

# Value Creation and Internal Capital Formation

*Internal capital refers to the reciprocal value created by the Bank and the Group for its own benefits. This capital is generated through activities, relationships and linkages with the various stakeholders. Internal capital consists of financial and institutional capital. Financial capital is defined as being quantifiable and hence warranting representation in the Group's financial statements. It is therefore available for investitures in economic capital. Institutional capital consists of abstract entities such as organisational knowledge, systems and processes, corporate culture and values, brand equity, business ethics, and integrity and associated collateral. This repository gives the Bank and the Group a positive edge in their respective markets. These synergised capitals aid the Bank and the Group in delivering ever greater value to stakeholders. The Bank in turn derives complementary value to grow these capitals further.*

## **FINANCIAL CAPITAL**

### **Financial Performance**

#### **Overview**

The year under review is the first complete year of operations after the amalgamation of DFCC Vardhana Bank PLC with DFCC Bank PLC. The amalgamation took place on 01 October 2015.

Comparative Financials given in the Income Statement include only nine months results of the Bank from 01 April 2015 to 31 December 2015 as the Bank changed its financial year from 31 March to 31 December in the year 2015. The comparative financials include results for six months of DFCC Bank PLC before the amalgamation from 01 April 2015 to 30 September 2015 and three months results of the amalgamated operation from 01 October 2015 to 31 December 2015.

In this analysis of the Bank's business results, for the purpose of a more equitable comparison, the current year's results are compared with the comparative financials given in the Supplementary Combined Income Statement on page 133 where the results of DFCC Vardhana Bank PLC for the period 01 January 2015 to 30 September 2015 and three months results of DFCC Bank PLC for the period 01 January 2015 to 31 March 2015 have also been incorporated as if the amalgamation and the change of financial year took place prior to 01 January 2015.

#### **Net Interest Income**

DFCC Bank PLC (Bank) recorded a credible improvement in all key performance indicators during the year ended 31 December 2016. The Bank recorded a total income of LKR 26,754 million for the year which reflects a growth of 34.4% over the previous year. Due to progressive increase

in market interest rates, interest expense on deposits grew at a higher rate than increase in lending rates. The increase in deposit rates led to a shifting of funds towards time deposits. The resulting negative impact to profitability was managed effectively through timely decisions on asset/liability re-pricing and shift of lending rates to variable from fixed. These efforts generated positive results, recording a 25.2% growth in net interest income (NII) during the year. NII as a percentage of total operating income posted a credible 77.7%. The Bank's strategy to grow the core business was well demonstrated in interest income exceeding 90% of total income.

#### **Fee and Commission Income**

During the year, the Bank expanded its branch network by converting eight extension offices to fully-fledged branches and opening of two new branches in the Kandy City Centre and Main Street, Pettah. This approach along with increased focus on other ancillary services and usage of digital banking delivery channels helped the Bank to achieve 14.3% growth in net fee and commission income. Key contributors for this growth accounted from issue of guarantees and services related to Trade, Remittance and other products. In December 2016, the Bank entered into an exclusive strategic partnership with AIA Insurance Lanka PLC to grow Bancassurance business that would open up a sustainable revenue stream for the Bank.

#### **Total Operating Income**

The Bank effectively made use of market opportunities that helped to post 56.3% growth in trading results contributed from trading of Forex and in Government securities. The loss from forward exchange fair value changes and interest rate swap fair value changes totalling to LKR 179.7 million is recorded under 'Net gain/loss from financial instruments at fair value through profit or loss'.

The Bank's net gain from financial investments amounted to LKR 1,165 million mainly from the dividend of LKR 713 million received from its investment in equity of Commercial Bank of Ceylon PLC. New contracts entered during the year in foreign currency swaps to fund the Rupee book had increased the swap cost. This cost is recorded in 'Other operating (loss)/income (net)'. Corresponding Rupee income generated from this funding is reflected in interest income.

The overall positive results reported from income sources helped to surpass LKR 11 billion in Operating Income that enabled recording LKR 11,461 million for the 12 months ended 31 December 2016.

### **Impairment Charge on Loans and Other Losses**

The Bank had a successful year in curtailing non-performing advances despite a growth of 15.9% (net) in its loan portfolio. The Bank's impaired loans (computed as per LKAS 39) recorded a decline to 4.5% as a percentage of total loans during the year under review from 5.1% of total loans as at end of the previous year. Accordingly, total impairment charge declined by 6.9% to LKR 937 million as compared to LKR 1,007 million in 2015 on combined results basis. There was no major change in the methodology adopted in computing collective impairment and specific impairment on individually significant loans during the year.

In view of the introduction of the new accounting standard in Financial Instruments, SLFRS 9 with effect from 01 January 2018, the Bank has already undertaken a project in developing methodologies and capturing data for implementation of SLFRS 9 reporting.

### **Operating Expenses**

During the year, the Bank undertook aggressive marketing campaigns to reach untapped customer segments; especially to drive financial inclusivity and penetrate into the micro financing business. This along with the increased presence during the year in urban and rural geographies by expanding the Bank's fully-fledged branches had proportionately increased personal and other overhead expenses. Close monitoring of expenses and effective utilisation of resources along with the synergies realised from the amalgamation of the two Banks, helped to mitigate the operating expenses and record a slight decline compared to the cost in 2015 based on combined results. The Bank recorded a cost to income ratio of 44.7%, which is one of the lowest in the industry.

### **Profit before Tax (PBT)**

The Bank recorded an operating profit (before value added, NBT and income tax) of LKR 5,400 million, a growth of 51.4% as against LKR 3,567 million based on combined results of the previous year. The rate of value added tax (VAT) on financial services was increased by 4% during the year with effect from 02 May 2016. This has increased the VAT charge by LKR 91 million during the year. The Bank reported a profit before income tax of LKR 4,414 million depicting a growth of 54.0% compared to previous year's combined results.

### **Profit after Tax (PAT)**

The Bank continued its low effective income tax rate based on its strategic investments and prudent cost allocations that contributed to report a profit after tax of LKR 3,289 million, an increase of 60.2% compared to LKR 2,053 million in 2015, based on combined results.

### **Finance Position Analysis**

#### **Assets**

The Bank's total assets grew by 17.9% mainly due to loans to and receivable from other customers increasing by LKR 25,439 million. Confirming the Bank's strong presence in project lending, loans related to projects (included in term loans) recorded a growth of LKR 8,923 million followed by LKR 5,984 million in trade finance-related loans. The Bank was able to book higher volumes of loans during the latter part of the year that would strengthen revenue streams in 2017.

Investments in Sri Lanka Development Bonds denominated in foreign currency increased by LKR 7,841 million during the year. The Government Bonds and Bills classified under held-to-maturity category increased by LKR 4,692 million which in turn improved the liquidity ratio as at end 2016.

#### **Liabilities**

Total liabilities increased by 20.1% during the year mainly due to the increase of customer deposits. The Bank's other borrowings increased by LKR 4,847 million. The Bank continued to have access to foreign currency credit lines at competitive rates that enabled to increase foreign currency borrowings by LKR 4,410 million during the year. In augmenting supplementary capital, the Bank successfully issued five and seven-year subordinated debentures totalling LKR 7,101 million in November 2016. The Bank also issued listed debentures totalling LKR 5,746 million in March 2016. The improved presence through the branch network and rationalisation of delivery channels helped

the Bank to grow its customer deposits by LKR 29,624 million (26.7%) to LKR 140,514 million from LKR 110,891 million as at December 2015. Current and savings accounts (CASA) increased by LKR 7,368 million. CASA as a percentage of total deposits improved to 20.2% from 19.0% as at end 2015. The Bank took steps to strengthen its foreign currency deposit base to secure an adequate funding line for foreign currency-related lending. Accordingly, the Bank's foreign currency deposits increased by LKR 17,512 million year-on-year.

### Equity and Capital Adequacy

The Shareholder's equity grew by 7.1% mainly from the increase in retained earnings. Other comprehensive income recorded a gain of LKR 404.7 million that brought the total comprehensive income to LKR 3,693.4 million.

Stock market movement year-on-year had contributed to favourable gains in fair value of investments in equity investments, particularly the investment in shares of Commercial Bank of Ceylon PLC. Investments in bonds and bills had resulted in mark-to-market losses consequent to increase in market interest rates. The net gain from aforesaid investments amounted to LKR 263.8 million net of taxes. Due to change in assumptions in relation to change in market trends, the Bank reported an actuarial gain of LKR 137.8 million (before tax) from defined benefit plans.

The Bank has been consistently maintaining higher capital adequacy ratios compared to its peers. The Tier I ratio slightly declined to 13.62% from 14.26% in 2015 mainly due to growth of loans while the total capital ratio improved to 17.09% from 14.88% in 2015 due to issue of LKR 7,101 million subordinated debentures during the year.

The Bank's return on assets (ROA) as at end 2016 was 1.3% compared to 1.0% as at end 2015. The Bank's return on equity as at end 2016 recorded at 10.99% compared to 5.0% reported as at end 2015 based on nine months results.

### Credit Quality

Loans and advances recorded a considerable growth during the year under review. The Bank undertook successful recovery drives that enabled recovery of a significant component of non-performing advances which included a few large accounts. Improved processes in risk assessments and credit underwriting along with successes made in recoveries, brought down the NPA ratio (computed as per regulator's guidelines) to 2.97% as at 31 December 2016 being one of the lowest in the Bank's history, from 3.7% as at 31 December 2015. Provision cover of the Bank increased to 76.9% of the impaired loans.

### Dividend Policy

The Bank has been maintaining an above average dividend payout ratio compared to the industry. The Directors approved a first and final dividend of LKR 4.50 per share for the year ended 31 December 2016. In deciding this payout, due consideration was given to the financial stability and future expansions planned in consolidating the Bank's position as a fully-fledged commercial Bank.

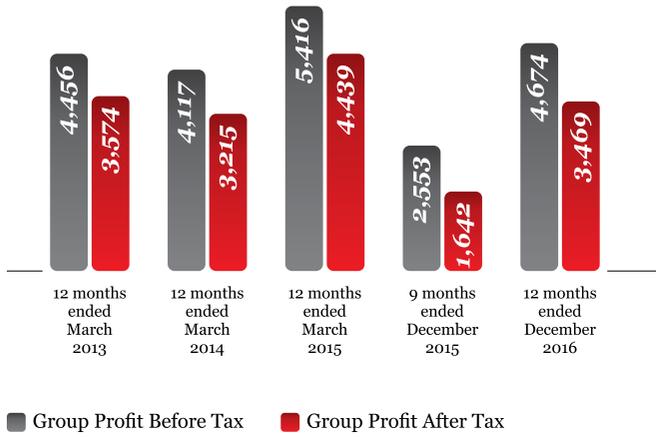
### Group Performance

The DFCC Group consists of DFCC Bank PLC and its Subsidiaries; DFCC Consulting (Pvt) Limited, Synapsys Limited, Lanka Industrial Estates Limited (LINDEL), its associate company National Asset Management Limited (NAMAL) and its joint venture company Acuity Partners (Pvt) Limited. LINDEL is a March reporting entity while others are 31 December reporting entities. For the purpose of consolidated financials, 12 months results from 01 January to 31 December 2016 were accounted in all Group entities. Financials of 31 March entities were subject to a review by their respective External Auditors covering the period reported.

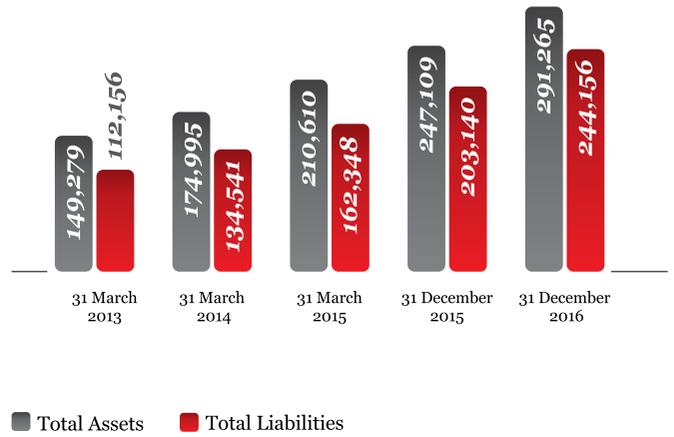
The Group made a profit after tax of LKR 3,469 million during the year ended 31 December 2016.

Major contributions for the Group performance apart from DFCC Bank accounted from Acuity Partners (Pvt) Limited, LINDEL and NAMAL which made profit after tax of LKR 298.8 million, LKR 110.8 million and LKR 39.1 million respectively in their individual financials. Other Subsidiaries, DFCC Consulting and Synapsys made losses of LKR 2.6 million and LKR 19.6 million respectively during the year under review.

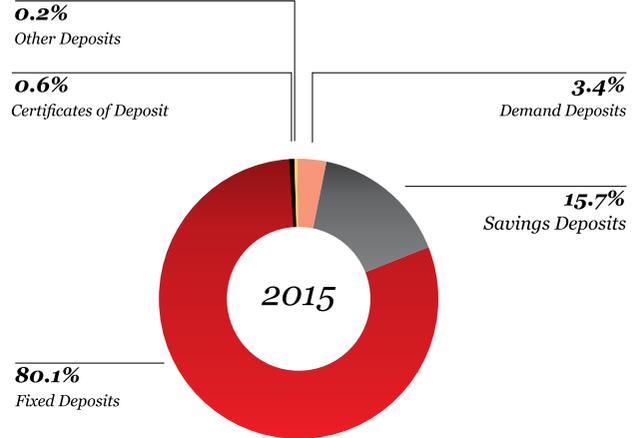
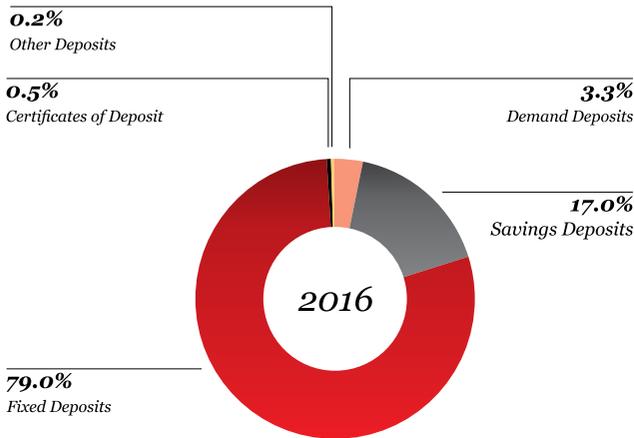
**Group Profit Before and After Tax – LKR million**



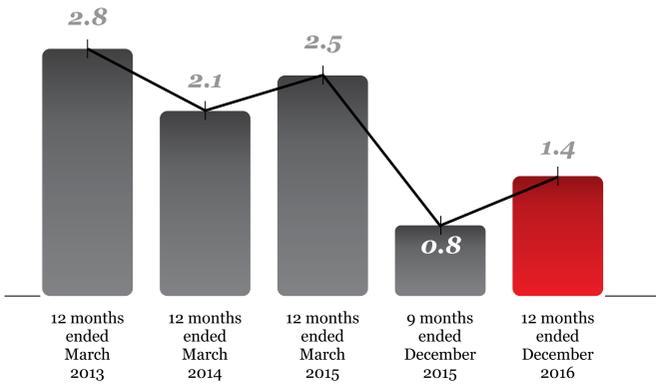
**Group Assets and Liabilities – LKR million**



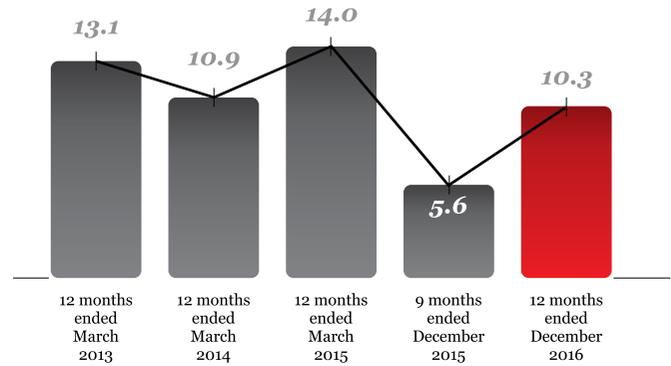
**Group Deposit Mix**



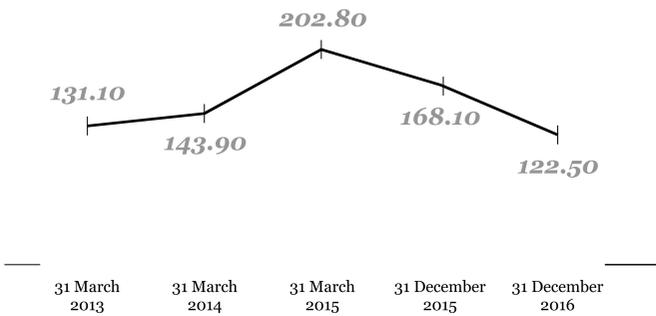
**Group Return on Assets – (%)**



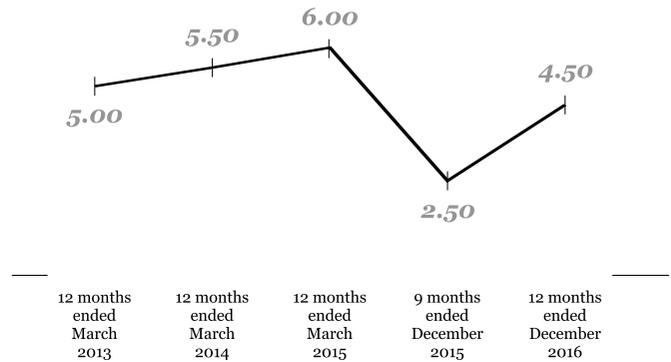
**Group Return on Equity – (%)**



**Bank Share Price – LKR**



**Bank Dividend per Share – LKR**



## ***INSTITUTIONAL CAPITAL***

Institutional capital encompasses the portfolio of non-financial, intangible constituents of capital that are unique to DFCC Bank. It includes organisational knowledge, systems, processes and ICT, corporate culture and values, brand equity, business ethics and integrity. These are all significant tools that we employ in creating sustainable, long-lasting value for our stakeholders.

### ***Organisational Knowledge***

The Bank places priority to sharing organisational knowledge amongst employees and refining itself as a learning institution. DFCC Bank gathers, organises, shares and analyses its knowledge in terms of resources, documentation and people skills. To develop people skills, the Bank organises customised internal, foreign and external knowledge disseminating training programmes with modules designed using the support of focus groups. The Bank has an internally developed e-learning platform with content produced by internal experts. Human Resources also communicates news and announcements to all employees in a much easier and faster manner through the Bank's Intranet portal.

### ***Systems, Processes and ICT***

DFCC Bank understands the importance of leading edge information technology solutions in enabling business and driving the digital strategy of the Bank. As a constituent of its digital transformation strategy, the Bank considered the utilisation of cloud-based application services for several non-financial systems in line with enhancing operational efficiency and minimising costs.

DFCC Bank was thus the first bank in Sri Lanka to move its entire collaboration platform onto Google's G Suite, from its legacy email and collaborating platform hosted on premise. This gave employees the freedom of working from virtually anywhere and on any device. The Bank has similarly envisaged shifting its enterprise budgeting platform to a cloud-based model by Oracle.

Special focus was given to the Vardhana Virtual Wallet (VWV) platform launched during the year and the Bank connected over 500 merchants to encourage cashless transactions. The VWV is now available to non-customers of the Bank as well and is explained in greater detail in the Customer Capital section.

The Bank also linked its ATM network to the LankaPay network giving its customers unbridled access to over 3,600 ATMs island-wide.

DFCC Bank is always cognisant of the increase in risks prevalent in the digital world. To address these, the Bank initiated a cutting-edge Security Information Event Management System to monitor ongoing security events from all systems on a single platform. Especially noteworthy is that the Bank's IT Department obtained the ISO 27001 certification by implementing the best

practices in legal, physical and technical controls in the information security management processes.

In line with its value of being socially responsible, the Bank partnered with an electronic waste management company to recycle, reuse and dispose any acquired electronic waste under the imposed guidelines of the Central Environmental Authority. This is a combined effort in rectifying the damages posed by e-waste to the environment and human health.

### ***Corporate Culture and Values***

DFCC Bank encourages its staff to speak up, voice their concerns and share suggestions. The Bank gives prominence to creating an environment that stimulates discussion, professionalism, individual respect, outstanding customer service and invigorating teamwork. Following the amalgamation, the Bank's core values were revised, and all employees were encouraged to get involved in this process by giving their input. Consequently, seven core values were identified; 'Innovative', 'Customer centric', 'Professional', 'Ethical', 'Accountable', 'Team Oriented', and 'Socially Responsible'.

To help staff identify with and embrace these values, the Bank launched a campaign including a number of inspirational sessions and activities built around them, for employees across the branch network.

DFCC Bank's working culture is further nourished by recognising and rewarding positive behavioural attributes. The Bank diligently works towards ensuring an amicable, team oriented, supportive culture that encourages performance excellence, whilst enabling employees to strike a healthy work-life balance. Numerous social events and wellness related initiatives were hosted throughout the year, encouraging employees to find time to relax and enjoy with their colleagues.

One of the core Human Resources strategies of the Bank during the year was partnering with Great Place to Work Research and Consultancy (Pvt) Limited. The objective of this initiative was to assess the Bank's existing working culture and obtain useful insights into what improvements need to be addressed to ensure it remains an employer of choice, whilst encouraging optimal productivity and efficiency.

Branching out from this analysis, a variety of new projects are being introduced to revise the Bank's people management and development practices. These include providing more channels to encourage bottom-up communication, stimulating innovative thinking across all levels and introducing new motivational mechanisms in terms of peer-to-peer recognition and rewarding exceptional customer service.

The aforementioned are but a brief outline, and additional information is available in the Employee Capital section.

## **Brand Equity**

The DFCC Bank brand enjoys a proud legacy of over 60 years in Sri Lanka as the premier development financial institution in the country. DFCC Bank has nurtured entrepreneurs and start-up enterprises across all economic sectors. The Bank's initial clientèle were primarily small and large scale businesses requiring the competencies of a development bank to oversee the financing of their projects.

Following the successful amalgamation with DFCC Vardhana Bank in October 2015, DFCC Bank is now a fully-fledged commercial bank offering a diversified range of financial solutions that enable all stakeholders to '**Keep Growing**'.

By synchronising the joint aspects of development banking and commercial banking, DFCC Bank offers the best of both worlds, and is fully-equipped to fulfil the needs of a clientèle ranging from individuals, professionals and entrepreneurs to SMEs and corporates nationwide.

During the year under review, many brand-building initiatives were effectuated to firmly position DFCC Bank as a commercial bank. This included the launch of a marketing campaign, segmented product offerings catering to salaried employees and product campaigns showcasing the full range of savings, loans and current account products. The Vardhana Virtual Wallet; an innovative mobile solution was launched mid-year, which was a first in the banking industry. This revolutionary product enables users to simplify the way they transact at over 500 partner outlets distributed island-wide, as well as stay in control of their finances.

Further, a savings solution catering to the entire family was launched during the latter part of the year.

Customer engagement through social media platforms was also carried out to showcase and build the DFCC Bank brand.

The Bank's website was redesigned to simplify navigation and render it adaptable across all digital channels, to include mobile, tablet, laptop and desktop PCs. The new website reflects the Bank's dynamic and progressive personality. The site will further be accessible in Sinhala and Tamil. With its legacy site, DFCC Bank was the first bank in Sri Lanka to offer a trilingual website. DFCC Bank will further refine its online presence by adding a feature to process applications and 24/7 chat support.

Active customer research was also carried out to measure the level of customer service offered across the network of branches in order to enhance service levels.

Furthermore, several branch locations were made fully-fledged branches capable of catering to expanding customer bases.

DFCC Bank will strive to enhance its position amongst the top 25 brands in Sri Lanka and will ensure that it

maintains its brand equity at favourable levels through continuous monitoring of its brand performance.

Finally, the DFCC Bank brand will continue to progress to remain relevant with changing times, with a strengthened focus on sustainable growth of all its stakeholders, true to its positioning; *Keep Growing*.

## **Business Ethics and Integrity**

DFCC Bank maintains unwavering loyalty in its commitment towards upholding its business to the highest levels of ethics and integrity. Detailed governing mechanisms are in place to ensure the tenure of these, and the Corporate Governance Report appearing on page 97, elaborates on these procedures in detail.

## **Anti-Corruption**

The Bank possesses a written Code of Conduct that sets out detailed provisions in anti-corruption. This is not just a legal prerequisite, but in the Bank's view, a fundamental ethical and business imperative. In order to streamline collective action by all Bank employees, these provisions have been thoroughly detailed to all members and are supplemented through necessary updates.

DFCC Bank is proud of its status as a responsible corporate citizen. It enjoys a transparent and unblemished track record of business which fortifies the Bank's resolve in ensuring sustainable action well into the future.

## **Compliance**

As a financial services intermediary, DFCC Bank realises the importance of satisfying all laws, rules and regulations that are imposed upon it. Compliance is a key cornerstone of the Bank's organisational culture and all members of the Bank are fully cognisant of this responsibility. DFCC Bank's policies and procedures extend beyond default legal and regulatory requirements to incorporate wider benchmarks of integrity and ethical conduct. Measures taken to mitigate all compliance-related risks are laid out in detail under Operational Risk on page 90 of this Annual Report.

The Bank therefore maintains a faultless record with the above in mind. For the period under consideration, DFCC Bank has not been party to any fines imposed or actions implemented by Regulators in instances of non-compliance.

The Bank also invested more resources in training its personnel across all sectors in areas of regulatory compliance. The compliance team is fully dedicated to continuously improving systems and procedures in line with changing legislation and international standards. Further to this, the team will be investing in the latest technology to enhance performance in this area in 2017.