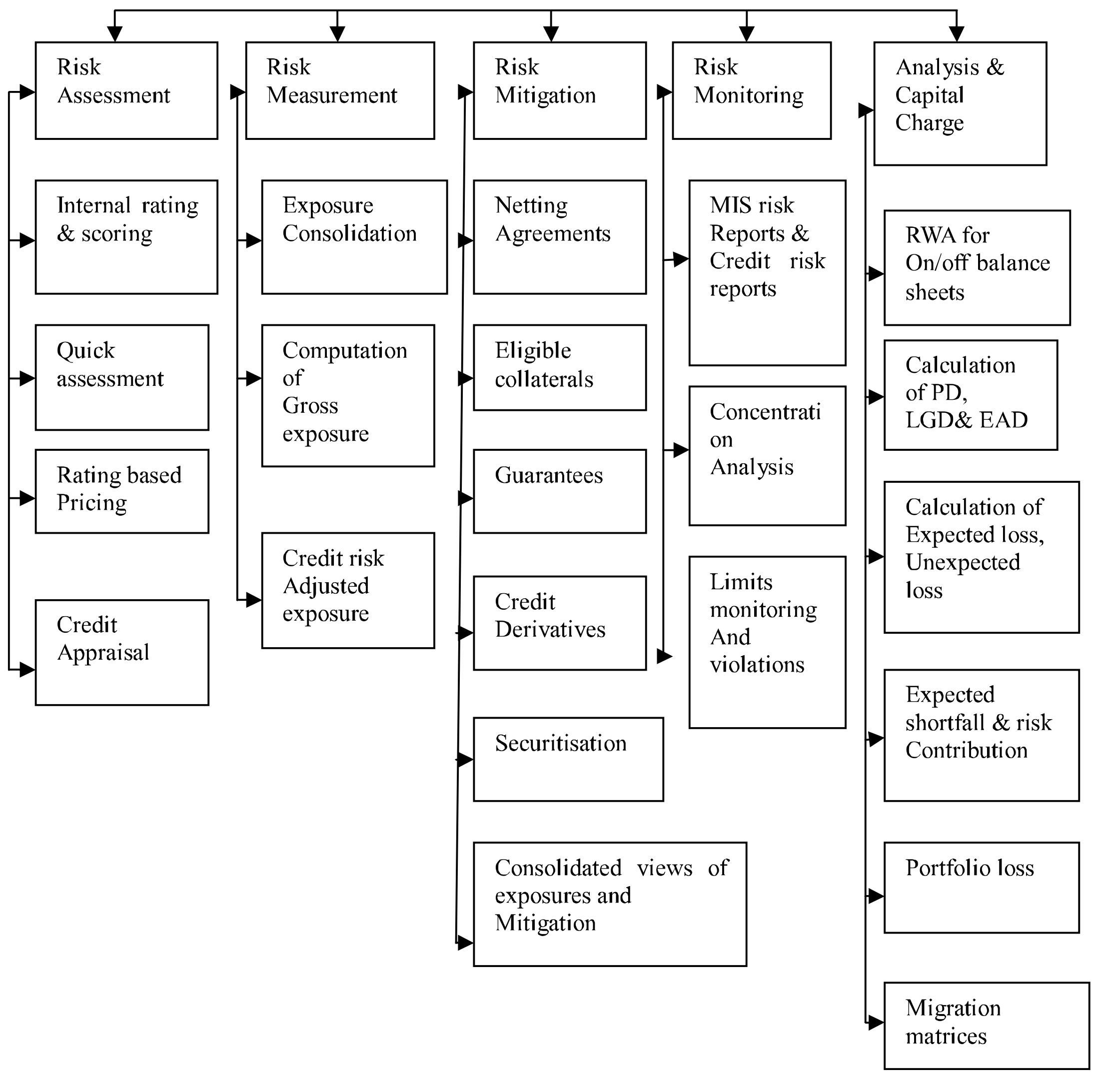


Exhibit 2

Table 1: Selected Financial Performance Indicators for the Banking Industry Sri Lanka

Item	2005	2006	2007	2008	30.09.09*
Assets and Liabilities, Rupees Million					
Assets	1,780,955	2,142,164	2,504,201	2,697,496	2,941,585
Gross Loans and Advances(a)	1,003,160	1,289,764	1,534,098	1,634,853	1,593,305
Net Loans and Advances(b)	955,760	1,241,189	1,483,100	1,572,006	1,526,756
Gross Non-performing Advances(a)	70,701	72,568	79,064	103,271	140,516
Net Non-performing Advances(b)	24,155	23,993	28,066	40,424	73,967
Provision for Bad and Doubtful Advances	46,546	48,575	50,999	62,846	66,550
Investments	442,646	487,804	552,231	673,459	866,812
Risk Weighted Assets(c)	858,337	1,131,032	1,315,685	1,571,384	1,543,550
Capital(d)	137,272	162,519	199,779	218,777	240,283
Core Capital (Tier 1 Capital)(e)	113,712	136,420	165,625	195,776	190,549
Capital Base(e)	115,187	150,001	185,856	227,436	223,701
Deposits	1,272,983	1,494,457	1,741,310	1,878,231	2,162,645
Borrowings	289,091	387,593	439,474	458,122	391,772
Commitments and Contingencies	413,613	696,079	1,139,192	1,180,738	1,088,930
Earnings/Profitability, Rupees Million					
Interest Income	141,847	193,645	278,634	343,785	269,943
Interest Expenses	76,129	108,699	177,029	228,682	177,618
Net-interest Income	65,718	85,478	101,605	115,103	92,325
Non-interest Income	30,200	32,674	40,203	54,450	43,633
Foreign Exchange Income (Net)	5,759	9,413	9,210	13,887	9,337
Non-interest Expenses	52,775	67,077	75,437	88,952	67,784
Staff Cost	23,946	29,357	33,332	39,590	31,777
Provision for Bad and Doubtful Advances	7,667	8,713	11,532	16,579	10,832
Profit Before Tax	29,958	37,089	44,134	50,424	44,649
Profit After Tax	19,972	22,797	25,353	27,756	25,506
Selected Financial Performance Ratios, Percentage					
Core Capital (Tier 1 Capital) Adequacy	13	12	13	12	12
Total Capital Adequacy	13	13	14	14	14
Net Non-performing Advances to Capital	18	15	14	18	31
Gross Non-performing Advances (a)	7	6	5	6	9
Net Non-performing Advances (b)	2	2	2	3	5
Provision Coverage (f)	66	67	65	61	47
Profitability					
Return on Assets (ROA) Before Tax	2	2	2	2	2
Return on Assets (ROA) After Tax	1	1	1	1	1
Return on Equity (ROE)	16	15	14	13	15
Efficiency (g)	67	57	56	56	52

Staff Cost to Operating Expenses(h)	40	44	44	45	47
Interest Margin(i)	4	4	4	4	4
Liquidity Indicators					
Liquid Assets Ratio(j)	32	30	30	31	39
Credit to Deposit Ratio	79	86	88	87	74

Table 2: Selected Financial Performance Indicators for Licensed Specialised Banks

Item	2005	2006	2007	2008*	30.09.09*
Assets and Liabilities, Rupees Million					
Assets	319,415	355,215	405,922	437,582	490,564
Market Share,(%)-Sector	100	100	100	100	100
Industry	18	17	16	16	17
Gross Loans and Advances(a)	101,115	138,604	167,645	178,250	189,611
Market Share,(%)-Sector	100	100	100	100	100
Industry	10	11	11	11	12
Net Loans and Advances(b)	99,070	136,469	165,114	172,980	184,069
Gross Non-performing Advances(a)	8,936	9,317	11,290	15,875	20,350
Net Non-performing Advances(b)	6,892	7,182	8,759	10,606	14,808
Provision for Bad and Doubtful Advances	2,045	2,135	2,531	5,270	5,541
Investments	181,232	190,031	203,721	219,417	260,126
Risk Weighted Assets(c)	69,276	94,421	100,839	144,739	168,865
Capital(d)	32,674	32,776	38,069	39,727	44,422
Core Capital (Tier 1 Capital)(e)	17,809	19,589	21,364	37,006	33,660
Capital Base(e)	13,866	18,709	20,816	30,359	30,145
Deposits	230,979	258,920	284,609	317,985	365,389
Market Share,(%)-Sector	100	100	100	100	100
Industry	18	17	16	17	17
Borrowings	43,939	49,580	65,621	57,992	56,156
Market Share,(%)-Sector	100	100	100	100	100
Industry	15	13	15	13	14
Commitments and Contingencies	11,136	2,070	1,468	1,616	1,431
Earnings/Profitability, Rupees Million					
Interest Income	30,579	37,445	46,856	57,225	46,866
Interest Expenses	18,281	23,390	33,528	45,111	36,154
Net-interest Income	12,298	14,055	13,328	12,114	10,712
Non-interest Income	2,190	1,537	3,977	7,987	7,112
Foreign Exchange Income (Net)	2	12	4	44	(18)
Non-interest Expenses	5,844	7,185	7,984	9,391	7,381
Staff Cost	3,082	3,816	4,387	5,012	4,109
Provision for Bad and Doubtful Advances	329	579	805	1,328	709
Profit Before Tax	7,494	6,787	6,550	6,051	8,754
Profit After Tax	4,731	3,836	3,557	2,582	5,570

Selected Financial Performance Ratios, Percentage					
Capital Adequacy					
Core Capital (Tier 1 Capital) Adequacy	26	21	21	26	20
Total Capital Adequacy Ratio	20	20	21	21	18
Net Non-performing Advances to Capital	21	22	23	27	33
Assets Quality					
Gross Non-performing Advances Ratio(a)	9	7	7	9	11
Net Non-performing Advances Ratio(b)	7	5	5	6	8
Provision Coverage Ratio(f)	23	23	22	33	27
Profitability					
Return on Assets (ROA) Before Tax	3	2	2	1	3
Return on Assets (ROA) After Tax	2	1	1	1	2
Return on Equity (ROE)	15	12	10	7	17
Efficiency Ratio(g)	55	45	48	51	39
Staff Cost to Operating Expenses(h)	38	53	55	53	56
Interest Margin(i)	4	4	4	3	3
Liquidity Indicators					
Liquid Assets Ratio(j)	69	64	61	62	69
Credit to Deposit Ratio	44	54	59	56	52

Source: Central Bank of Sri Lanka (Web-based returns)

** Provisional Data

(a) Net of interest in suspense.

(b) Net of interest in suspense and loan loss provisions.

(c) Estimated in terms of Capital Adequacy Requirement.

(d) Capital reported in the balance sheet.

(e) Capital defined in the Capital Adequacy Requirement.

(f) Provision for bad and doubtful advances as a % of non-performing advances-net of interest in suspense.

(g) Non-interest expenses as a percentage of Operating Income

(h) Staff cost as a percentage of Non-interest expenses.

(i) Net interest income as a percentage of average assets.

(j) Estimated in terms of statutory liquid assets requirement.

Table 3: Performance indicators of selected commercial banks

		Return on Average Assets	Growth in Income (%)	Capital Adequacy Tier 1 (%)	Nonperforming Loans / Gross Loans (%)	Fitch Rating
Business Bank	2004	1.35	22.17	10.78	5.20	AA+
	2005	1.48	31.00	9.68	3.22	AA+
	2006	1.00	51.99	7.62	2.74	AA+
	2007	1.67	43.95	10.60	2.96	AA+
	2008	1.55	25.25	10.55	5.19	AA+
PDB	2004	0.70	5.00	9.83	9.70	A
	2005	1.00	20.00	10.87	8.21	A
	2006	1.20	27.00	10.23	7.10	A
	2007	1.40	40.00	10.32	5.70	AA-
	2008	1.30	24.00	9.25	6.72	AA-
Derana Bank	2004	0.49	0.98	4.65	18.74	A-
	2005	0.68	29.96	4.07	15.34	A-
	2006	0.73	31.26	4.86	13.85	A-
	2007	0.67	22.67	4.88	15.39	A-
	2008	0.10	19.76	4.54	16.93	BBB+

AAA - reliable and stable

AA - quality with a bit higher risk

A - economic situation could affect finance

BBB - middle class-an acceptable risk

BB - more prone to economic changes

National ratings - 2009

Citibank Sri Lanka Branch	AAA(lka)
HSBC Sri Lanka Branch	AAA(lka)
Sampath National Bank	AAA(lka)
National Savings Bank	AAA(lka)
Business Bank PLC	AA+(lka)
Bank of Ceylon	AA(lka)
DFCC Bank	AA(lka)
Public Development Bank PLC	AA(lka)
DFCC Vardhana Bank	AA–(lka)
Hatton National Bank PLC	AA–(lka)
Resource Bank PLC	AA–(lka)
Nations Trust Bank PLC	A(lka)
People’s Bank	A(lka)
Derana Bank PLC	BBB+(lka)
Pan Asia Banking Corporation PLC	BBB–(lka)

Table 4: Income Statement Extracts

	SNB		RB		BB	
	2009	2008	2009	2008	2009	2
	RS. Mn.	RS. Mn.	RS. Mn.	RS. Mn.	RS. Mn.	RS.
Income	18,268	17,511	25,213	22,242	32573	32
Interest Income	15,194	15,314	20,970	19,451	27,012	27
Interest expense	(11,746)	(11,595)	(13,165)	(12,801)	(18,192)	(18,(
	3,448	3,719	7,805	6,650	8,820	9
Net trading income	1,727	2,186	0	0	-	
Foreign exchange profit	-	-	774	647	2,506	1
Credit related fees and commissions	3,997	4,875	1,205	1,355	2,510	2
Other fee and commission income	120	-	2,263	789	0	
Net income from investments in associated companies	545	319	0	0	0	
Personnel expenses	4,164	4,943	2,194	1,953	3,371	2
Provision for staff benefits	-	-	468	185	245	
Other expenses	1,773	1,963	2,404	1,811	1,455	
Premises, Equipment & Establishment expenses	720	829	1,802	1,675	1,614	1
Impairment loss	-	-	917	442	51	
Provisions for doubtful debts and contingencies	1,166	3,561	296	803	492	1
Taxes	331	(192)	1,877	1,150	(3,661)	(4,(
Profit / loss for the period	1,683	(5)	3,474	2,049	3,271	2
Minority interest	10	2	0	0	0	

Table 5: Summarised Balance Sheet

Sampath National Bank PLC

	2009	2008
Assets	RS. Mn.	RS. Mn.
Cash	21,320	23,430
Trading securities	583,970	701,070
Investment securities	128,940	107,580
Bills and money market instruments	179,530	204,040
Mortgage loans	692,200	701,910
Loans and advances to banks	912,860	1,046,770
Loans and advances to customers	837,820	1,047,860
Financial investments	14,200	18,790
Property, plant & equipments	470,710	467,320
Intangible assets	74,750	77,180
Liabilities	3,916,300	4,395,950
Money market liabilities	130,530	213,400
Due to banks	1,182,190	1,323,720
Due to customers on savings	1,518,400	1,762,050
Other amounts due to customers	19,020	22,220
Medium term notes	220,590	222,170
Accrued expenses	2,300	1,210
Other liabilities	352,380	504,590
Allowance for general credit losses and other provisions	91,310	114,880
Equity		
Reserves	2,340	3,232
Stated capital	200,000	200,000
Retained profits	196,330	28,138
Minority interest	910	340
	3,916,300	4,395,950

Table 6: Summarised Balance Sheets of other selected banks

	RB		BB	
	2009	2008	2009	2008
Assets	RS. Mn.	RS. Mn.	RS. Mn.	RS. Mn.
Cash & short term funds	3,395	2,829	4268	5,120
Balance with Central Bank	7,397	6,878	10971	10,322
Treasury Securities	31,768	20,281	78820	49,001
Dealing Securities	276	1,223	10451	3,886
Loans and advances to banks	2,473	4,093	27270	22,390
Investment securities	7,264	5,397		
Loans and advances to customers	97,352	89,712	166573	180,401
Investment in Associates	27	969	0	-
Interest receivables	1,854	2,301	0	-
Other assets	937	1,452	7555	5,510
Property, plant & equipments	3,420	3,289	3930	3,721
Intangible assets	71	109	380	250
Liabilities	156,234	138,533	310,218	280,601
Money market liabilities	2,887	2,423	29657	25,075
Due to banks	4,819	4,592	8122	8,131
Due to customers on savings	125,690	106,931	223213	199,880
Other amounts due to customers	872	3,828	2240	4,160
Medium term notes	3,102	4,513	4436	4436
Accrued expenses	1,089	956	2643	2925
Other liabilities	5,854	5,515	12034	10103
Equity				
Reserves	1,623	1,566	1847	1847
Stated capital	1,582	1,582	9585	9548
Retained profits	8,716	6,627	16441	14496
	156,234	138,533	310,218	280,601

Exhibit 3

Table 1: Sri Lankan Economic Indicators

	Unit	2005	2006	2007	2008	2009
Gross domestic product (GDP), constant prices	Rs. Billions	1,941.60	2,090.50	2,232.60	2,365.50	2,449.30
GDP, current prices	$ Billions	24.4	28.2	32.3	39.6	41.3
GDP per capita, current prices	$	1,241	1,421	1,634	2,014	2,053
Market Price Earnings Ratio	Times	12.4	13.9	11.6	5.4	14.4
Treasury Bill Yield 12 months	% p.a.	10.37	12.96	19.96	19.12	9.33
Treasury bonds 1+ Years	% p.a.	13.4	13.62	19.34	21.05	10
SLIBOR	% p.a.	14.2	14.73	21.75	13.74	9.03
Commercial banks deposit rates AWDR	% p.a.	6.25	7.6	10.31	11.63	8.03
Sector P/E ratio – Bank Finance & Insurance	Times	8	8.5	8.8	3.9	10

Source: Central Bank of Sri Lanka

Figure 1: Market behaviour

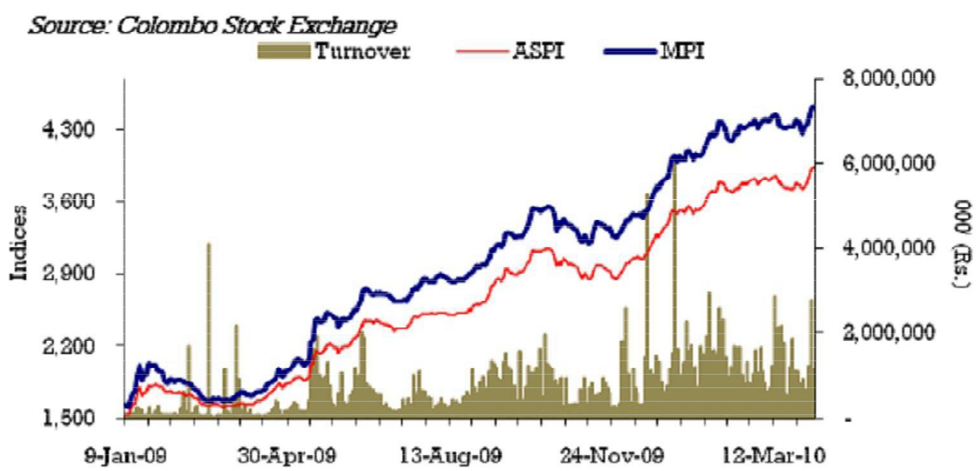


Table 3: Government debt rates

T- Bond %		
Maturity	Bid	Ask
1/3/2011	9.58	9.65
15/04/2012	10.55	10.6
1/2/2013	10.75	10.9
15/07/2014	11.65	11.75
15/03/2015	11.9	12

Table 3: Price Earnings Ratios of Major Sectors of CSE

Sector	2006 December	2007 December	2008 December	2009 October
Bank, Finance & Insurance	8.5	8.8	3.9	10
Beverages, Food & Tobacco	10.5	8.9	5.8	13.9
Diversified	18.6	15.7	5.1	18
Telecommunication	24.4	17.6	7.2	18.5
Hotels Travels	22.8	23.2	15.9	64.7
Manufacturing	9.1	6.5	7.2	16
Oil Palms	9	9	2.9	32.8
Health Care	29.5	36.7	46.3	59.5
Plantations	10.3	15.6	2.7	11
Market Price Earnings Ratio (P/R)	13.9	11.6	5.4	14.4
Source: Colombo Stock Exchange				