ANNEX 3: RISK MANAGEMENT REPORT
PRUDENT GROWTH WITHIN A DEFINED RISK APPETITE

Further to the Risk Review on page 36 and the Managing Risk: An Overview on page 154, this Risk Management Report details the risk management infrastructure, types of risk, risk management framework, and risk mitigation measures. Hence, it is recommended that this be read in conjunction with the Risk Review and the Managing Risk: An Overview write-ups referred to above.

The Board of Directors is responsible for overseeing the risk management function of the Bank. The Board carries out this responsibility directly by determining the desired risk profile of the Bank which is strongly correlated to achieving its strategic goals and indirectly by delegating oversight responsibility to the BIRMC which works closely with the executive level committees to review and assess the effectiveness of the risk management function and report to the Board on a regular basis. These reports provide a comprehensive perspective of the Bank's risk management efforts and outcomes, enabling the Board to identify the risk exposures, any potential gaps and mitigating actions necessary, on a timely basis. The tone at the top and the corporate culture reinforced by the ethical leadership of the Board play a key role in managing risk at the Bank.

Besides the tone at the top and the three lines of defence, the Bank's Code of Ethics sets out the Bank's commitment and expectations of all the employees to undertaking business in a responsible, transparent and disciplined manner and demands honesty, integrity and accountability from all employees. As a financial services intermediary, importance of such behaviour cannot be overemphasised. Accordingly, ethical conduct of the business too plays a significant role in managing risk in the Bank.

Credit ratings

The Bank's ability to borrow is significantly dependent on its credit ratings which were as follows:

Credit ratings Figure – 34

Commercial Bank of Ceylon PLC

AA(lka)/ Stable

Fitch Ratings

Fitch Ratings Lanka Limited.

Bangladesh

AAA

CRISL

Credit Rating Information and Services Limited.

The rating of AA(lka) is the strongest rating given to a Sri Lankan non-state sector bank. The AAA (Triple A) long-term credit rating accorded to the Bangladesh operations of Commercial Bank of Ceylon PLC has been reaffirmed by CRISL for the 7th consecutive year and is the highest credit rating given to any financial institution in Bangladesh by CRISL. (Figure 34)

In addition to the deposits, the Bank uses low cost international borrowings as a source of funding taking in to consideration the Swap cost of converting such funds in to LKR.

However, such strategy is embedded with the risk of premium volatilities that could result fluctuating marking to market gains or losses.

Summary of key risks

The Bank tracks a number of risks it is exposed to on a day-to-day basis. They include conventional externally driven and internally generated risks as well as emerging risks. Besides the correlations of risks, the dynamic and volatile operating environment and the unprecedented pace of technological advancements have caused the likelihood of occurrence and the impact of risk events themselves to be volatile, making the risk management function highly challenging.

Strategic goals and Risk Appetite Statement Table – 36

Aspect	Measure	Risk appetite (%)	2017 (%)	2016 (%)
Returns	ROA	> 2	1.54	1.53
	ROE	>20	17.88	19.52
Capital	CAR			
	CET 1	> 10	12.11	10.37
	Total Capital	> 14	15.75	14.87
Liquidity	SLAR	> 22	27.28	27.41
Asset quality downgrade	Gross NPA	4-5	1.88	2.18

These risks and mitigatory measures taken are summarised below:

Summary of key risks Figure – 35

Internal

	Credit risk	People and operational risk	Market risk	Model risk	Liquidity risk
Our objective	Safeguard the asset quality and reduce exposures to high risk segments	Creating an environment that enables performance while safeguarding the business	Safeguard against adverse movement of market factors arising out of price sensitivities of funding sources, investments, lending or trading portfolios	Develop predictive capability to support the decision making process	Safeguard against funding constraints that prevent growth and meet demands of depositors/investors
Mitigation	Robust and rigorous risk assessment and pricing of loans in line with risk appetite and collateral support	Succession plans, code of conduct and business ethics, competency, policy frameworks, segregation of duties and internal controls	Monitoring, predicting and controlling through stringent limits and management action triggers	Assumptions based models and behavioural testing through internal/ external independent validation	Retention and growth of stable deposit base and tapping low cost funding sources locally and overseas, act as a buffer in addition to sound maintenance of liquid asset portfolio to support contingencies

Bank

External

	Economic growth and trade cycles	Cyber threat	Increased regulations	Fiscal and monetary policy	Other emerging risks
Mitigation	Guiding business strategy and resource allocation communicated to business lines	Specialised teams within the risk management function (in addition to the first line of defence) and continued investments in enhancing cyber security	A dedicated compliance function and an independent internal audit function facilitate compliance	Close monitoring of trends for possible ramifications on economy and business strategy which could impact asset quality and profitability	Offering unparalleled and unprecedented convenience by adopting latest banking technology
Our objective	Safeguard stable funding sources, asset quality and returns	Safeguard information and ensure business continuity	Dynamic approach to comply with regulations	Dynamic approach to comply with regulations	To satisfy the rising expectations of stakeholders and to be future ready

Increasing trend in risk · Decreasing trend in risk · No significant change

Risk management infrastructure

Risk management infrastructure which is an integral part of the Bank's effective risk management framework encompasses both human and physical resources that enhance the Bank's preparedness to identify and manage risk including policies and procedures, limits, tools, databases, competencies, communication etc.

The Bank has invested a significant amount of resources to build its risk management infrastructure and to maintain it up to date on an ongoing basis by embracing international best practices. This is as part of the overall risk management system in line with the Board-approved roadmap in the direction of achieving a fully-fledged Enterprise Risk Management System in the near future.

Given that each and every employee in the Bank needs to understand that the Bank is exposed to risk, creating awareness by disseminating risk knowledge and enhancing skills on an on-going basis is essential to inculcate the desired risk culture. In this regard, Risk Management Department provides appropriate training/awareness to the employees, risk owners in particular, on all aspects related to risk based on the relevant policy documents.

Risk management policy, procedures and limits

The Bank has a comprehensive Risk Management Policy that addresses all the risks managed by the Bank, encompassing compliance with the regulatory requirements including the Banking Act Direction No. 07 of 2011 – Integrated Risk Management Framework for Licensed Commercial Banks based on the Basel Framework. Apart from institutionalising the risk knowledge base, this helps minimise bias and subjectivity in risk decisions. This key document clearly defines the objectives, outlines priorities and processes and roles of the Board and the Management in managing risk, shaping the risk culture of the Bank. The Risk Assessment Statement (RAS) sets out the limits for risks and forms an integral part of the risk management framework. The RAS and all risk policies are reviewed by the BIRMC at least annually or more frequently depending on the regulatory and business needs.

The overall risk exposure of the Bank including its overseas operations is compliant with the regulatory framework of the CBSL. Additionally, in order to ensure compliance, the risk management framework takes into account the regulatory requirements of the respective countries where the Bank conducts its operations.

Bank has issued detailed operational guidelines to facilitate implementation of the risk management policy and the limits specified in the RAS. These guidelines relate to specification of types of facilities, processes and terms and conditions under which the Bank will conduct business, providing clarity to the employees in their day-to-day work.

Risk management tools

Bank employs a combination of qualitative and quantitative risk management tools for identifying, measuring, managing and reporting risks. The choice of a tool(s) for managing a particular risk depends on the likelihood of occurrence and the impact of the risk as well as the availability of data. These tools vary from risk policies, risk registers, risk maps, heat maps, diversification, SEMS, insurance and benchmarking to limits, gap analysis, NPV analysis, swaps, caps and floors, hedging, risk rating, risk scoring, risk modeling, duration, scenario analysis, marking to market, stress testing, and VaR analysis.

Risk management tools Table – 37

Type of risk	Qualitative tools	Quantitative tools
Credit	Risk policies, risk registers, risk maps, heat maps, benchmarking, SEMS, diversification, and insurance	NPV analysis, caps and floors, hedging, risk rating, risk scoring, stress testing,
Market	Risk policies, risk registers, risk maps, heat maps, diversification, and benchmarking	Limits, gap analysis, swaps, hedging, risk rating, risk modelling, duration, scenario analysis, mark to market, stress testing, VaR, and probabilistic techniques
Operational	Risk policies, risk registers, risk maps, heat maps and benchmarking	Risk modelling and insurance

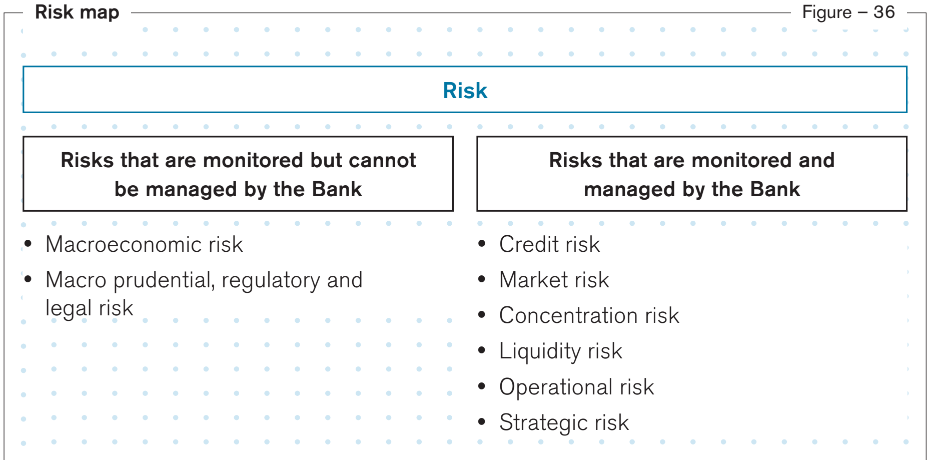
Monitoring and reporting

It is the responsibility of the risk management function of the Bank to identify, measure, monitor and report risk. In order to enhance the effectiveness of its role, staff attached to it undergoes regular training, enabling them to develop and refine their skills. They are well aided by IT systems which enable extraction of data, analysis and modelling. Regular and ad hoc reports are generated for review by the Senior Management, management committees and the Board which rely on such reports for evaluating performance and providing strategic direction. The reports provide information on aggregate measures of risks across products, portfolios, and geographies which are compared against agreed policy parameters providing a clear representation of the risk profile and sensitivities of the risks assumed by the Bank.

Risk map

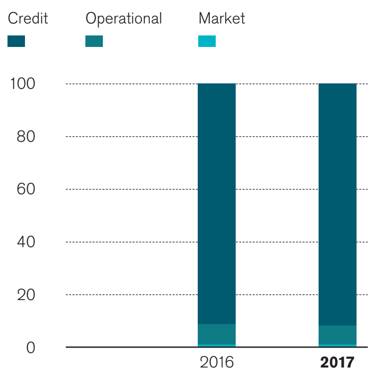
Based on the likelihood of occurrence and the impact of such risks on achieving strategic goals including the financial performance, the Bank has broadly categorised its risk exposures as shown in the risk map below [Figure 38]. While most of the risks are within the purview of the Bank and hence can be managed, there are a few other key risks that are beyond the purview of the Bank and hence can only be monitored to assess their impact.

Risk map Figure – 36



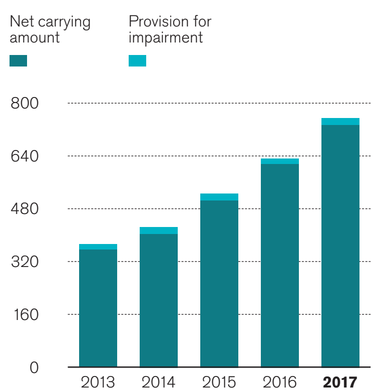
Risk-weighted assets composition as at December 31 Graph – 81

(%)



Gross loans and receivables to other customers as at December 31 Graph – 82

Rs. Bn.



Credit risk

Credit Risk is the risk of potential loss resulting from the failure of a customer/borrower or counterparty to honour its financial or contractual obligations to the Bank. It arises mainly from direct lending activities which are reflected in on-balance sheet assets as well as off-balance sheet transactions such as letters of credit, guarantees, documents against acceptance etc. Counterparty risk, concentration risk and settlement risk together constitute the total Credit risk of the Bank.

Maximum credit risk exposure Table – 38

	Maximum exposure 2017		Maximum exposure 2016	
	Rs. Mn.	%	Rs. Mn.	%
Carrying amount of credit exposures				
Loans and receivables to other customers	737,447	46.9	616,018	44.3
Loans receivables to banks	641	0.0	624	0.0
Financial investments	271,400	17.3	277,817	20.0
	1,009,488		894,459	
Off-balance sheet maximum exposures				
Lending commitments	124,595	7.9	131,382	9.4
Contingencies	438,454	27.9	365,854	26.3
	563,049		497,236	
Maximum credit exposure	1,572,537	100.0	1,391,695	100.0
Individually Impaired loans	23,043		22,102	
Impaired loans as a % of gross loans and receivables	3.05		3.49	
Provisions for impairment (individual and collective)	17,261		17,373	
Net carrying amount of loans and receivables	737,447		616,018	
Provisions as a % of gross loans and receivables	2.29		2.74	
Loan impairment charge (individual and collective)	1,957		1,511	

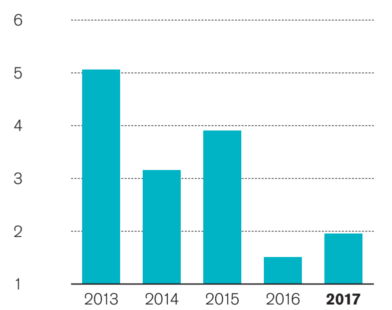
Overall credit exposure

The Bank's maximum credit exposure has increased by 12.99% in 2017 compared to the previous year. Both retail banking and corporate banking portfolios have contributed to this growth. Individually impaired loans have increased by 4.26% as a result of a policy decision of the Bank to lower the threshold for recognition of individually significant loans and the growth in loan book during the year.

Since a large number of individually significant loans are subject to rigorous evaluation at the time of being subjected to impairment trigger tests, final provisioning figures reflect a more realistic picture of the quality of the advances portfolio of the Bank.

During the year, an increase of 29.5% is observed in impairment charges compared to the previous year. Due to the revision of thresholds for identifying the loans to be subjected to individual impairment in 2016 and the resultant shift of a sizable portfolio from collective impairment to individual impairment has contributed to this increase in impairment charges. A detailed clarification in this regard is given on page 55.

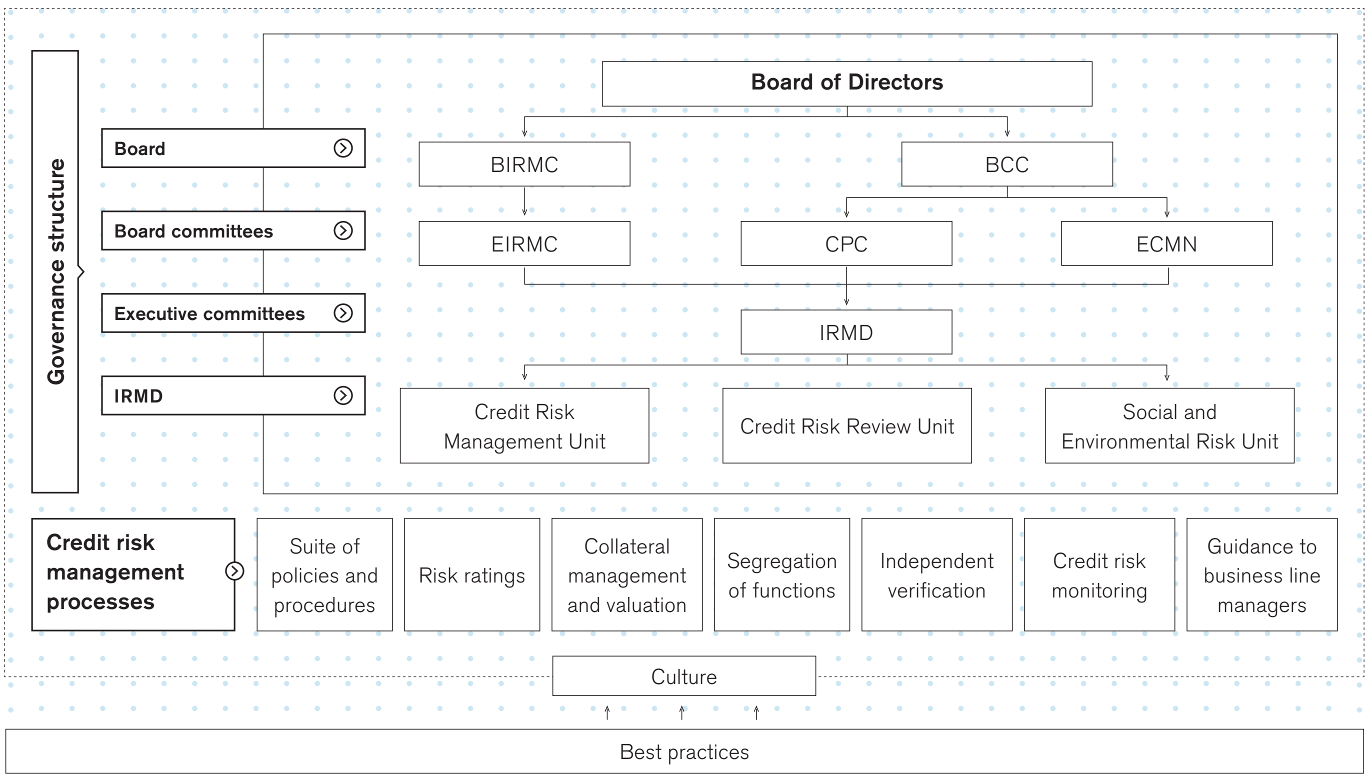
Impairment charge Graph – 83



Managing credit risk

Credit risk governance

Figure – 37

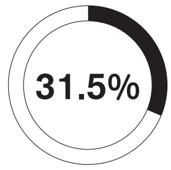


Given that credit risk accounts for 91.9% of the risk-weighted assets as at December 31, 2017 (91.6% as at December 31, 2016), management of credit risk is critical to the Bank. Our objective is to enhance value through credit risk management going beyond mere regulatory compliance. It is managed through the Credit Risk Management Framework approved by the Board, which is summarised graphically in the Figure 38 on page 379.

- **A robust risk governance structure –** Credit risk is monitored by the Board, BCC and BIRMC which are responsible for formulating policy including setting the parameters of the RAS. EIRMC, CPC and ECMN are the principal management committees responsible for monitoring credit risk exposure and initiating appropriate action to maintain the overall credit risk exposures within the defined risk appetite. Credit Risk Management Unit, Credit Risk Review Unit and Social and Environmental Risk Review Unit of the IRMD are responsible for daily credit risk management activities including measuring, monitoring and reporting of credit risk exposures and facilitating review of the Bank's credit risk-related policies and exposure limits at least annually. It also provides independent reviews on credit risk associated with new products/product relaunches and process changes to optimise risk-return trade-off.
- **A comprehensive suite of risk management processes** comprising the following:
  - **Policies and procedures –** These comprise the RAS, Delegation of Authority, Credit Risk Review Framework, Social and Environmental Management System, Policies and Guidelines for valuation of collateral which are reviewed and amended as deemed necessary by the Board based on the recommendations of the CPC and the BCC. These guide the Bank in underwriting new lending as well as post disbursement monitoring of accommodation granted.
  - **Risk ratings –** A comprehensive risk rating system compliant with Basel Guidelines representing diverse risk factors through a single point indicator is in place. The indicator uses borrower and transaction specific criteria for predicting the probability of default, facilitating measurement of risk in credit portfolios in an objective and consistent manner. During 2018, the Bank will be obtaining a validation of the rating system through an independent party. This is expected to facilitate the move towards calculating the impairment under SLFRS using rating based method whilst supporting the Bank's progression from the present Basel II Standardised Approach towards the more advanced Internal Ratings Based approach for calculating the capital requirement for credit risk.

- **Collateral management and valuation –** The Bank obtains collaterals as a possible secondary recourse in the form of cash, marketable securities, properties, stocks, trade debtors, other receivables, machinery and equipment and other physical or financial assets which are valued in accordance with strict guidelines. A panel of reputed professional valuers appointed by the Bank provides valuations of properties, machinery and vehicles obtained as collateral periodically, ensuring sufficient coverage through collateral. Collaterals vulnerable to frequent fluctuations in values are subject to stringent haircuts and/or more frequent valuations. The Bank also accepts personal and/or corporate guarantees, guarantees from other banks and creditworthy bodies which are assessed considering the financial strength of guarantors as against their cash flows, net worth etc.
- **Segregation of Credit Risk Management Functions –** Credit risk management comprises three functional components with pre-sanction risk being evaluated and monitored by the Credit Risk Management Function, post-sanction credit risk being monitored by the Credit Risk Review Function and the social and environment risk being evaluated/monitored by the Social and Environmental Risk Review Function. This facilitates a high degree of specialisation and leveraging of skills resulting in focused analysis supporting effective credit risk management.
- **Social and environmental risk management –** During 2017, the Bank took several steps to enhance S&E Risk assessment and management of Bank's lending activities which included providing the S&E officers with a series of regular S&E risk management training in collaboration with IFC, developing additional tools to ensure that S&E risks are appropriately screened, S&E officers undertaking more site visits to identify S&E risks and to formulate corrective action plans with the involvement of customers where necessary, to ensure that appropriate environmental management plans are in place. The Bank strengthened the S&E appraisal process in achieving a level of due diligence to commensurate with the level of S&E risk in the lending proposals.

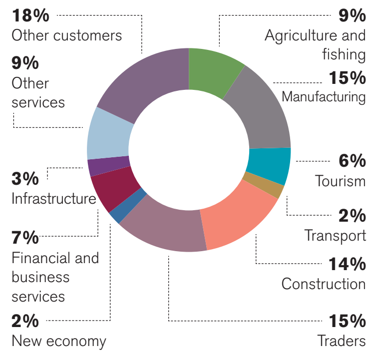
  The Bank also took the initiative to empanel independent external social and environmental consultants in year 2017 after carefully evaluating their experience and expertise in order to obtain their services when necessary to carry out S&E due diligence on complex project financing activities.
- **Independent verification of risk assessments –** The Credit Risk Management Unit (CRMU) independently verifies that the proposals with exposures above identified threshold levels fall within the established credit risk framework of the Bank and that they comply with the internal as well as regulatory requirements.
- **Credit risk monitoring –** Branch Credit Monitoring Unit independently monitors the loans and advances portfolio for signs of delinquency and supports lending officers in maintaining portfolio quality. CRMU prepares monthly reports on Key Credit Risk Indicators (KCRIs) which include segmentation of the loans and advances portfolio using a number of different parameters enabling the analysis of the portfolio at high level of granularity. KCRI monthly reports also include an in-depth analysis of exposure to the financial subsidiaries thus providing a holistic view of the overall credit risk of the Group thereby facilitating identification of emerging risks in individual portfolios and implementation of corrective action in a timely manner.
- **Providing direction to business line managers –** The credit risk monitoring process provides information on products, industries and other indicators of elevated risk facilitating diversification into thriving economic segments whilst reducing the overall credit risk concentration and optimising returns.
- **Internal audit –** Credit risk management processes are reviewed by internal audit to ensure that they comply with regulatory requirements and the Bank's policy framework.



Credit risk review

CBSL requires 30-40% of the Total Loans and Receivables of the Bank to be subjected to Credit Risk Review (CRR). The Bank has covered 31.5% of the total loans and receivable portfolio under CRR in 2017 (38.05% in 2016).

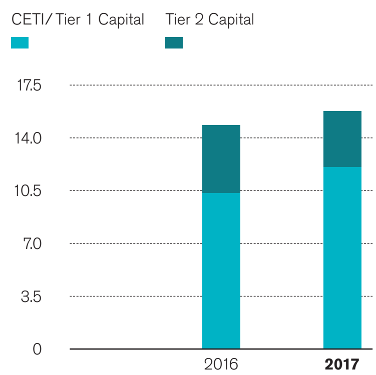
Industry-wise analysis of loans and receivables to other customers as at December 31, 2017 (Net carrying value) — Graph – 84



The graph depicts that there is no significant concentration to any industry sector.

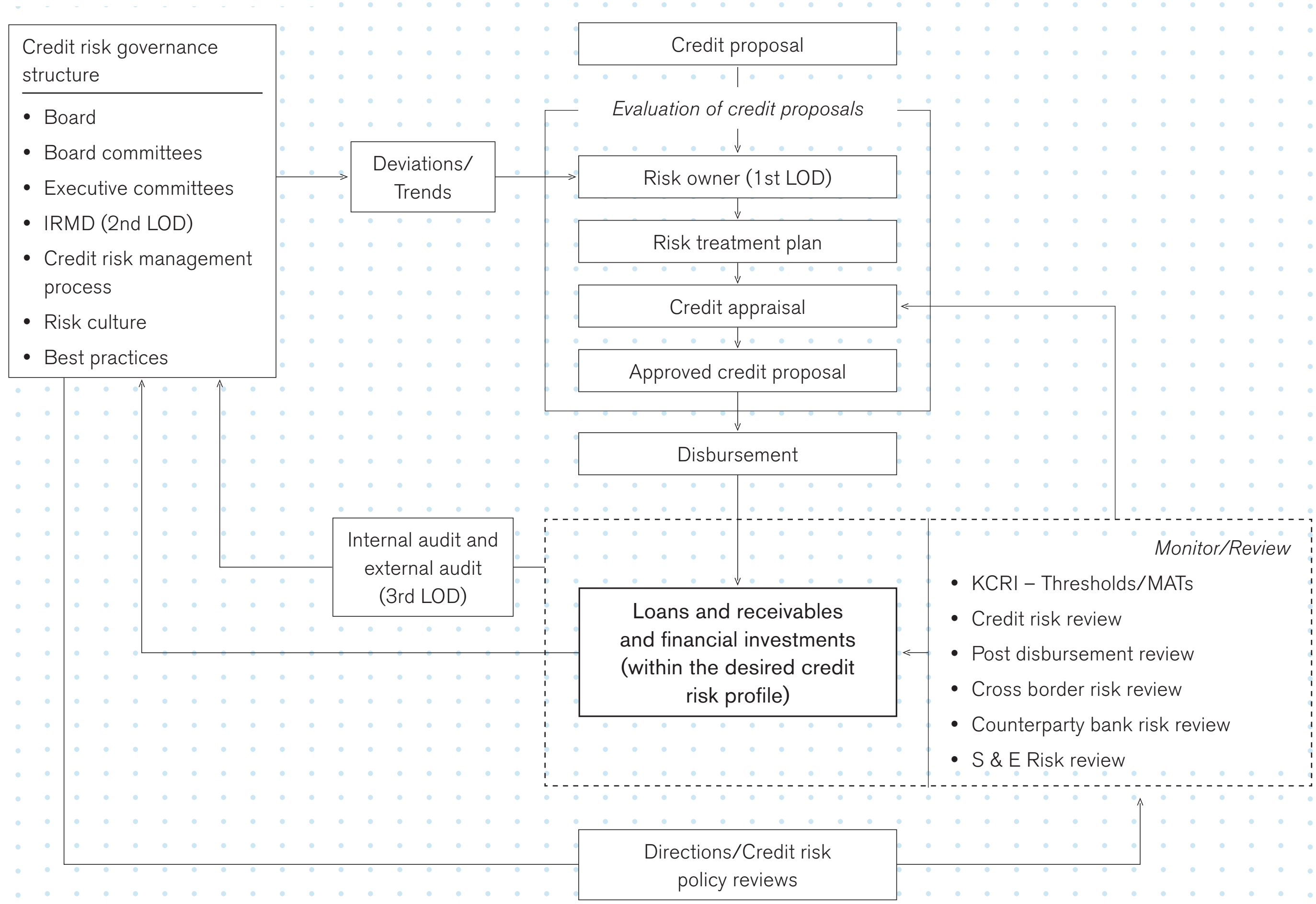
Capital adequacy composition — Graph – 85

%



The CET 1 capital increased due to the rights issue of shares during the year.

Credit risk management framework Figure – 38



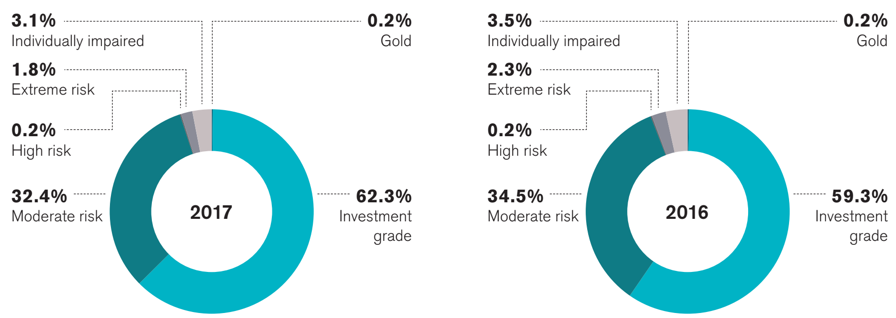
Review of credit risk

Elevated levels of attention given to loan approvals and disbursements coupled with concerted efforts in keeping the NPA levels in tandem with the established policy parameters paved the way to improve the asset quality of the Bank.

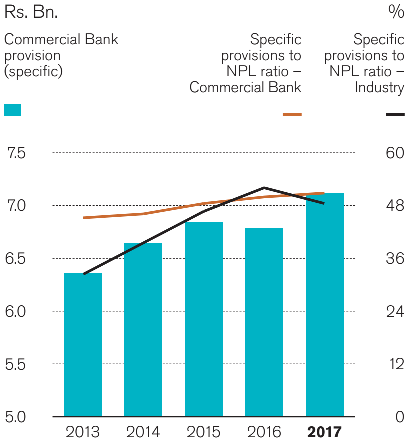
The effective Credit Risk Management Framework referred to above that guides the Bank throughout the process of on-boarding new exposure and monitoring existing exposure contributes immensely to preserve the quality of the loan book. In addition, the Bank is cautious and exercises restraint in the choice of customers, products, segments and geographies it caters to. Continuous monitoring of age analysis and the underlying movement across arrears buckets of past due loans enabled the Bank to swiftly take action, thereby moderating default risk during the year.

The allowance for individually impaired loans decreased by 7.1% whilst the allowance for collective impairment increased by 5.5% during the year, distribution of which is given on page 232.

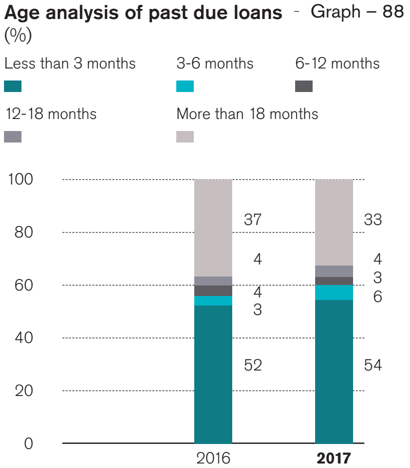
Risk ratings-wise distribution of loans and receivables to other customers Graph – 86



Provision cover of the Bank — Graph – 87



Age analysis of past due loans – Graph – 88



Individual/collective impairment distribution – Sri Lanka operation — Table – 39

Industry sector	Past due and individually impaired advances Rs. '000	Allowance for collective impairment Rs. '000	Allowance for individually impaired loans Rs. '000	Amount written off Rs. '000
Exports	3,318,650	471,706	583,982	5,717
Imports and trading	3,862,404	948,398	1,482,820	2,494
Wholesale and retail trading	1,331,525	377,490	267,397	1,871
Construction industry	1,945,727	199,382	376,267	53,182
Any other commercial activity	1,296,311	290,014	156,438	6,762
Industries – MFG for local market	6,591,036	802,929	1,312,957	6,544
Agricultural activity	1,794,354	644,642	247,302	19,412
Housing and property development	830,748	255,699	447,870	123
Tourism and hospitality trade	7,769,395	385,719	1,534,875	213
Personal	5,158,044	2,013,335	918,743	26,914
Services	1,978,533	696,474	233,399	4,959
Holding companies	41,417	65,691	1,619	–
Finance and insurance industry	82,694	161,324	35,235	–
State institutions	–	11,429	–	1,588
Others	1,249,650	1,045,854	53,066	690
Total	37,250,489	8,370,086	7,651,971	130,468

Individual/collective impairment distribution – Outside of Sri Lanka — Table – 40

Industry sector	Past due and individually impaired advances Rs. '000	Allowance for collective impairment Rs. '000	Allowance for individually impaired loans Rs. '000	Amount written off Rs. '000
Exports	–	224,379	–	–
Imports and trading	–	–	–	–
Wholesale and retail trading	255,513	129,553	–	–
Construction industry	–	–	–	–
Any other commercial activity	74,433	70,923	–	–
Industries – MFG for local market	427,732	451,739	78,916	–
Agricultural activity	–	18,282	–	–
Housing and property development	102,252	12,058	–	–
Tourism and hospitality trade	–	1,742	–	–
Personal	14,333	13,866	–	–
Services	10,158	20,483	73,007	–
Holding companies	–	–	49,755	–
Finance and insurance industry	–	56,409	–	–
State institutions	–	–	–	–
Others	–	38,236	–	–
Total	884,421	1,037,670	201,678	–

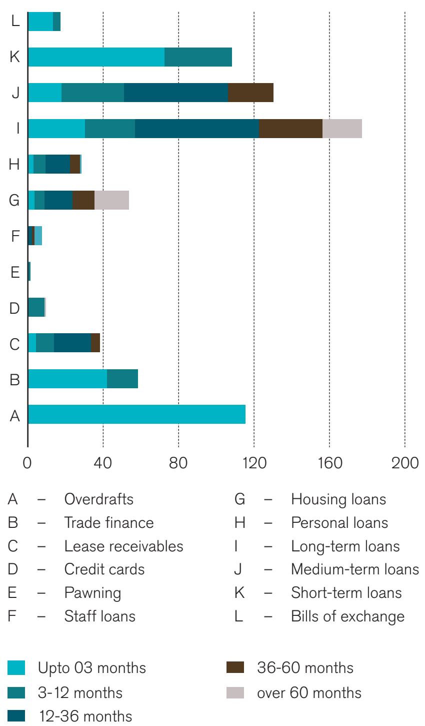
Concentration risk

Concentration risk is managed by diversification of risk across industry sectors, products, counterparties and geographies. The Bank's RAS defines the limits for these segments and exposures are monitored by the Board, BIRMC, EIRMC and the CPC to ensure compliance. They also make recommendations on modifications to specified limits taking into consideration trends and events shaping the business environment.

Individual and collective impairment distribution to identified industry sectors as at year end is given in Tables 39 and 40.

The below graph depicts that the tenor-wise breakdown of the portfolio of total loans & receivables to other customers is within the risk appetite of the Bank.

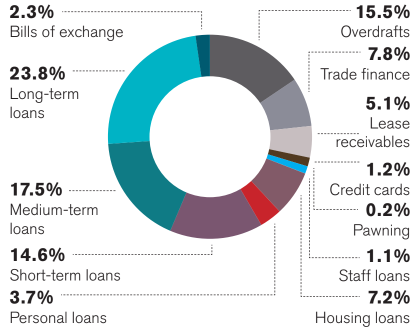
Loans and receivables to other customers by tenor-wise as at December 31, 2017 (based on residual maturity) — Graph – 89
Rs. Bn.



An analysis of loans and receivables by product (Graph 90) also reflects the effectiveness of the Bank's credit policies with risk being well-diversified across the Bank's range of credit products.

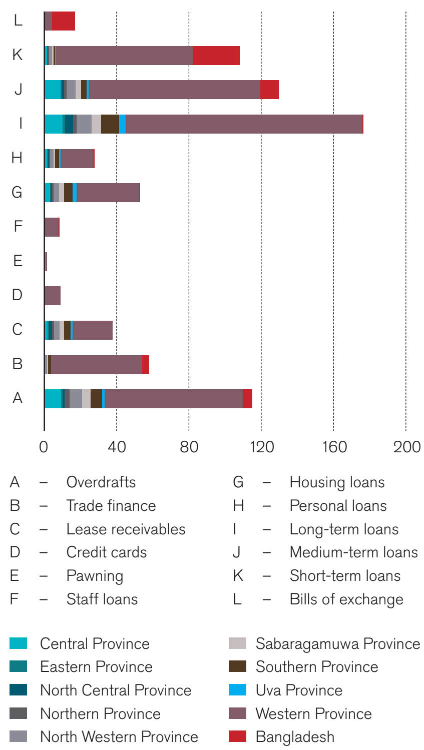
The relatively high exposure of 23.8% to long-term loans is rigorously monitored and mitigated with collateral.

Product-wise analysis of loans and receivables to other customers as at December 31, 2017 — Graph – 90



A geographical analysis reflects a high concentration of loans (Graph 91) in the Western Province which is due to concentration of economic activities in the Province and the head offices of most borrowing entities being located there.

Geographical analysis of loans and receivables product-wise to other customers as at December 31, 2017 — Graph – 91
Rs. Bn.

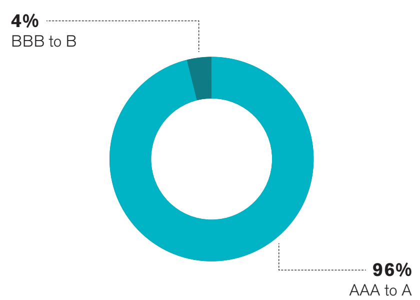


Counterparty risk

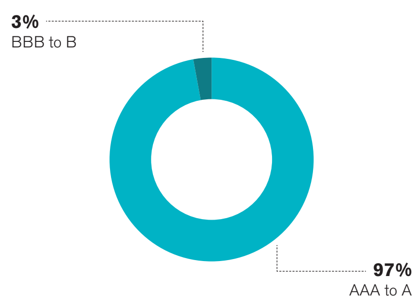
The Bank has laid down policies/procedures and limit structures including single borrower limits and group exposure limits with sub-limits for products etc. to manage the counterparty risks. The limits set by the Bank are far more stringent than those stipulated by the regulator. This provides the Bank with a greater leeway in managing its concentration levels with regard to the counterparty exposures.

A key component in managing counterparty risk is the loans and receivables to banks both local and foreign which is being monitored through a specific set of policies, procedures and a limit structure. At frequent intervals the counterparty bank exposures are monitored against the established prudent limits whilst market information on the financial/economic performance of these counterparties are subject to a rigorous scrutiny throughout the year and the limits are revised to reflect the latest information where deemed necessary.

The concentration of counterparty bank exposures in Sri Lanka as at December 31, 2017 (Fitch ratings-wise) — Graph – 92



The concentration of counterparty bank exposures in Bangladesh as at December 31, 2017 (CRAB ratings-wise*) — Graph – 93



**Equal CRISL/Alpha ratings are given where CRAB ratings are unavailable*

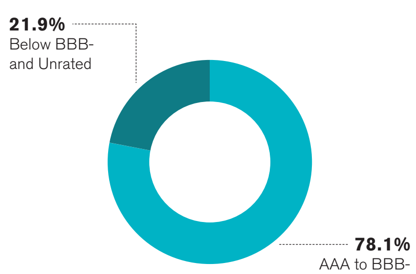
The analysis uses Fitch Ratings for local banks in Sri Lanka and Credit Ratings Agency in Bangladesh (CRAB) for local banks in Bangladesh (Equivalent CRISL/ Alpha ratings have been used where CRAB ratings are not available). Exposures for local banks in Sri Lanka rated AAA to A category stood at 96% (Graph 92) whilst 97% of exposure of local banks in Bangladesh consisted of AAA to A rated counterparty banks (Graph 93).

Cross-border risk

The risk that the Bank will be unable to obtain payment from its customers or third parties on their contractual obligations as a result of certain actions taken by foreign Governments, mainly relating to convertibility and transferability of foreign currency is referred to as the Cross-border Risk. Cross-border assets comprise loans and advances, interest-bearing deposits with other banks, trade and other bills and acceptances and predominantly relate to short-term money market activities.

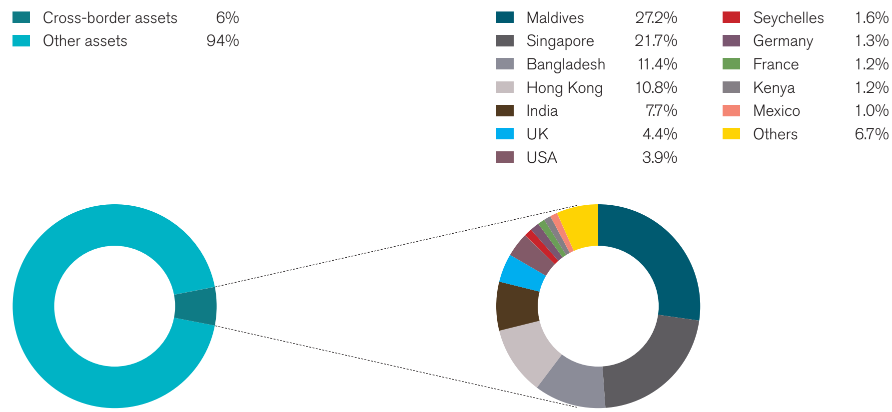
In addition to the limit structure in place to minimise risk arising from over concentration, the Bank continuously monitors macro-economic and market developments of the countries with exposure to counterparties besides stringent evaluations of counterparties and maintaining frequent dialogue with them. Timely action is taken to suspend limits to countries with adverse economic/political developments.

The concentration of cross-border exposure (Sri Lanka and Bangladesh operations) – S&P Rating wise as at December 31, 2017 Graph – 94



Note: Excluding the investment in Bangladesh operation and Direct lending in Maldives and Bangladesh

Cross-border exposure of the Bank Graph – 95



Total cross-border exposure is only 6% of total assets of the Bank (Graph 95). The Bank has exposures to cross-border through a spread of countries which primarily include Maldives, Singapore, Hong Kong, USA, India, etc.

With the start of operations in the Maldives through our subsidiary "Commercial Bank of Maldives Limited (CBM)", the Group level cross-border exposure measurements are now analysed and monitored. However, as of year-end there are no additional exposures to this entity, other than the capital investment.

Market risk

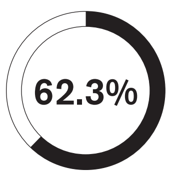
Market risk is the risk of loss arising from movements in interest rates, foreign exchange rates, commodity prices, equity and debt prices and their correlations. Most of the Bank's operations are subject to at least one or more elements of market risk.

Elements and measurement of market risk Table – 41

	Trading activities	Non-trading activities
Risk type	• Interest rate risk ◦ Repricing risk ◦ Yield curve risk ◦ Basis risk • Foreign exchange risk • Equity price risk • Commodity price risk	• Interest rate risk ◦ Repricing risk ◦ Basis risk • Foreign exchange risk
Business Lines	Treasury	Retail, Corporate, International Operations and Treasury
Measurement	Value-at-Risk, Sensitivity Analysis, Stress Testing, Gap Analysis	Sensitivity Analysis, Stress Testing, Gap Analysis

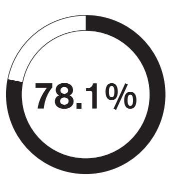
Market risk categories Table – 42

Major market risk category	Risk components	Description	Tools to monitor	Severity	Impact	Exposure
Interest rate		Risk of loss arising from movements or volatility in interest rates				
	Re-pricing	Differences in amounts of interest earning assets and interest-bearing liabilities getting re-priced at the same time or due to timing differences in the fixed rate maturities and appropriately re-pricing of floating rate assets, liabilities and off-balance sheet instruments	Re-pricing gap limits and interest rate sensitivity limits	High	High	High
	Yield curve	Unanticipated changes in shape and gradient of the yield curve	Rate shocks and reports	High	High	High
	Basis	Differences in the relative movements of rate indices which are used for pricing instruments with similar characteristics	Rate shocks and reports	High	Medium	Medium
Foreign exchange		Possible impact on earnings or capital arising from movements in exchange rates arising out of maturity mismatches in foreign currency positions other than those denominated in base currency, Sri Lankan Rupee (LKR)	Risk tolerance limits for individual currency exposures as well as aggregate exposures within regulatory limits for NOP	High	Medium	Medium
Equity		Possible loss arising from changes in prices and volatilities of individual equities	Mark-to-market calculations are carried out daily and quarterly for Held for Trading (HFT) and Available for Sale (AFS) portfolios respectively	Low	Low	Negligible
Commodity		Exposures to changes in prices and volatilities of individual commodities	Mark to market calculations	Low	Low	Negligible



Distribution of borrower ratings

Borrowers with Investment Grade Ratings where default risk is considered to be very low, comprised 62.3% of the total loans and receivables to other customers.



Distribution of country rating

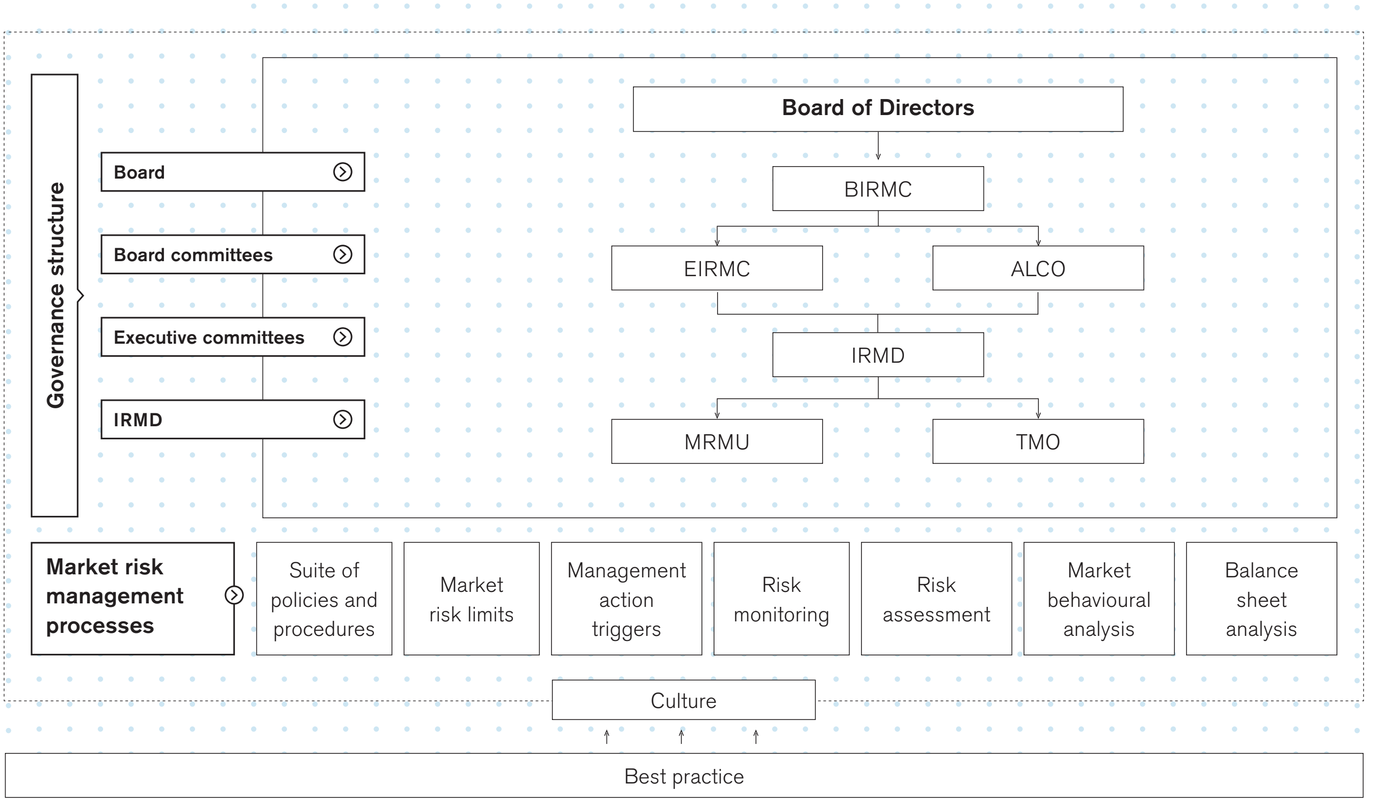
Exposure to countries which are rated AAA to BBB- (S&P or equivalent) accounted for 78.1% of the total cross-border exposure of the bank.

Managing market risk

The Market risk is managed through the Market Risk Management Framework approved by the Board, which is summarised graphically in the Figure 40 on page 385.

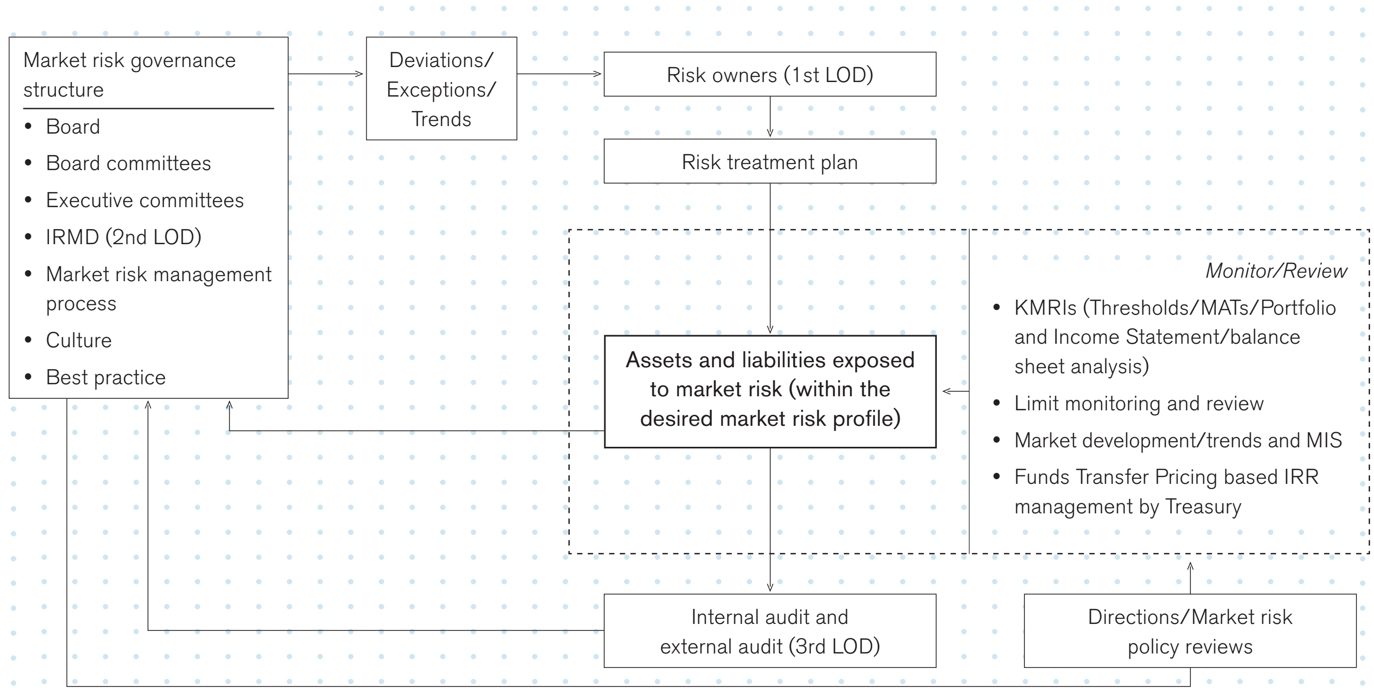
- **A robust risk governance structure –** Market risk is monitored by the Board, BIRMC and EIRMC which are responsible for formulating policy including setting the parameters of the RAS. ALCO is the principal Management Committee responsible for monitoring market risk exposure and initiating appropriate action to optimise overall market risk exposures within the defined risk appetite. Market Risk Management Unit (MRMU) of the IRMD is responsible for daily Market Risk Management activities including measuring, monitoring and reporting of market risk exposures and facilitating review of the Bank's market risk-related policies and exposure limits at least annually. It prepares and presents Key Market Risk Indicators (KMRIs) on a monthly basis to EIRMC in which they are extensively discussed and considered for appropriate actions. It also provides independent reviews on market risks associated with new investment proposals and products to optimise risk-return trade-off. The Treasury Middle Office (TMO) is an integral part of MRMU and functions independently from both the Treasury Front Office (i.e. trading unit) and Treasury Back Office (i.e. settlement unit). TMO independently monitors, measures and analyses exposures as per the comprehensive limit framework pertaining to Treasury transactions. Further it reports on Management Action Triggers (MATs), which alert of imminent limit breaches and recurring loss events, to initiate preventive measures to mitigate potential losses.

Market risk governance Figure – 39



- **A comprehensive suite of risk management processes** comprising the following:
  - **Policies –** In addition to the Bank Risk Management Policy, policies covering various aspects of market risk which include Market Risk Management Policy, Asset and Liability Management (ALM) Policy, Foreign Exchange (FX) Risk Management Policy, Derivative Policy, Treasury Policy, Stress Testing Policy Code of Ethics for Dealers define exposure limits and procedures for transactions.
  - **Market risk limits –** These are regularly reviewed by ALCO and EIRMC which are revised to narrower bands than specified in the RAS if market dynamics indicate elevated risk levels.
  - **MATs –** These are risk thresholds determined based on the risk appetite of the Bank, that trigger specific actions to safeguard the market risk exposures of the Bank within the levels specified in the RAS.
  - **Risk monitoring –** ALCO monitors asset and liability gaps and market trends to determine strategy, pricing of risk and funding requirements while also guiding Treasury on management of IRR. Tools such as gap analysis (income perspective) and duration analysis (value perspective) are used to monitor IRR on an ongoing basis factoring the re-pricing characteristics of all assets and liabilities of the Bank's balance sheet. The Bank assesses IRR exposure based on both the Earnings at Risk (EAR) approach focusing on the impact of interest rate changes on its near-term earnings and the Economic Value of Equity (EVE) approach, focusing on the time value of the Bank's net cash flows over longer time horizons. Exchange Rate Risk (ERR) is monitored through variance analysis, SWAP exposures, Counter party limits, and Net Open Positions.
  - **Risk assessment –** A range of techniques including sensitivity analysis, stress testing, Mark to Market and Value at Risk (VaR) calculations are used to assess market risk across portfolios.

Market risk management framework Figure – 40



Review of market risk

Market risk arises mainly from the Non-Trading Portfolio (Banking Book) which accounts for 91.52% of the total assets and 93.32% of the total liabilities subject to market risk. Exposure to market risk arises mainly from IRR and FX risk as the Bank has negligible exposure to commodity related price risk and equity and debt price risk which was less than 12% of the total risk weighted exposure for market risk.

The Bank's exposure to market risk analysed by Trading Book and Non-Trading Portfolios (or Banking Book) are set out in the Table 43 below:

Bank's exposure to market risk Table – 43

as at December 31, 2017	Note	Carrying amount	Market risk measurement: Trading portfolio	Market risk measurement: Non-trading portfolio
Assets subject to market risk				
Cash and cash equivalents	27	12,387,967		12,387,967
Balances with central banks	28	4,601,606		4,601,606
Placements with banks	29	17,633,269		17,633,269
Securities purchased under resale agreements		–		–
Derivative financial assets	30	2,334,536	2,334,536	
Other financial instruments –Held for trading	31	4,410,913	4,410,913	
Loans and receivables to banks	32	640,512		640,512
Loans and receivables to other customers	33	737,446,567		737,446,567
Financial investments – Available for sale	34	154,714,132		154,714,132
Financial investments – Held to maturity	35	63,562,752		63,562,752
Financial investments – Loans and receivables	36	48,712,477		48,712,477
		1,046,444,731	6,745,449	1,039,699,282
Liabilities subject to market risk				
Due to banks	43	57,120,991		57,120,991
Derivative financial liabilities	44	3,678,494	3,678,494	
Securities sold under repurchase agreements	–	49,676,767		49,676,767
Due to other customers/deposits from customers	45	807,630,072		807,630,072
Other borrowings	46	23,786,094		23,786,094
Subordinated liabilities	52	25,165,924		25,165,924
		967,058,342	3,678,494	963,379,848

Market risk portfolio analysis

The gap report is prepared by stratifying Rate Sensitive Assets (RSA) and Rate Sensitive Liabilities (RSL) into various time bands according to maturity (if fixed rates) or time remaining to their next re-pricing (if floating rate). Savings Deposits balances are distributed in line with the findings of behavioural analysis conducted by the Bank. Vulnerability of the Bank to interest rate volatility is indicated by the gap between RSA and RSL.

Interest rate sensitivity gap analysis of assets of the banking book as at December 31, 2017 – Bank Table – 44

	0-90 days	3-12 months Rs. '000	1-3 years Rs. '000	3-5 years Rs. '000	Over 5 years Rs. '000	Non-sensitive Rs. '000	Total Rs. '000
Financial assets							
Total financial assets	541,347,702	216,019,552	130,748,898	96,641,458	38,604,415	77,373,750	1,100,735,775
Financial liabilities							
Total financial liabilities	323,590,213	344,150,761	88,233,157	90,783,854	85,195,402	73,923,900	1,005,877,287
Period gap	217,757,488	(128,131,209)	42,515,741	5,857,604	(46,590,987)		
Cumulative gap	217,757,488	89,626,279	132,142,020	137,999,624	91,408,637		
RSA/RSL	1.67	0.63	1.48	1.06	0.45		

Interest Rate Risk (IRR)

Extreme movements in interest rates expose the Bank to fluctuations in Net Interest Income (NII) and have the potential to impact the underlying value of interest earning assets and inherent liabilities and off-balance sheet items. The main types of IRR to which the Bank is exposed to are re-pricing risk, yield curve risk and basis risk.

Sensitivity of projected NII

Regular stress tests are carried out on Interest Rate Risk in Banking Book (IRRBB) encompassing changing positions and new economic variables together with systemic and specific stress scenarios. Change in value of the Fixed Income Securities (FIS) portfolio in HFT and AFS categories due to abnormal market movements is measured using both EVE and EAR perspectives. Results of stress test on IRR are analysed to identify the impact of such scenarios on Bank's profitability and capital.

Impact on NII due to rate shocks on LKR and FCY is continuously monitored to ascertain the Bank's vulnerability to sudden interest rate movements [Refer Note 69.3.2 (b) on page 328].

Sensitivity of NII to rate shocks Table – 45

	2017		2016	
	Parallel increase Rs. '000	**Parallel decrease Rs. '000**	Parallel increase Rs. '000	Parallel decrease Rs. '000
As at December 31,	1,243,611	(1,241,623)	670,859	(668,620)
Average for the year	920,414	(918,225)	634,306	(632,375)
Maximum for the year	1,243,611	(1,241,623)	827,488	(824,962)
Minimum for the year	706,442	(704,325)	366,432	(365,569)

Foreign exchange risk

Stringent risk tolerance limits for individual currency exposures as well as aggregate exposures within the regulatory limits ensure that potential losses arising out of fluctuations in FX rates are minimised and maintained within the Bank's risk appetite.

USD/LKR exchange rate fluctuated between a low of Rs. 149.65 and a high of Rs. 153.85 (source: Bloomberg) during the year under review and the annual rupee depreciation was recorded at approximately 2.46%. The Table 46 below indicates the Bank's exposure to FX risk as at end 2017.

Bank's exposure to FX risk Table – 46

Currency	Net open position (NOP)	Overall exposure in respective foreign currency	Overall exposure in Rs.
	'000	'000	'000
United States Dollar	2,734.00	7,162.00	1,100,083.20
Great Britain Pound	20.00	(29.00)	(5,990.50)
Euro	(52.00)	(269.00)	(49,344.50)
Japanese Yen	372.00	(2,965.00)	(4,039.22)
Indian Rupee	0.00	0.00	0.00
Australian Dollar	10.00	(51.00)	(6,105.51)
Canadian Dollars	(34.00)	18.00	2,200.75
Other currencies in USD	(88.00)	93.00	14,284.80
Total exposure USD	2,595	6,843	1,051,089.02
Total capital funds as at December 31, 2017			122,415,881.71
Total exposure as a % of capital funds as at December 31, 2017			0.86%

Stress testing is conducted on NOP by applying rate shocks ranging from 6% to 15% in order to estimate the impact on profitability and capital adequacy of the Bank (Refer Note 69.3.3 on page 329). The impact of a 1% change in exchange rate on the NOP indicates a loss of Rs. 171.27 Mn. on the positions as at December 31, 2017.

Equity price risk

Although the Bank's exposure to equity price risk is negligible, mark-to-market calculations are conducted daily on HFT and AFS portfolios. The Bank has also commenced VaR calculations on equity portfolio. The Table 47 below summarises the impact of a shock of 10% on equity price on profit, other comprehensive income (OCI) and equity.

Impact of 10% shocks on equity portfolio Table – 47

	2017			2016		
	Held for trading Rs. '000	Available for sale Rs. '000	Total Rs. '000	Held for trading Rs. '000	Available for sale Rs. '000	Total Rs. '000
Market value of Equity Securities as at December 31,	314,745	500,278	815,023	293,809	246,548	540,357
	Impact on P&L Rs. '000	Impact on OCI Rs. '000	Impact on equity Rs. '000	Impact on P&L Rs. '000	Impact on OCI Rs. '000	Impact on equity Rs. '000
Shock of 10% on equity price (upward)	31,475	50,028	81,503	29,381	24,655	54,036
Shock of 10% on equity price (downward)	(31,474)	(50,028)	(81,502)	(29,381)	(24,655)	(54,036)

Commodity price risk

The Bank has a negligible exposure to commodity price risk which is limited to the extent of the fluctuations in gold price on the Pawning portfolio. The portfolio is less than 0.177% of total market risk exposure.

Liquidity risk

Liquidity Risk is the Bank's inability to meet "on" or "off" balance sheet contractual and contingent financial obligations as they fall due, without incurring unacceptable losses.

Banks are vulnerable to liquidity and solvency problems arising from asset and liability mismatches. Consequently, the primary objective of liquidity risk management is to assess and ensure availability of funds required to meet obligations at appropriate times, both under normal and stressed conditions.

The Bank has maintained the following liquid asset ratios as at December 31, 2017:

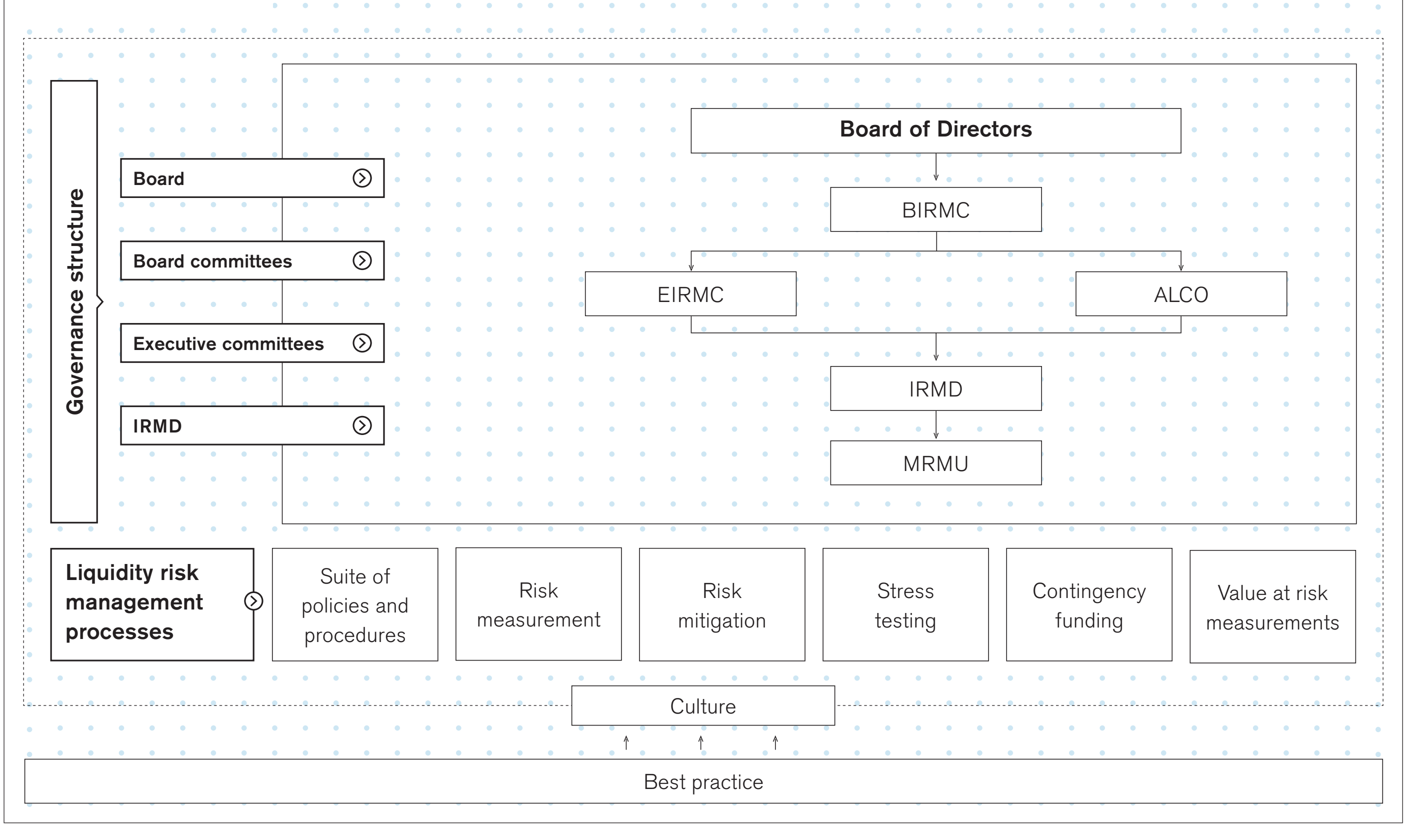
Liquid asset ratios Table – 48

	Domestic Banking Unit (DBU) %	Off-shore Banking Unit (OBC) %
Statutory Liquid Assets Ratio (SLAR)	27.28	30.95
	Local currency %	All currencies %
Liquidity Coverage Ratio (LCR)	272.15	209.17

Managing liquidity risk

Liquidity risk governance

Figure – 41

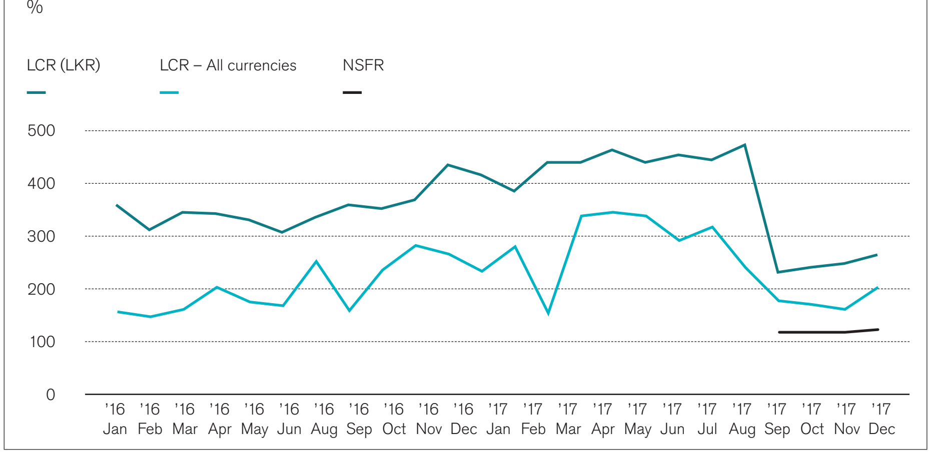


The Bank manages liquidity risk through the Liquidity Risk Management Framework on a continuous basis to ensure that it is managed within the parameters of the risk appetite.

- **A robust risk governance structure –** ALCO is mandated with the implementation of liquidity risk management policies and procedures which encompass establishing and monitoring liquidity targets, determining strategies and tactics to meet those targets and ensuring availability of sufficient liquidity for unanticipated contingencies. Strategies include effective diversification of sources and tenors of funding, monitoring off-balance sheet activity related liquidity impact and diversifying deposit maturity base avoiding concentrations. The Board, BIRMC, ALCO and EIRMC regularly review reports of key liquidity risk indicators to ensure that they are within the agreed parameters.
- **A comprehensive suite of risk management processes** comprising policies and procedures, measurement approaches, mitigation measures, stress testing methodologies, contingency funding arrangements and VaR measurements, as detailed below:
  - **Measurement –** Liquidity is monitored within both stock (based on key ratios) and flow (based on cash inflows and outflows in time bands) approaches. Key liquidity risk indicators used by the Bank to assess adequacy of its liquidity position include Statutory Liquid Assets Ratio (SLAR), Liquidity Coverage Ratio (LCR), Net Advances to Deposits Ratio, Dynamic and Static (Structural) Liquidity Gap Summary, Net Stable Funding Ratio, Funding Concentration and Commitments in relation to funding sources. A more stringent internal limit has been set for SLAR compared to the statutory requirement of 20% of total liabilities excluding contingent liabilities as well as LCR as per the Basel III Guidelines.

Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)

Graph – 96



209.17%

Liquidity Coverage Ratio (LCR)

Liquidity Coverage Ratio of the Bank which stood at 209.17% was well above the minimum statutory requirement of 100%.

127.87%

Net Stable Funding Ratio (NSFR)

NSFR, requires banks to maintain a stable funding profile by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis, over a longer time horizon, in relation to the composition of their assets and off-balance sheet exposures.

Compliance for NSFR to be made with effect from April 1, 2018 as per the Consultation paper issued by CBSL in November 2017 and banks are required to maintain a minimum NSFR of 100%.

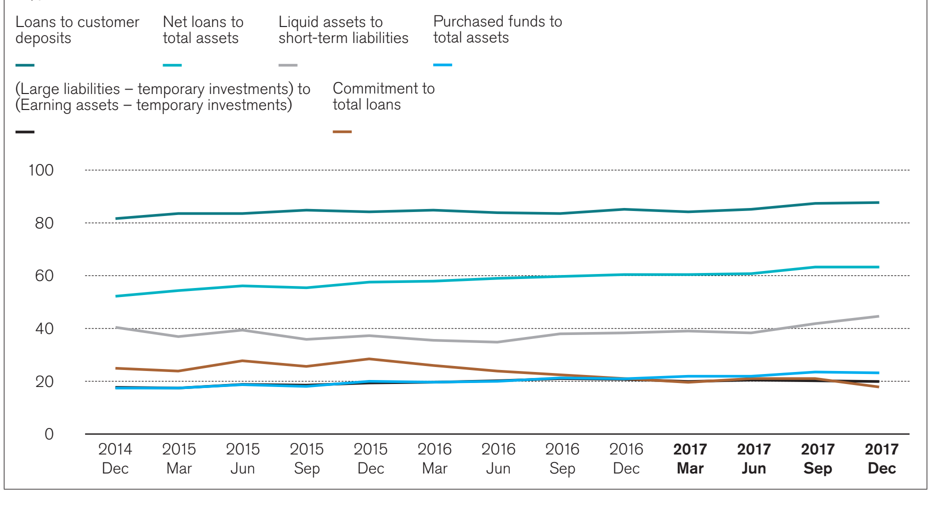
- **Risk mitigation –** An adequate margin is maintained in high quality liquid assets and access to diverse funding sources such as inter-bank market, wholesale and retail repurchase agreements, assets and investments available-for-sale. Additionally, contingency funding agreements with peer banks are in place ensuring availability of adequate liquidity to fund its existing asset base and growth whilst maintaining sufficient liquidity buffers to operate smoothly under varying market conditions in the short-term.
- **Stress testing –** Liquidity stress tests and scenario analysis are carried out on an annual basis in line with the guidelines on stress testing of LCBs and LSBs issued by the CBSL in September 2014 to evaluate the potential impact of sudden and severe stress events on the Bank's liquidity position. This enables the Bank to proactively identify appropriate funding arrangements that can be used to manage such stress situations with a minimum financial and/or reputational impact.
- **Contingency funding –** The Contingency Funding Plan provides guidance in managing liquidity in Bank specific or market specific scenarios. It outlines how assets and liabilities of the Bank are to be monitored, emphasising avoidance of a liquidity crisis. These procedures address unlikely but possible events of either short or long-term funding crisis, forecast funding needs as well as funding sources under different market situations including aggressive asset growth or loan rollover and rapid liability erosion or sharp decline in deposits during a 3-month period which is considered the most critical time span in a liquidity crisis. The Management and reporting framework identifies early warning signals and enumerates means to avoid and mitigate possible crises promptly. A Management Action Plan with alternative sources of inflows and trigger levels for action, a communication plan to prevent further escalation or contagion and regular sources of liquidity supplemented with contingent sources in detail are among other things covered in this important plan.
- **Value at Risk (VaR) –** The Bank carries out VaR calculations based on the historical simulation method on four portfolios categorised as HFT, using a market risk software solution (which has the capability to compute VaR based on Monte Carlo Simulation and Variance-Covariance as well) in order to measure its market risk exposure. VaR is computed in line with Basel II Market Risk Framework, considering a 99% "Confidence Interval" and a 10-trading-days Holding Period. VaR, a quantitative measure, depicts the maximum loss the Bank may incur, under specific conditions during a period of 250 days due to changes in interest rates, exchange rates, debt and equity prices as well as price of financial products. During the year, the Bank obtained validation on its VaR model through an external consultant. Recommendations have been deployed for effective decision-making.

Liquidity risk review

The net loans to deposits ratio is regularly monitored by ALCO to ensure that the asset and liability portfolios of the Bank are geared to maintain a healthy liquidity position. Net stable funding ratio indicating stability of funding sources compared to loans and advances granted was maintained well above the policy threshold of 100%, which is considered healthy to support the Bank's business model and growth.

The key ratios used for measuring liquidity under the stock approach are depicted below (Graph 97):

Liquidity ratios Graph – 97



Maturity gap analysis of assets and liabilities as at December 31, 2017 – Bank

Maturity analysis of financial assets and liabilities of the Bank (Table 49) indicates sufficient funding for foreseeable adverse situations based on prescribed behavioural patterns observed.

Table – 49

As at December 31,	Up to 3 months Rs. '000	3 to 12 months Rs. '000	1 to 3 years Rs. '000	3 to 5 years Rs. '000	More than 5 years Rs. '000	**Total as at 31.12.2017 Rs. '000**	Total as at 31.12.2016 Rs. '000
Interest earning assets							
Financial assets							
Cash and cash equivalents	3,457,539	–	–	–	–	**3,457,539**	7,930,050
Balances with central banks	887,551	263,830	–	4,607	–	**1,155,988**	498,616
Placements with banks	17,633,269	–	–	–	–	**17,633,269**	11,718,499
Securities purchased under resale agreements	–	–	–	–	–	**–**	–
Derivative financial assets	–	–	–	–	–	**–**	–
Other financial instruments – Held fo trading	4,096,168					**4,096,168**	4,693,989
Loans and receivables to banks	–	–	–	–	–	**–**	–
Loans and receivables to other customers	231,342,860	198,426,781	169,978,799	93,774,191	43,923,936	**737,446,567**	616,018,228
Financial investments – Available for sale	13,025,195	67,787,547	59,124,910	14,229,518	–	**154,167,170**	159,573,316
Financial investments – Held to maturity	4,077,407	9,871,844	12,885,249	29,661,652	7,066,600	**63,562,752**	60,981,298
Financial investments – Loans and receivables	2,521,780	5,188,975	16,430,329	24,571,393	–	**48,712,477**	51,824,026
Total interest earning assets as at December 31, 2017	**277,041,769**	**281,538,977**	**258,419,287**	**162,241,361**	**50,990,536**	**1,030,231,930**	
Total interest earning assets as at December 31, 2016	276,268,527	174,556,015	269,347,751	113,511,379	79,554,350		913,238,022
Non-interest earning assets							
Financial assets							
Cash and cash equivalents	29,767,080	–	–	–	–	**29,767,080**	22,263,539
Balances with central banks	26,999,348	14,321,349	783,669	730,063	811,029	**43,645,458**	43,374,589
Placements with banks	–	–	–	–	–	**–**	–
Securities purchased under resale agreements	–	–	–	–	–	**–**	–
Derivative financial assets	959,937	1,374,599	–	–	–	**2,334,536**	1,052,829
Other financial instruments – Held for trading	314,745					**314,745**	293,809
Loans and receivables to banks	–	–	640,512	–	–	**640,512**	624,458
Loans and receivables to other customers	–	–	–	–	–	**–**	–
Financial investments – Available for sale	–	–	–	17,491	529,471	**546,962**	450,155
Financial investments – Held to maturity	–	–	–	–	–	**–**	–
Financial investments – Loans and receivables	–	–	–	–	–	**–**	–
Non-financial assets							
Investments in subsidiaries	–	–	–	–	3,065,935	**3,065,935**	2,435,392
Investments in associates	–	–	–	–	44,331	**44,331**	44,331
Property, plant and equipment	–	–	–	–	14,634,710	**14,634,710**	10,307,825
Intangible assets	–	–	–	–	776,810	**776,810**	640,645
Leasehold property	–	–	–	–	72,594	**72,594**	73,536
Deferred tax assets	–	–	–	–	–	**–**	963,935
Other assets	12,270,707	257,173	1,245,002	506,177	3,019,103	**17,298,162**	16,438,166
Total non-interest earning assets as at December 31, 2017	70,311,817	15,953,121	2,669,183	1,253,731	22,953,983	**113,141,835**	
Total non-interest earning assets as at December 31, 2016	62,243,958	14,616,440	3,826,664	991,974	17,284,173		98,963,209
Total assets – as at December 31, 2017	**347,353,586**	**297,492,098**	**261,088,470**	**163,495,092**	**73,944,519**	**1,143,373,765**	
Total assets – as at December 31, 2016	338,512,485	189,172,455	273,174,415	114,503,353	96,838,523		1,012,201,231
Percentage – as at December 31, 2017 (*)	**30.38**	**26.02**	**22.83**	**14.30**	**6.47**	**100.00**	
Percentage – as at December 31, 2016 (*)	33.44	18.69	26.99	11.31	9.57		100.00

(*) Total assets of each maturity bucket as a percentage of total assets employed by the Bank.

As at December 31,	Up to 3 Months Rs. '000	3 to 12 Months Rs. '000	1 to 3 Years Rs. '000	3 to 5 Years Rs. '000	More than 5 Years Rs. '000	**Total as at 31.12.2017 Rs. '000**	Total as at 31.12.2016 Rs. '000
Interest-bearing liabilities:							
Financial liabilities							
Due to banks	32,840,250	3,840,696	12,232,304	–	41,224	**48,954,474**	63,523,388
Derivative financial liabilities	–	–	–	–	–	**–**	–
Securities sold under repurchase agreements	35,951,132	10,978,972	2,746,663	–	–	**49,676,767**	69,867,469
Other financial liabilities – Held for trading	–	–	–	–	–	**–**	–
Due to other customers/deposits from customers	455,218,755	288,988,744	18,492,159	13,050,348	13,783,280	**789,533,286**	683,569,052
Other borrowings	657,813	2,091,720	5,021,093	7,503,789	8,511,679	**23,786,094**	9,270,154
Subordinated liabilities	203,326	314,552	–	9,477,720	15,170,326	**25,165,924**	24,849,539
Total interest-bearing liabilities as at December 31, 2017	524,871,276	306,214,684	38,492,219	30,031,857	37,506,509	**937,116,545**	
Total interest-bearing liabilities as at December 31, 2016	504,725,495	263,099,940	31,662,332	21,783,917	29,807,918		851,079,602

Maturity analysis of financial assets and financial liabilities of the Bank (Table 49) does not indicate any adverse situation when due cognisance is given to the fact that cash outflows include savings deposits which can be considered as a quasi stable source of funds based on historical behavioural patterns of such depositors as explained below.

Behavioural analysis on savings accounts

Savings accounts are treated as a non-maturing demand deposit as the customers do not enter into a contractual agreement with the Bank about the maturity of same. There is no exact re-pricing frequency for the product and the Bank resets rate offered to these deposits considering the factors such as re-pricing gap, liquidity and profitability etc. Since, there is no exact re-pricing frequency could be identified for the product, for the purpose of gap analysis of the Bank 100% of the LKR and FCY denominated Savings accounts were considered under the overnight category. This has created a significant mismatch in the overnight bucket of the re-pricing gap report of the Bank.

In 2017, the Bank carried out a behavioural analysis of savings accounts with the support of an external party in order to identify a mechanism to segregate the portfolio into re-pricing buckets.

It was revealed from the analysis that the Bank's Savings Accounts Portfolio is not sensitive to market interest rates movements. Hence, the liquidity approach is considered to segregate the portfolio between the buckets.

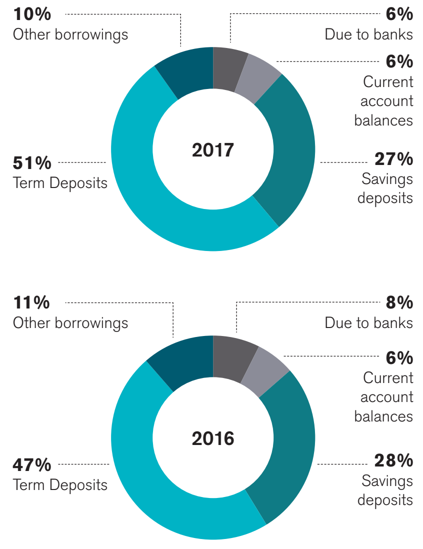
Segregation of the savings products, among the predefined maturity buckets in Maturity Gap report is currently done based on the regular simulations carried out by the Bank in line with the behavioural study.

The liquidity position is measured in all major currencies at both individual and aggregate levels to ensure that potential risks are within specified threshold limits. Additionally, potential liquidity commitments resulting from loan disbursements and undrawn overdrafts are also monitored to ensure sufficient funding sources.

Funding diversification by product

The Bank's primary sources of funding are deposits from customers. The Graph 98 provides a product-wise analysis of the Bank's funding diversification as at year end.

Funding diversification by product Graph – 98



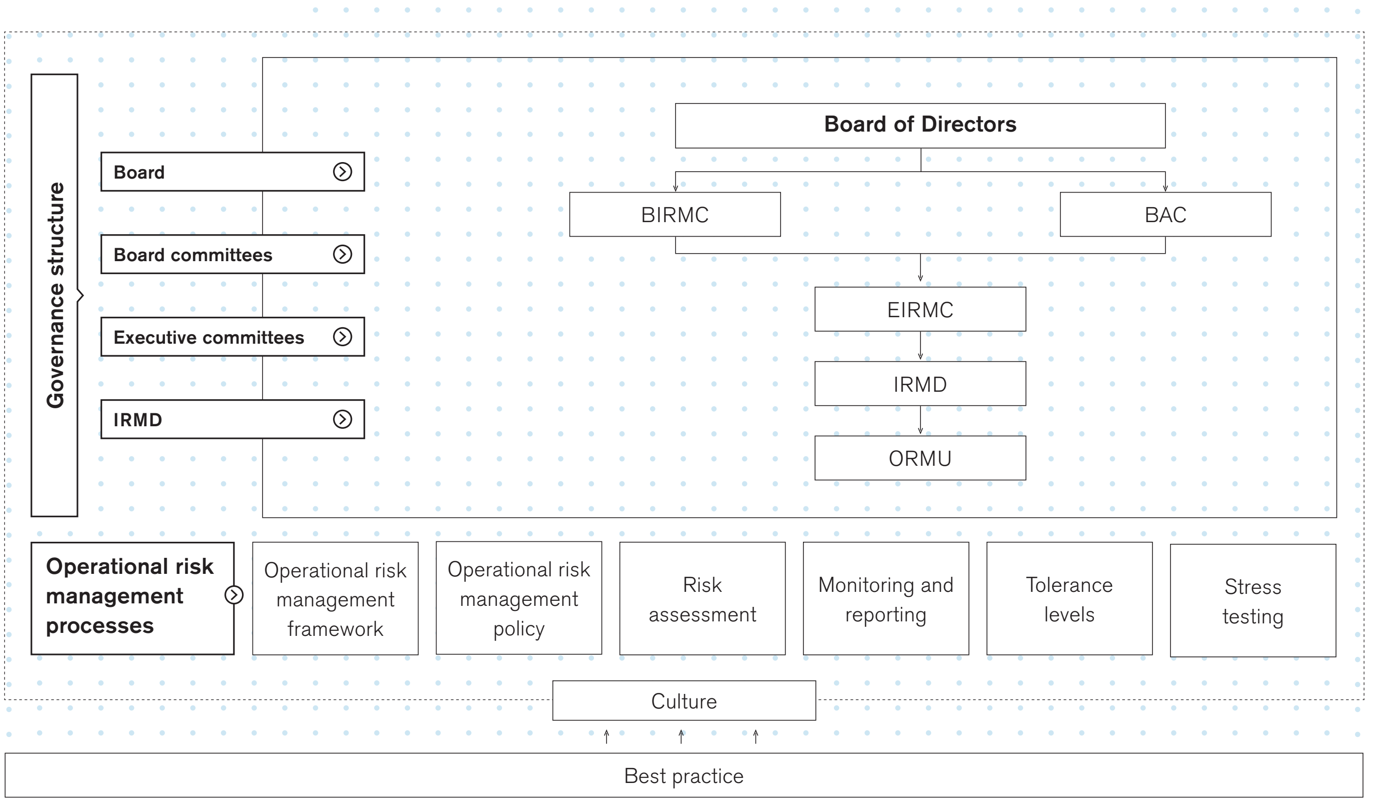
Operational risk

Operational risk is the risk of losses stemming from inadequate or failed internal processes, people and systems, or from external events such as natural disasters, social or political events. It is inherent in all banking products and processes and our objective is to control it in a cost-effective manner. Operational risk includes legal risk but excludes strategic and reputational risk.

Managing operational risk

Operational risk governance

Figure – 42



The Bank manages operational risk through the Operational Risk Management Framework which is summarised graphically in the Figure 43 on page 394. It enables the Bank to determine the operational risk profile in relation to its risk appetite and systematically identify operational risk themes and concentrations to define risk mitigating measures and priorities, as described below.

- **A robust risk governance structure –** The Board of Directors aided by the BIRMC ensures that a sufficiently robust framework for managing operational risks is established. The Bank's first line of defence is the Management and staff of the Bank and a rigorous system of review is in place to identify operational risks within the strategic business units. An independent Operational Risk Management Unit (ORMU) reporting to the Chief Risk Officer (CRO) supports the EIRMC in monitoring operational risk providing independent oversight of the first line of defence. Internal Audit provides assurance on the effectiveness and integrity of the first and second lines of defence independently to the BAC.
- **A comprehensive suite of risk management processes** comprising the following:
  - **Policies –** The Bank's Operational Risk Management Framework defines the Bank's approach in identifying, assessing, mitigating, monitoring and reporting the operational risks which may impact the achievement of the Bank's business objectives. The risk management responsibilities and obligations of the Board of Directors, Corporate Management, ORMU and all other Risk Owners are clearly specified in the Operational Risk Management Policy which is reviewed annually.
  - **Risk assessment –** Each business function proactively identifies and assesses its significant operational risks and the controls in place to manage those risks in a semi-annual RCSA process which is automated via the Operational Risk Management System (ORMS). Findings from the RCSA exercise is used to formulate appropriate action plans to address identified control gaps which are monitored as part of the overall Operational Risk Management exercise. The Bank also conducts reviews of new products, processes, services, operations, etc., to assess risk on a regular basis.
  - **Risk mitigation –** Risk mitigation is planned in accordance with the 'as low as reasonably practicable' principle by balancing the cost of mitigation with the benefits thereof and formally accepting the residual risk. Several risk mitigation policies and programmes, including a robust internal control framework are in place to maintain a sound operating environment within the established risk appetite of the Bank.
    - Insurance coverage is used as an external mitigant for 'low probability – high impact' events and uncontrollable operational risk events such as damage to physical assets by natural disasters, fire etc. Insurable risks are transferred to reputed insurance

providers, which are periodically reviewed comprehensively by the ORMU for adequacy.

– Policies and procedures relating to outsourcing of business activities of the Bank ensure that all significant risks arising from outsourcing arrangements of the Bank are identified and effectively managed on a continuous basis. Details of all outsourced functions are reported to CBSL annually. Due diligence tests of outsourced vendors are carried out by respective risk owners prior to executing new agreements and renewal of existing agreements. Assistance of Information Systems Audit Unit is obtained when conducting due diligence tests of outsourced parties which provide IT services. Further, bi-annual review meetings are conducted with key IT service providers to monitor service performance levels and to verify adherence to the agreements.

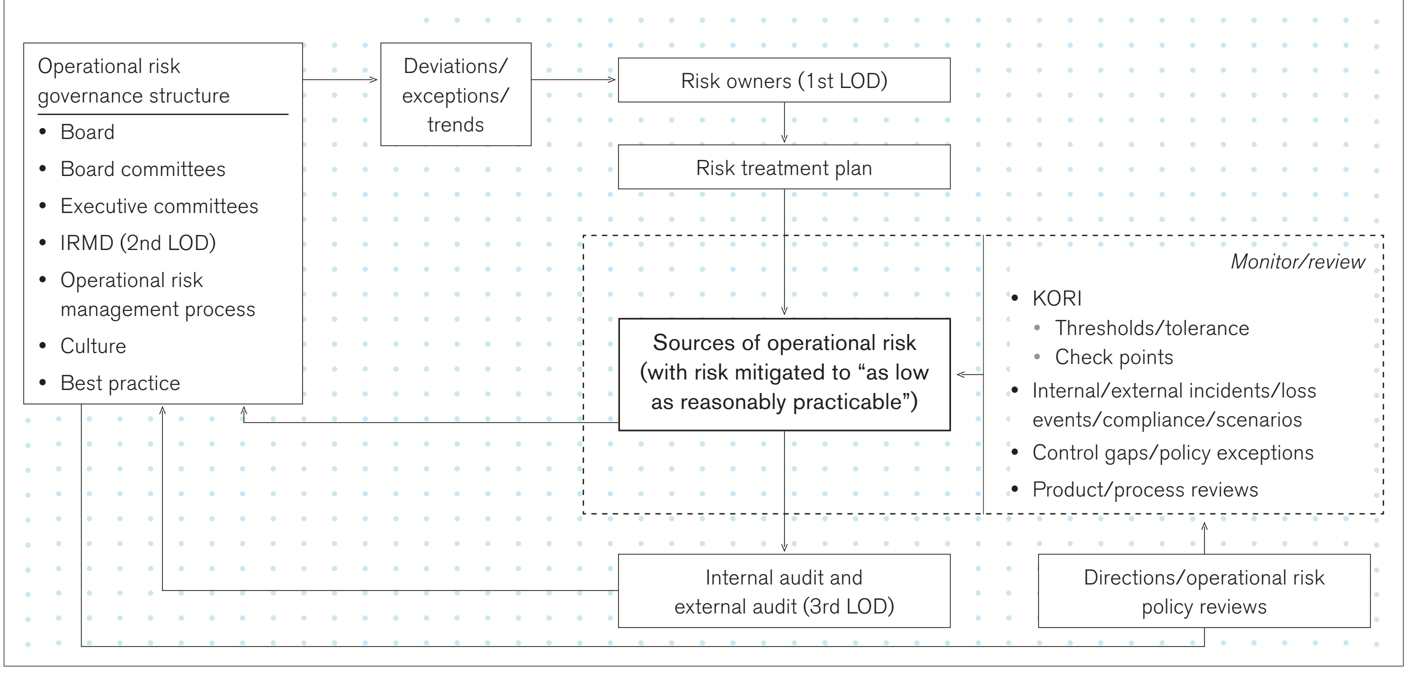
– Technology risk is managed in a systematic and consistent manner to avoid potential operational losses to the Bank resulting from technological obsolescence. Accordingly, existing Information Technology Systems including the core-banking systems are upgraded and new software solutions implemented in a timely and appropriate manner. Further, in order to prevent information and communications systems failures, the Bank maintains redundancies and backup facilities.

– The Bank has a comprehensive Business Continuity Plan (BCP) and Disaster Recovery Plan (DRP) to assure the immediate continuity of all essential operations in case of a disaster and the eventual continuity of all other operations, which are continuously updated and tested to ensure ongoing readiness. These plans are reviewed independently by the ORMU and the Internal Audit Department in line with CBSL requirements.

– Creating a culture of risk awareness across the Bank through comprehensive training programmes together with high standards of ethics and integrity is also a key component of the Bank's risk mitigatory measures.

- **Monitoring and reporting of operational risk –** Key Operational Risk Indicators (KORIs) and corresponding tolerance levels are reported to designated Committees and the Board. KORIs comprise both financial and non-financial indicators. A database of operational risk events and losses, including losses without any financial impact and 'near-misses' has been established through the ORMS to facilitate the analysis of loss trends and root causes as prescribed in Basel II. This is a key component in progressing towards advanced approaches in operational risk capital calculations.
- **Stress testing of operational risk –** The Bank commenced conducting of stress testing on operational losses during the year 2014 by considering the historical data as per the scenarios proposed in the Stress Testing Policy of the Bank. This exercise is being carried out quarterly by the Bank as an additional measure to confirm its sound position.

Operational risk management framework Figure – 43



Review of operational risk

In the absence of any upside unlike in the case of credit and market risks, the Bank has a low appetite for operational risks and has established tolerance levels for all material operational risk loss types based on historical loss data, budgets and forecasts, performance of the Bank, existing systems and controls governing Bank operations etc. Following thresholds have been established based on audited financials for monitoring purposes:

- Alert level – 3% of the average gross income for the past three years
- Maximum level – 5% of the average gross income for the past three years

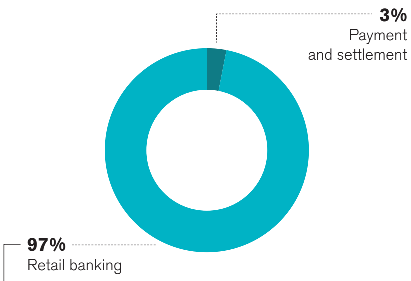
Operational losses for the financial year 2017 were below the internal alert level at 2.85% (of average audited gross income for past three years). The Bank has been consistently maintaining operational losses below the alert level for the past eight years, reflecting the "tone at the top", effectiveness of the governance structures and the rigour of processes and procedures in place to manage operational risk.

The Graph 99 analyses the operational risk losses incurred by the Bank under each business line/category during the year 2017.

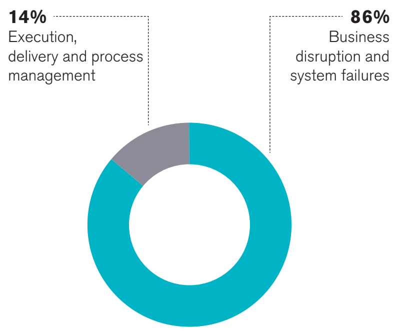
When analysing the losses incurred during 2017 under the Basel II defined business lines, it is evident that the majority (97%) of losses with financial impact falls under the business line of "Retail Banking", followed by the losses reported under the "Payment and Settlement" business line. Losses relating to other business lines remain negligible.

The Graphs 102 and 103 depict the comparison of operational losses reported during the last two years (2017 and 2016) under each Basel II loss event type both in terms of number of occurrences and value.

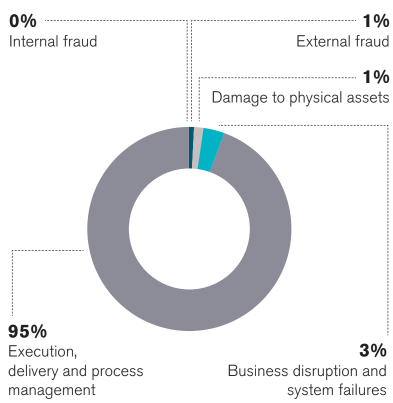
Composition of losses by value 2017 Graph – 99



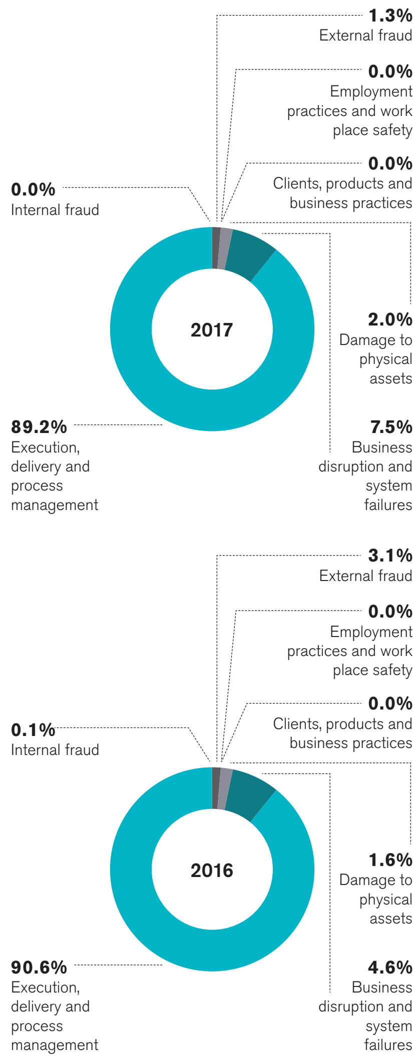
Composition of losses – payment and settlement – 3% Graph – 100



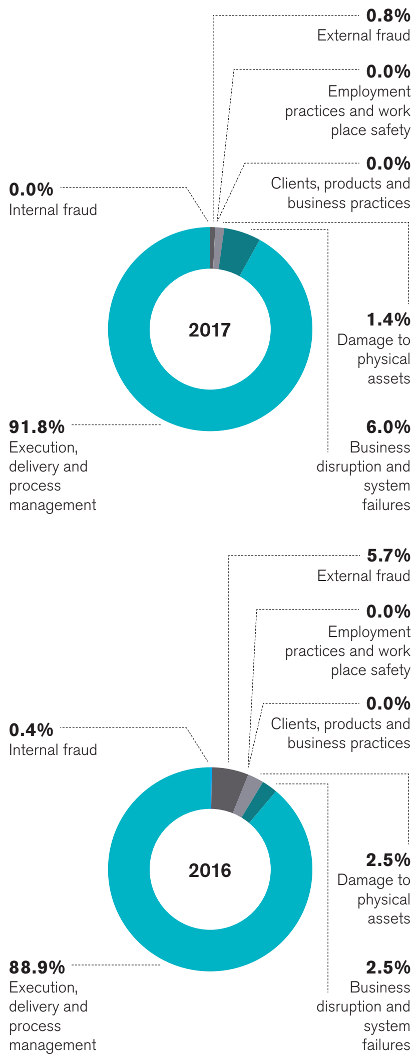
Composition of losses – retail banking – 97% Graph – 101



Operational loss events by category – % of total losses by number of events Graph – 102



Operational loss events by category – % of total losses by value — Graph – 103



As typical with operational risk losses, majority of the losses encountered by the Bank during 2017 consists of high frequency/low financial impact events mainly falling under the loss category "Execution, Delivery and Process Management". These low value events are mainly related to cash and ATM operations of the Bank's service delivery network consisting of over 1,000 points across Sri Lanka and Bangladesh. Individual events with monetary values less than Rs. 100,000 account for more than 89% of the total loss events for the year. Also, the number of loss events for the year when compared to the number of transactions performed during the year stands at a mere 0.0079%.

When considering the values of the losses incurred by the Bank during the period under review (2017), they can be mainly categorised under Execution, Delivery and Process Management related and Business Disruption and System Failures. The losses for the year were primarily driven by a limited number of events in Execution, Delivery, and Process Management category, majority of which the Bank managed to resolve through subsequent recovery/rectification with minimum financial impact to the Bank. Further, necessary process improvements have been introduced to prevent recurrence. After the recovered amounts are discounted, the net loss amounts to a mere 0.08% of the average audited gross income for the last three years, as compared to the capital allocation of 15% under the Basic Indicator Approach of capital computation as per Basel II. This trend of exceptionally low levels of operational risk losses of the Bank bears testimony to the effectiveness of the Bank's Operational Risk Management Framework and the internal control environment.

IT risk

Defined as the business risk associated with use, ownership, operation, involvement, influence and adoption of IT within an organisation, IT risk is a key area of concern globally as threats continue to escalate in scale, speed, and sophistication. A major component of operational risk, IT risk comprises IT-related events such as system interruptions, errors, frauds through system manipulations, cyber attacks, obsolescence in applications, falling behind competitors concerning the technology, etc., that could potentially impact the business as a whole.

Occurrence is uncertain with regard to frequency and magnitude, posing challenges in managing this vital aspect. In such a backdrop, addressing this emerging IT risk category has become a top priority of the Bank, with the IT risk function giving more focus to cyber security strategies.

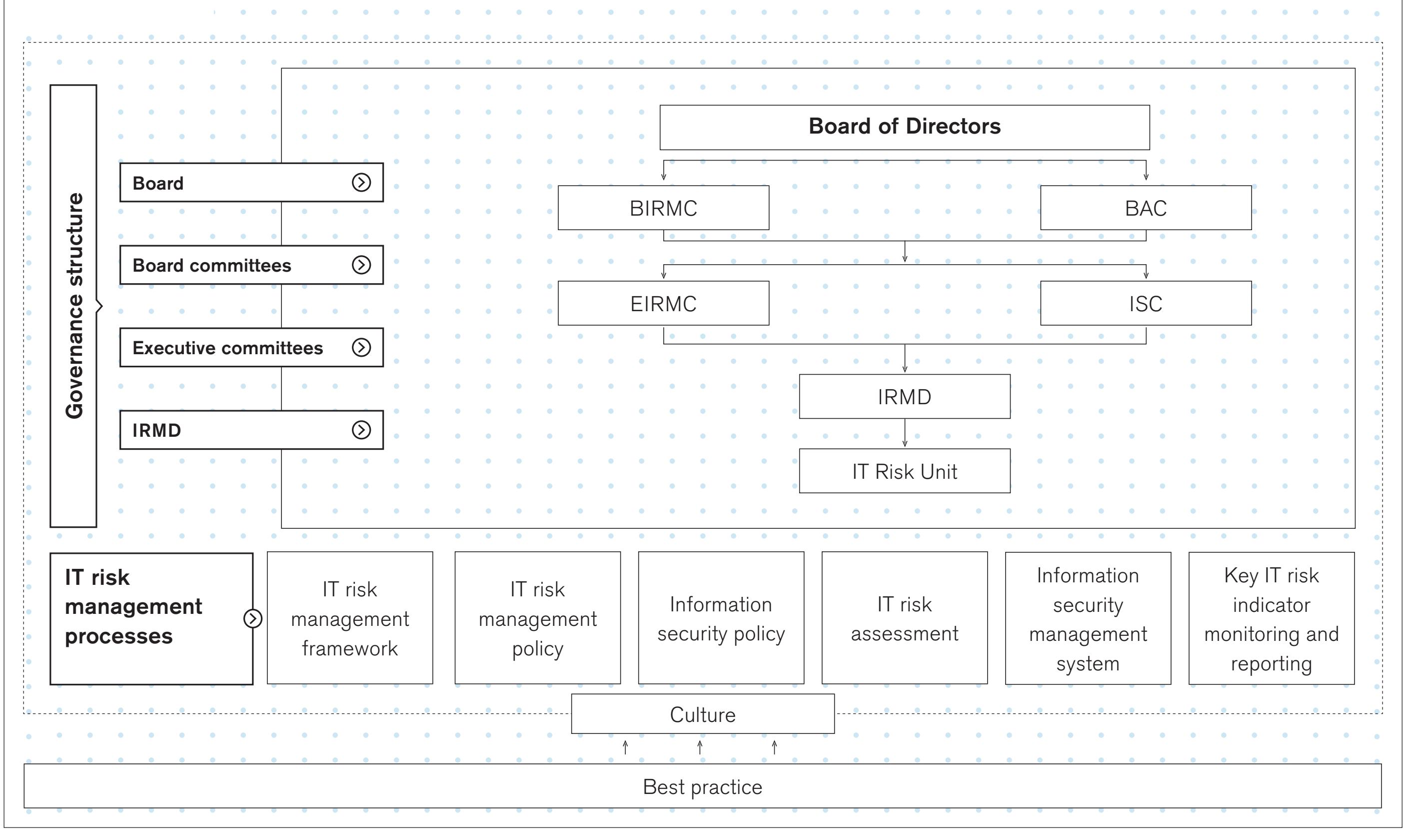
Year 2017 saw the number of cyber attacks directed at global financial institutions of all sizes growing, including several high profile attacks involving fraudulent fund transfers, data breaches, ransom demands and other hacks. Being a key player in the local financial sector, Commercial Bank too realises that it is a likely target for various evolving and adaptive cyber attacks, akin to any other organisation. We maintain a relentless focus on cyber security and continually invest on improving the Bank's cyber security capabilities. Our cyber security strategy is focused on securely enabling new technology and business initiatives while maintaining a persistent focus on protecting the Bank and its customers from cyber threats.

Established in 2012, the IT risk function operating under the CRO is responsible for implementing the IT Risk Management Framework for the Bank, ensuring that the appropriate governance framework, policies, processes and technical capabilities are in place to manage all significant IT risks in a consistent and effective manner across the organisation. The IT Risk Management Policy, aligned with the Operational Risk Management Policy of the Bank complements the Information Security Policy, the related processes, objectives and procedures relevant for managing risk and improving information security of the Bank.

With regard to the overall IT Risk Management process, RCSA is used as one of the core mechanisms for IT risk identification and assessment, while the IT Risk Unit carries out independent IT risk reviews both separately and in conjunction with regular operational risk reviews, in line with the established structure of the Operational risk management process. Results of these independent IT risk assessments together with audit findings, analysis of information security incidents, internal and external loss data are also employed for IT risk identification and assessment purposes.

IT risk mitigation involves prioritising, evaluating and implementing the appropriate risk-reducing controls or risk treatment techniques recommended from the risk identification and assessment process. The Bank seeks to operate within a highly secure environment which protects its data, systems, people and other information assets from various threats, through a multilayered approach of building controls in to each layer of technology, including data, applications, devices, network, etc. This ensures robust end-to-end protection, while enhancing the cyber threat detection, prevention, response and recovery opportunities. Being the first local Bank in the country to be certified under the ISO/IEC 27001 information security standard way back in 2010, the Bank has continued to demonstrate its commitment towards information security by maintaining the certification throughout, by successfully under-going the annual audits.

IT risk governance Figure – 44



The Bank continues to make significant investments in cyber security to enhance its resilience towards the cyber threats.

- A key initiative during the year was enhancing the endpoint security capabilities of the network and improvements made to the network architecture through finer segregations and adoption of additional network security technologies.
- The Network Operations Centre established with the objective to improve the cyber incident response capabilities expanded its security incident and event monitoring functions with a view towards a fully-fledged Security Operations Centre.
- The Information Security Policy Framework, which includes information security principles and detailed information security policies and procedures, was further enhanced during the year with the introduction of the Commercial Bank Group Information Security Policy Framework with the aim of maintaining an appropriate level of information security protection Group-wide.
- The Bank is proactively involved in industry cyber security efforts and working with other parties, including third-party service providers and governmental agencies, to continue to enhance defenses and improve resiliency to cyber security threats.

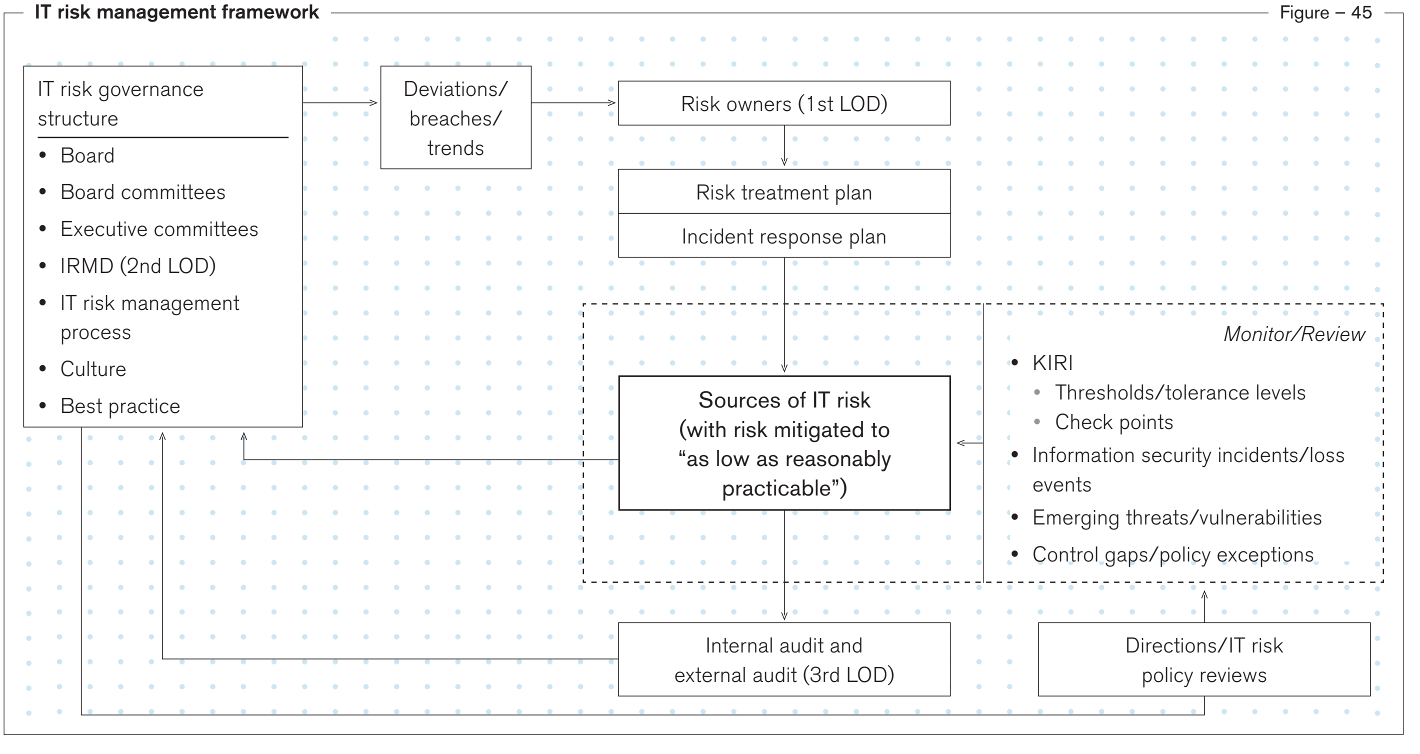
Given that risk management relies heavily on an effective monitoring mechanism, the IT Risk Function carries out continuous, independent monitoring of the Bank's IT risk profile. A range of tools and techniques including Key IT Risk Indicators (KIRIs) are used in this regard, where deviations from set thresholds receive a differential level of management attention in order to initiate appropriate corrective action.

Legal risk

Defined as the exposure to the adverse consequences resulting from inaccurately drafted contracts, their execution, the absence of written agreements or inadequate agreements, Legal Risk is an integral part of operational risk. It includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as cost of private settlements.

Legal risk is managed by ensuring that applicable regulations are fully taken into consideration in all relations and contracts with individuals and institutions who maintain business relationships with the Bank, and that they are supported by required documentation whereas risk of breaching the rules and regulations is managed by establishing and operating a sufficient mechanism for verification of conformity of operations with applicable regulations.

IT risk management framework Figure – 45



Compliance and regulatory risk

Compliance and regulatory risk refers to the potential risk to the Bank arising from failure to comply with applicable laws, rules and regulations and codes of conduct and may lead to regulatory sanctions, financial losses, disruptions to business activities and reputational damage. A compliance function reporting directly to the Board of Directors is in place to assess the Bank's compliance with external and internal regulations.
A comprehensive compliance policy specifies how this key risk is identified, monitored and managed by the Bank in a structured manner. Bank's culture and the code of ethics too play a key role in managing this risk.

Other related risks

Strategic risk

Strategic risks are the risks that are associated with the strategic decisions and may manifest in the Bank not been able to keep up with the changing market dynamics, leading to loss of market share and failure to achieve strategic goals. Strategic risk has gained an added importance in the context of the emerging risks referred to on page 154. Corporate planning and budgeting process and critical evaluation of their alignment with the Bank's vision, mission and the risk appetite facilitate management of strategic risk. The detailed scorecard-based qualitative model aligned to ICAAP is used to measure and monitor strategic risk of the Bank. This scorecard-based approach takes into consideration a range of factors, including the size and sophistication of the organisation, the nature and complexity of its activities in measuring strategic risk and highlights the areas that need emphasis to mitigate potential strategic risks.

Reputational risk

Reputational risk is the risk of adverse impact on earnings, assets and liabilities or brand value arising from negative stakeholder perception of the Bank's business practices, activities and financial condition. The Bank recognises that reputational risk is driven by a wide range of other business risks that must all be actively managed. In addition, the exponential growth in channels of communication such as social media has widened the stakeholder base and expanded the sources of reputational risk. Accordingly, reputational risk is broadly managed through the systems and controls adopted for all other risk types such as credit, market, operational risk etc., which are underpinned by the code of conduct, communication policy and business ethics. Further, reputational risk is measured through the detailed scorecard-based model developed by the Bank to measure and monitor reputational risk under ICAAP. Timely actions are initiated to mitigate potential reputational risks by critically evaluating the criteria given in the said scorecard.

Capital management

The ICAAP framework in line with Basel requirements sets out the process for assessing total overall capital adequacy in relation to its risk profile. Internal limits which are more stringent than the regulatory requirement provide early warnings with regard to capital adequacy.

Target and actual capital levels — Table – 50

Capital ratios	Goal (internal limit)	**2017 (%)**	2016 (%)
CET 1 (regulatory minimum 6.25%)	> 10%	**12.12**	10.47
Total capital (regulatory minimum 11.75%)	> 14%	**15.70**	14.91

Summary of capital adequacy computation — Table – 51

Capital	**2017 Rs. '000**	2016 Rs. '000
CET 1 capital	**96,980,344**	69,996,519
Deductions and adjustments	**1,255,038**	1,132,669
Eligible CET 1 capital	**95,725,306**	68,863,850
Tier 2 capital	**28,264,629**	29,232,514
Deductions and adjustments	**–**	–
Total capital base	**123,989,935**	98,096,364
Risk-weighted assets	**789,711,397**	657,951,630

We are compliant with both regulatory and our own prudential requirements. We are also well positioned to meet future expected requirements as we continue to generate sufficient cash flows to support our growth aspirations and business needs.

Capital management process

ICAAP supports the regulatory review process providing valuable inputs for evaluating the required capital in line with future business plans. It integrates strategic plans and risk management plans with the capital plan in a meaningful manner with inputs from Senior Management, Management Committees, Board Committees and the Board. It also supports profit optimisation through proactive decisions on exposures both current and potential through measurement of vulnerabilities by carrying out stress testing and scenario-based analysis. The ICAAP process also identifies gaps in managing qualitative and quantitative aspects of reputational risk and strategic risk which are not covered under Pillar 1 of Basel II.

Basel III minimum capital requirements and buffers

The Banking Act Direction No. 01 of 2016 introduced capital requirements under Basel III for licensed commercial banks commencing from July 1, 2017 with specified timelines to increase minimum capital ratios to be fully-implemented by January 1, 2019.

A comparison of the position as at December 31, 2017 and the minimum capital requirement prescribed by the CBSL effective from January 1, 2019 as given below demonstrates the capital strength of the Bank and bears testimony to the ability to meet stringent requirements imposed by the regulator.

Basel III readiness Table – 52

Ratios (%)	Bank's position as at 31.12.2017	Minimum capital ratio prescribed by CBSL by 01.01.2019
Common Equity Tier 1 (CETI) including Capital Conservation Buffer (CCB) and Capital Surcharge on Domestic Systemically Important Banks (D-SIBs)	12.12	8.50
Total Tier 1 including CCB and Capital Surcharge on D-SIBs	12.12	10.00
Total Capital including CCB and Capital Surcharge on D-SIBs	15.70	14.00

Through a rights issue of shares, the Bank raised Rs. 10 Bn. in CET 1 capital during the year. However, the Bank foresees challenges in meeting the increasing capital requirements in the years to come. In this regard, it is relevant to mention here that both the SLFRS 9 implementation and the Debt Repayment Levy proposed in the Government budget 2018 which is to be borne by the financial institutions are expected to have a significant impact on the internal capital generation capabilities of the Bank.

Going forward, the Bank will explore the possibility of raising capital by issuing Basel III compliant debt securities. Details of the debentures that were issued prior to Basel III guidelines (effective from July 1, 2017), and considered as qualifying instruments during the transition period are given in the Note 52 to the Financial Statements on page 276.

'Basel Workgroup' of the Bank consists of representation from members from a cross-section of business units and supporting units that work as a team to ascertain levels of capital adequacy in line with strategic direction of the Bank. While ICAAP acts as a foundation for such assessment, the Basel Workgroup is constantly on the lookout for improvements amidst changing landscape in different frontiers, to recommend to the ALCO on the desired way forward including indications on current and future capital needs, anticipated capital expenditure based assessments and desirable capital levels, etc. The Bank is aware of the importance of capital as a scarce and valuable resource. The Bank has access to contributions from shareholders as well as to built up capital over a period of time by adopting prudent dividend policies, ploughing back a portion of the profits, etc. In addition, the Bank is continuously finding ways to improve judicious allocation of capital to requirements associated with the day-to-day activities so that an optimised level of capital allocation can be achieved. The challenges associated with mobilising capital from external sources are also given due cognisance, but not excluded as a sustainable option to boost the capital in the long run. The Bank is reasonably comfortable with the current and future availability of capital buffer to withstand an ambitious growth/ stressed market conditions, but not complacent with current comfort levels and believe in providing stakeholder confidence that the Bank is known for, through sound capital buffer levels.

Stress testing

An integral part of ICAAP under Pillar II, stress testing is used to evaluate the sensitivity of the current and forward risk profile relative to risk appetite. It also supports a number of business processes, including strategic planning, the ICAAP including capital management, liquidity management, setting of risk appetite triggers and risk tolerance limits, mitigating risks through actions such as reviewing and changing limits, limiting or reducing exposures and hedging thereof, facilitating the development of risk mitigation or contingency plans across a range of stressed conditions supporting communication with internal and external stakeholders.

The Bank's Stress Testing Governance Framework sets out the responsibilities for and approaches to stress testing activities which are conducted at Bank, business line and risk type level. The Bank's stress testing programme uses one or a combination of stress testing techniques, including scenario analysis, sensitivity analysis and reverse stress testing to perform stress testing for different purposes.

The framework covers all the material risks such as credit risk, credit concentration risk, operational risk, liquidity risk, FX risk, IRRBB using EVE and EAR perspectives. The Bank looks at different degrees of stress levels which are defined as Minor, Moderate and Severe stress levels in the Stress Testing Policy. The resultant impact on the capital through these stress tests is carefully analysed. If the stress tests bring about a deterioration of the capital which has no impact on the policy level on capital maintenance, same is defined as minor risk, while a deterioration of up to 1% is considered moderate risk. If the impact results in the capital falling below the statutory requirement such a level will be considered severe risk, warranting immediate attention of the Management to rectify the situation.

As it provides a broader view of all risks borne by the Bank in relation to its risk tolerance and strategy in a hypothetical stress situation, stress testing has become an effective communication tool to Senior Management, risk owners and risk managers as well as supervisors and regulators. The results of the stress testing are reported to the EIRMC and BIRMC on a quarterly basis for appropriate, proactive decision making. Extracts from the stress testing results are set out in Table 53.

Impact on CAR at minor, moderate and severe stress levels — Table – 53

Particulars	Description	2017			2016		
		Minor %	**Moderate %**	**Severe %**	Minor %	Moderate %	Severe %
Credit risk – asset quality downgrade	Increasing the direct non-performing facilities over the direct performing facilities for the entire portfolio	-0.15	-0.37	-0.73	-0.14	-0.36	-0.71
Operational risk	Impact of; 1. Top five operational losses during last five years 2. Average of yearly operational risk losses during last three years whichever is higher	-0.07	-0.17	-0.34	-0.01	-0.03	-0.05
Foreign exchange risk	% shock in the exchange rates for the Bank and Maldives operations (gross positions in each book without netting)	-0.05	-0.09	-0.13	-0.06	-0.10	-0.15
Liquidity risk (LKR) – Sri Lanka	1. Withdrawal of % of the clients, banks and other banking institution deposits from the Bank within a period of three months 2. Rollover of loans to a period greater than three months	-0.09	-0.25	-0.50	-0.24	-0.53	-0.83
Interest rate risk – EAR and EVE (LKR) – Sri Lanka	To assess the long-term impact of changes in interest rates on Bank's EVE through changes in the economic value of its assets and liabilities and to assess the immediate impact of changes in interest rates on Bank's earnings through changes in its Net Interest Income	-0.05	-0.09	-0.14	-1.33	-2.45	-3.42

Capital adequacy computation – Group

1. Capital Adequacy Ratios

1.1 Common equity Tier 1 (CET 1) capital ratio

As at December 31,	2017 Rs. '000	2016 Rs. '000
Common equity Tier 1 (CET 1) Capital (Refer Note 2.1)	95,725,306	68,863,850
Total risk weighted amount (Refer Note 3)	789,711,397	657,951,630
Common equity Tier 1 (CET 1) capital ratio (minimum requirement 6.25%) (%)	12.12	10.47

1.2 Total Tier 1 capital ratio

As at December 31,	2017 Rs. '000	2016 Rs. '000
Total Tier 1 capital [Refer Note 2.2]	95,725,306	68,863,850
Total risk weighted amount [Refer Note 3]	789,711,397	657,951,630
Total Tier 1 capital ratio (minimum requirement 7.75%) (%)	12.12	10.47

1.3 Total capital ratio

As at December 31,	2017 Rs. '000	2016 Rs. '000
Total capital [Refer Note 2.3]	123,989,935	98,096,364
Total risk-weighted amount [Refer Note 3]	789,711,397	657,951,630
Total capital ratio (Minimum requirement 11.75%) (%)	15.70	14.91

2. Computation of Capital

2.1 Computation of common equity Tier 1 (CET 1) capital

As at December 31,	2017 Rs. '000	2016 Rs. '000
Common Equity Tier 1 (CET 1) capital	95,725,306	68,863,850
Total Common Equity Tier 1 (CET 1) capital	96,980,344	69,996,519
Equity capital or stated capital/assigned capital	37,143,541	24,977,700
Reserve fund	6,492,552	5,647,993
Published retained earnings/(Accumulated retained losses)	1,783,969	1,518,984
Accumulated other comprehensive income (OCI)	(1,501,321)	(6,692,495)
General and other disclosed reserves	52,799,820	43,910,281
Ordinary shares issued by consolidated banking and financial subsidiaries and held by third parties	261,783	634,056
Total Adjustments to CET 1 capital	1,255,038	1,132,669
Goodwill (net)	400,045	400,045
Other intangible assets (net)	851,180	732,624
Revaluation losses of property, plant and equipment	3,813	–

2.2 Computation of additional Tier 1 (AT1) capital

As at December 31,	**2017 Rs. '000**	2016 Rs. '000
Common Equity Tier 1 (CET 1) capital [Refer Note 2.1]	95,725,306	68,863,850
Total additional Tier 1 (AT1) capital	–	–
Qualifying additional Tier 1 capital instruments	–	–
Instruments issued by consolidated banking and financial subsidiaries of the Bank and held by third parties	–	–
Total sdjustments to AT1 capital	–	–
Investment in own shares	–	–
Reciprocal cross holdings in AT1 capital instruments	–	–
Investments in the capital of banking and financial institutions where the bank does not own more than 10 per cent of the issued ordinary share capital of the entity	–	–
Significant investments in the capital of banking and financial institutions where the bank own more than 10 per cent of the issued ordinary share capital of the entity	–	–
Regulatory adjustments applied to AT1 due to insufficient Tier 2 capital to cover adjustments	–	–
Total Tier 1 Capital	95,725,306	68,863,850

2.3 Computation of total capital

As at December 31,	**2017 Rs. '000**	2016 Rs. '000
Common equity Tier 1 capital [Refer Note 2.1]	95,725,306	68,863,850
Additional Tier 1 (AT1) capital [Refer Note 2.2]	–	–
Total Tier 2 capital	28,264,629	29,232,514
Qualifying Tier 2 capital instruments	22,799,002	24,334,875
Revaluation gains	2,024,804	2,034,231
General provisions	3,440,823	2,863,408
Total capital	123,989,935	98,096,364

3. Computation of risk-weighted amount – RWA

As at December 31,	2017 Rs. '000	2016 Rs. '000
Credit risk		
RWA of On-Balance sheet assets [Refer Note 4.1]	647,913,282	542,762,509
RWA of Off-Balance sheet assets [Refer Note 4.2]	77,587,693	60,169,944
Total RWA for credit risk (a)	725,500,975	602,932,453
Market risk		
Capital charge for interest rate risk	354,758	226,153
Capital charge for equities	58,849	54,683
Capital charge for foreign exchange and gold	327,079	151,979
Total capital charge for market risk	740,686	432,815
Total RWA for market risk (Total capital charge for market risk x CAR) (b)	6,303,710	3,683,532
Operational risk		
Gross income		
Year 1	41,020,866	35,273,703
Year 2	44,349,587	41,018,522
Year 3	50,710,320	44,346,540
Average gross income	45,360,258	40,212,922
Total capital charge for operational risk – (Average gross income x 15%)	6,804,039	6,031,938
Total RWA for operational risk – (Total capital charge for operational risk x CAR) (c)	57,906,712	51,335,645
Total risk-weighted amount (a + b + c)	789,711,397	657,951,630

4. Computation of RWA of On-Balance Sheet and Off-Balance Sheet items

4.1 Computation of RWA of on-balance sheet items

As at December 31,		2017		2016	
	Risk weight factor %	Principal amount of On-Balance sheet items Rs. '000	Risk weighted amount Rs. '000	Principal amount of On-Balance sheet items Rs. '000	Risk weighted amount Rs. '000
Total risk weighted amount for credit risk		1,060,402,543	647,913,282	953,788,767	542,762,509
Claims on Government and Central Bank of Sri Lanka	0	294,231,073	–	304,463,654	–
Claims on foreign sovereigns and their central banks	0-150	20,197,669	20,197,669	14,828,182	14,828,182
Claims on public sector entities (PSEs)	20-150	16,913	16,913	8,137	8,137
Claims on Banks	0-150	29,324,762	18,798,415	27,621,363	16,462,840
Claims on financial institutions	20-150	29,093,851	13,947,299	30,283,774	13,081,513
Claims on corporates	20-150	356,378,524	340,525,766	284,911,325	277,008,403
Retail claims	0-100	204,755,354	169,019,740	185,320,826	146,093,718
Claims secured by residential property	50-100	61,278,959	46,757,354	54,430,398	43,784,768
Non-performing assets (NPAs)	50-150	6,889,792	8,911,843	6,559,370	8,820,073
Cash items	0-20	29,727,440	1,230,076	23,958,602	1,271,740
Property, plant and equipment	100	16,421,471	16,421,471	11,675,438	11,675,438
Other assets	100	12,086,736	12,086,736	9,727,696	9,727,696

4.2 Computation of RWA of off-balance sheet assets

As at December 31,		2017		2016	
	Credit conversion factor %	**Principal amount of off-balance sheet items Rs. '000**	**Risk weighted amount Rs. '000**	Principal amount of off-balance sheet items Rs. '000	Risk weighted amount Rs. '000
Off-balance Sheet items		523,762,051	77,587,693	458,326,443	60,169,944
Claims on Banks					
(a) Foreign exchange contracts		180,595,429	835,117	176,228,611	1,003,151
(i) Original maturity – Less than one year	2	176,726,053	768,333	176,228,611	1,003,151
(ii) Original maturity – More than one year and less than two years	5	3,869,376	66,784	–	–
Claims on corporates					
(a) Direct credit substitutes	100	29,015,341	25,177,541	21,068,556	18,265,104
(i) General guarantees of indebtedness		29,015,341	25,177,541	21,068,556	18,265,104
(b) Transaction-related contingencies	50	27,350,464	12,973,789	19,742,310	9,196,436
(i) Performance bonds, bid bonds and warranties		27,350,464	12,973,789	19,742,310	9,196,436
(ii) Others		–	–	–	–
(c) Short-term self-liquidating trade-related contingencies	20	90,792,584	17,555,825	60,508,393	11,846,911
(i) Shipping guarantees		8,763,204	1,744,464	1,625,728	283,712
(ii) Documentary letters of credit		41,707,879	7,949,343	32,920,889	6,370,844
(iii) Trade-related acceptances		40,321,501	7,862,018	25,961,776	5,192,355
(iv) Others		–	–	–	–
(d) Foreign exchange contracts		52,349,856	662,202	52,429,672	688,146
(i) Original maturity – Less than one year	2	40,398,616	521,314	47,395,225	634,094
(ii) Original maturity – More than one year and less than two years	5	11,951,240	140,888	5,034,447	54,052
Retail claims					
(a) Direct credit substitutes	100	8,809,529	4,709,620	6,927,352	3,817,954
(i) General guarantees of indebtedness		8,809,529	4,709,620	6,927,352	3,817,954
(b) Transaction-related contingencies	50	3,254,243	768,369	2,810,750	762,451
(i) Performance bonds, bid bonds and warranties		3,254,243	768,369	2,810,750	762,451
(c) Short-term self-liquidating trade-related contingencies	20	3,617,575	504,326	3,427,238	523,407
(i) Shipping guarantees		247,140	28,399	125,733	16,358
(ii) Documentary letters of credit		3,370,435	475,927	3,301,505	507,049
(iii) Trade related acceptances		–	–	–	–
(iv) Others		–	–	–	–
Other commitments with an original maturity of up to one year or which can be unconditionally cancelled at any time	0	98,236,200	–	86,858,200	–
Undrawn term loans		–	–	–	–
Undrawn overdraft facilities/unused credit card lines		74,929,577	–	67,597,434	–
Others		23,306,623	–	19,260,766	–
Commitments with an original maturity up to 1 year	20	1,565,036	313,007	320,988	64,198
Undrawn term loans		1,565,036	313,007	320,988	64,198
Undrawn overdraft facilities/unused credit card lines		–	–	–	–
Others		–	–	–	–
Other commitments with an original maturity of over one year	50	28,175,794	14,087,897	28,004,372	14,002,186
Undrawn term loans		28,175,794	14,087,897	28,004,372	14,002,186
Undrawn overdraft facilities/unused credit card lines		–	–	–	–
Others		–	–	–	–

Basel III – Market Discipline – Minimum Disclosure requirement Under Pillar 3 as per the Banking Act Direction No. 01 of 2016

Template 01

Key regulatory ratios – Capital and liquidity

	GROUP		BANK	
As at December 31,	**2017** **Rs. '000**	2016 Rs. '000	**2017** **Rs. '000**	2016 Rs. '000
Regulatory capital				
Common equity Tier 1	95,725,306	68,863,841	94,151,253	67,284,572
Tier 1 capital	95,725,306	68,863,841	94,151,253	67,284,572
Total capital	123,989,935	98,096,355	122,415,882	96,517,086
Regulatory capital ratios (%)				
Common equity Tier 1 capital ratio (minimum requirement -6.25%) (with effect from July 1, 2017) (%)	12.12	10.47	12.11	10.37
Tier 1 Capital Ratio (minimum requirement -7.75%) (with effect from July 1, 2017) (%)	12.12	10.47	12.11	10.37
Total Capital Ratio (minimum requirement -11.75%) (with effect from July 1, 2017) (%)	15.70	14.91	15.75	14.87
Regulatory liquidity				
Statutory liquid assets (Rs. '000)			243,945,792	211,363,134
Statutory liquid assets ratio (minimum requirement -20%)				
Domestic banking unit (%)			27.28	27.19
Off-shore banking unit (%)			30.95	30.19
Liquidity coverage ratio (%) – Rupee (Minimum requirement – 80%) (with effect from January 1, 2017)			272.15	196.34
Liquidity coverage ratio (%) – All currency (Minimum requirement – 80%) (with effect January 1, 2017)			209.17	150.93

Template 02

Key Regulatory Ratios – Capital and Liquidity

As at December 31,	GROUP		BANK	
	2017 **Rs. '000**	2016 Rs. '000	**2017** **Rs. '000**	2016 Rs. '000
Common equity Tier 1 (CETI) capital after adjustments	95,725,306	68,863,841	94,151,253	67,284,572
Total common equity Tier 1 (CET1) capital	96,980,344	69,996,510	96,696,269	69,368,825
Equity capital (stated capital)/assigned capital	37,143,541	24,977,700	37,143,541	24,977,700
Reserve fund	6,492,552	5,647,993	6,476,952	5,647,890
Published retained earnings/(accumulated retained losses)	1,783,969	1,518,984	1,798,112	1,538,142
Published accumulated Other Comprehensive Income (OCI)	(1,501,321)	(6,692,504)	(1,522,156)	(6,705,188)
General and other disclosed reserves	52,799,820	43,910,281	52,799,820	43,910,281
Unpublished current year's profit/(losses) and gains reflected in OCI	–	–	–	–
Ordinary shares issued by consolidated banking and financial subsidiaries of the Bank and held by third parties	261,783	634,056	–	–
Total adjustments to CET1 Capital	1,255,038	1,132,669	2,545,016	2,084,253
Goodwill (net)	400,045	400,045	–	–
Intangible Assets (net)	851,180	732,624	776,812	640,646
Revaluation losses of property, plant and equipment	3,813	–	3,813	–
Significant investments in the capital of financial institutions where the Bank owns more than 10 per cent of the issued ordinary share capital of the entity	–	–	1,764,391	1,443,607
Additional Tier 1 (AT1) capital after adjustments	–	–	–	–
Total additional Tier 1 (AT1) capital	–	–	–	–
Qualifying additional Tier 1 capital instruments	–	–	–	–
Instruments issued by consolidated banking and financial subsidiaries of the bank and held by third parties	–	–	–	–
Total adjustments to AT1 capital	–	–	–	–
Investment in own shares	–	–	–	–
Others (specify)	–	–	–	–
Tier 2 capital after adjustments	28,264,629	29,232,514	28,264,629	29,232,514
Total Tier 2 capital	28,264,629	29,232,514	28,264,629	29,232,514
Qualifying Tier 2 capital instruments	22,799,002	24,334,875	22,799,002	24,334,875
Revaluation gains	2,024,804	2,034,231	2,024,804	2,034,231
Loan loss provisions	3,440,823	2,863,408	3,440,823	2,863,408
Instruments issued by consolidated banking and financial subsidiaries of the Bank and held by third parties	–	–	–	–
Total adjustments to Tier 2 capital	–	–	–	–
Investment in own shares	–	–	–	–
Others (specify)	–	–	–	–
CET 1 capital	95,725,306	68,863,841	94,151,253	67,284,572
Total Tier 1 capital	95,725,306	68,863,841	94,151,253	67,284,572
Total capital	123,989,935	98,096,355	122,415,882	96,517,086

As at December 31,	GROUP 2017 Rs. '000	GROUP 2016 Rs. '000	BANK 2017 Rs. '000	BANK 2016 Rs. '000
Total risk-weighted amount	789,711,397	657,951,626	777,427,117	649,014,208
Risk-weighted amount for credit Risk	725,500,975	602,932,452	713,765,370	594,260,342
Risk-weighted amount for market risk	6,303,710	3,683,529	6,303,710	3,683,529
Risk-weighted amount for operational risk	57,906,712	51,335,645	57,358,037	51,070,336
CET 1 capital ratio (including capital conservation buffer, countercyclical capital buffer and surchage on D-SIBs) (%)	12.12	10.47	12.11	10.37
Of which: capital conservation buffer (%)				
Of which: countercyclical buffer (%)				
Of which: capital surcharge on D-SIBs (%)				
Total Tier 1 capital ratio (%)	12.12	10.47	12.11	10.37
Total capital ratio (including capital conservation buffer, countercyclical capital buffer and surcharge on D-SIBs) (%)	15.70	14.91	15.75	14.87
Of which: capital consevation buffer (%)				
Of which: countercyclical buffer (%)				
Of which: capital surcharge on D-SIBs (%)				

Template 03

Computation of Leverage Ratio

As at December 31, 2017	GROUP Rs. '000	BANK Rs. '000
Tier 1 capital	95,725,306	94,151,253
Total exposures	1,626,970,079	1,613,561,019
On-balance sheet items (excluding derivatives and securities financing transactions, but including collateral)	1,151,136,046	1,137,316,666
Derivative exposures	328,406,037	328,817,950
Securities financing transaction exposures	61,017,837	61,017,837
Other off-balance sheet exposures	86,410,159	86,408,566
Basel III leverage ratio (%) (Tier 1/total exposure)	5.88	5.83

Leverage ratio is prepared based on the consultation paper issued by the Central Bank of Sri Lanka. As per the paper minimum leverage ratio is 4%.

Template 04

Basel III Computation of Liquidity Coverage Ratio – All currency

As at December 31,	**2017**		2016	
	Total un-weighted value Rs. '000	**Total weighted value Rs. '000**	Total un-weighted value Rs. '000	Total weighted value Rs. '000
Total stock of High Quality Liquid Assets (HQLA)	167,783,592	167,583,281	139,200,928	139,088,165
Total adjusted level 1 assets	167,382,970	167,382,970	138,975,487	138,975,487
Level 1 assets	167,382,970	167,382,970	138,975,402	138,975,402
Total adjusted level 2a assets	–	–	–	–
Level 2A assets	–	–	–	–
Total adjusted level 2b assets	400,622	200,311	225,526	112,763
Level 2B assets	400,622	200,311	225,526	112,763
Total cash outflows	1,126,874,188	204,822,466	977,707,604	182,098,299
Deposits	647,140,480	64,714,048	552,552,387	55,255,239
Unsecured wholesale funding	228,997,705	111,382,639	208,051,363	101,309,555
Secured funding transaction	–	–	–	–
Undrawn portion of committed (irrevocable) facilities and other contingent funding obligations	250,736,003	28,725,779	216,807,539	25,237,190
Additional requirements	–	–	296,315	296,315
Total cash inflows	190,872,659	124,705,986	135,948,605	89,947,218
Maturing secured lending transactions backed by the following collateral	37,491,907	37,069,704	35,782,810	35,325,892
Committed facilities	–	–	–	–
Other inflows by counterparty which are maturing within 30 days	74,594,943	47,223,317	59,398,731	38,837,257
Operational deposits	11,301,982	–	9,198,927	–
Other cash inflows	67,483,827	40,412,965	31,568,137	15,784,069
Liquidity coverage ratio (%) (stock of high quality liquid assets/ total net cash outflows over the next 30 calendar days)*100		209.17		150.93

Template 05

Main Features of Regulatory Capital Instruments

Description of the Capital Instrument	Stated Capital	Debentures – Type "A" – 1	Debentures – Type "A" – 2	Debentures – Type "B" – 1	Debentures – Type "B" – 2	IFC Borrowings
Issuer	Commercial Bank	Commercial Bank	Commercial Bank	Commercial Bank	Commercial Bank	International Finance Corporation
Unique Identifier (e.g., ISIN or Bloomberg identifier for private placement)						
Governing law(s) of the instrument	Sri Lanka	Sri Lanka	Sri Lanka	Sri Lanka	Sri Lanka	United States of America
Original date of issuance	N/A	March 8, 2016	October 27, 2016	March 8, 2016	October 27, 2016	March 13, 2013
Par Value of instrument		Rs. 100/-	Rs. 100/-	Rs. 100/-	Rs. 100/-	
Perpetual or dated	Perpetual	Dated	Dated	Dated	Dated	Dated
Original maturity date, if applicable	N/A	March 8, 2021	October 27, 2021	March 8, 2026	October 27, 2026	March 14, 2023
Amount recognised in regulatory capital (in Rs. '000 as at the reporting date)	37,143,541	3,544,272	4,057,440	1,749,090	1,928,200	11,520,000
Accounting classification (equity/liability)	Equity	Liability	Liability	Liability	Liability	Liability
Issuer call subject to prior supervisory approval	No	No	No	No	No	No
Optional call date, contingent call dates and redemption amount (Rs. '000)	N/A	N/A	N/A	N/A	N/A	N/A
Subsequent call dates, if applicable	N/A	N/A	N/A	N/A	N/A	N/A
Coupons/dividends						
Fixed or floating dividend/coupon	N/A	Fixed	Fixed	Fixed	Fixed	Floating
Coupon rate and any related index		10.75%	12.00%	11.25%	12.25%	06 Months LIBOR + 5.75%
Non-cumulative or cumulative						
Convertible or non-convertible						
If convertible, conversion trigger(s)	N/A	N/A	N/A	N/A	N/A	N/A
If convertible, fully or partially	N/A	N/A	N/A	N/A	N/A	N/A
If convertible, mandatory or optional	N/A	N/A	N/A	N/A	N/A	N/A
If convertible, conversion rate	N/A	N/A	N/A	N/A	N/A	N/A

Template 06

Summary Discussion on Adequacy/Meeting Current and Future Capital Requirements

Bank prepares the Corporate Plan and Budget on a rolling basis covering a period of 5 years which includes the computation of Capital Adequacy ratios (CARs). The Bank carefully analyses the CARs against increases in risk-weighted assets underlying the budgeted expansion of business volumes. The Bank has set up an internal guideline on minimum CARs and ensures that measures to improve the CARs are also built into the budget should the CARs are expected to fall below that. These measures could either be to increase the CET 1 or raise Tier 2 debt capital. Further, in extreme situations, the Bank will deliberate on strategically curtailing risk weighted assets expansion.

Budgeting process of the Bank encapsulates all future capital requirements and finalises the process only after reaching the desired level of capital as well as the CARs.

Besides, the Bank has a dynamic ICAAP process with rigorous stress testing embodied in it in addition to taking into consideration the qualitative aspects such as reputational and strategic risks. This process also proactively identifies the gaps in CARs in advance, allowing the Bank to take calculated decisions to optimise utilisation of capital.

The Bank has a well-diversified assets portfolio which is neither overly exposed to any counterparty nor to any sector. Ways and means of improving the CARs are being monitored on an ongoing basis.

The Bank always strives to achieve a reasonable growth in profit which is above the industry average and is ever mindful to pay a consistent stream of dividends to the shareholders. Part of the profit generated is retained for future business expansion. Given the size of the Bank, capital generated through retained profits over the years could be considered as one of the primary sources of capital to the Bank.

Template 07

Credit Risk under Standardised Approach

Credit risk exposures and Credit Risk Mitigation (CRM) Effects – Group

As at December 31, 2017	Exposures before Credit Conversion Factor (CCF) and CRM		Exposures post CCF and CRM		RWA and RWA density (%)	
	On-balance sheet amount Rs. '000	Off-balance sheet amount Rs. '000	On-balance sheet amount Rs. '000	Off-Balance sheet amount Rs. '000	RWA Rs. '000	RWA density Rs. '000
Claims on Central Government and Central Bank of Sri Lanka	294,231,073	59,904,000	294,231,073	1,198,080	–	–
Claims on foreign sovereigns and their central banks	20,197,669	–	20,197,669	–	20,197,669	100.00
Claims on Public Sector Entities (PSEs)	16,913	–	16,913	–	16,913	100.00
Claims on official entities and Multilateral Development Banks (MDBs)	–	–	–	–	–	–
Claims on banks exposures	29,324,762	120,983,865	29,324,762	2,529,910	19,633,530	61.63
Claims on financial institutions	29,093,851	–	29,093,851	–	13,947,299	47.94
Claims on corporates	410,043,431	327,192,837	356,378,524	72,569,315	411,296,028	95.88
Retail claims	242,433,300	15,681,348	204,755,354	7,847,448	175,002,056	82.31
Claims secured by residential property	61,278,959	–	61,278,959	–	46,757,354	76.30
Claims secured by commercial real estate	–	–	–	–	–	–
Non-Performing Assets (NPAs)	6,889,792	–	6,889,792	–	8,911,843	129.35
Higher-risk categories	–	–	–	–	–	–
Cash Items and other assets	58,235,647	–	58,235,647	–	29,738,283	51.07
Total	1,151,745,396	523,762,050	1,060,402,543	84,144,753	725,500,975	63.39

Credit Risk Exposures and Credit Risk Mitigation (CRM) Effects – Bank

As at December 31, 2017	Exposures before Credit Conversion Factor (CCF) and CRM		Exposures post CCF and CRM		RWA and RWA density (%)	
	On-balance sheet amount Rs. '000	Off-balance sheet amount Rs. '000	On-balance sheet amount Rs. '000	Off-balance sheet amount Rs. '000	RWA Rs. '000	RWA density (%)
Claims on Central Government and Central Bank of Sri Lanka	294,031,685	59,904,000	294,031,685	1,198,080	–	–
Claims on foreign sovereigns and their central banks	13,649,722	–	13,649,722	–	13,649,722	100.00
Claims on Public Sector Entities (PSEs)	16,913	–	16,913	–	16,913	100.00
Claims on official entities and Multilateral Development Banks (MDBs)	–	–	–	–	–	–
Claims on banks exposures	28,172,419	120,983,865	28,172,419	2,535,758	18,487,036	60.20
Claims on financial institutions	29,093,851	–	29,093,851	–	13,947,299	47.94
Claims on corporates	405,766,848	327,482,087	352,101,941	72,567,722	407,017,852	95.84
Retail claims	242,433,300	15,681,348	204,755,354	7,847,448	175,002,056	82.31
Claims secured by residential property	61,278,959	–	61,278,959	–	46,757,354	76.30
Claims secured by commercial real estate	–	–	–	–	–	–
Non-Performing Assets (NPAs)	6,513,033	–	6,513,033	–	8,535,084	131.05
Higher-risk categories	957,101	–	957,101	–	2,392,752	250.00
Cash items and other assets	56,160,204	–	56,160,204	–	27,959,303	49.78
Total	1,138,074,034	524,051,300	1,046,731,182	84,149,008	713,765,370	63.12

Template 08

Credit Risk under Standardised Approach

Exposures by Asset Classes and Risk Weights (Post CCF and CRM) – Group

As at December 31, 2017	Risk weight								
	0%	20%	50%	60%	75%	100%	150%	>150%	Total credit exposures amount
Asset class	Rs. '000	Rs. '000	Rs. '000	Rs. '000	Rs. '000	Rs. '000	Rs. '000	Rs. '000	Rs. '000
Claims on Central Government and Central Bank of Sri Lanka	295,429,153	–	–	–	–	–	–	–	295,429,153
Claims on foreign sovereigns and their central banks	–	–	–	–	–	20,197,669	–	–	20,197,669
Claims on Public Sector Entities (PSEs)	–	–	–	–	–	16,913	–	–	16,913
Claims on official entities and Multilateral Development Banks(MDBs)	–	–	–	–	–	–	–	–	–
Claims on banks exposures	–	6,187,529	14,542,236	–	–	11,124,906	–	–	31,854,672
Claims on financial institutions	–	2,919,555	25,621,814	–	–	552,481	–	–	29,093,851
Claims on corporates	–	14,406,322	12,253,508	–	–	402,288,010	–	–	428,947,839
Retail claims	603,259	617,735	–	8,063,619	133,111,405	70,206,784	–	–	212,602,802
Claims secured by residential property	–	–	29,043,211	–	–	32,235,749	–	–	61,278,959
Claims secured by commercial real estate	–	–	–	–	–	–	–	–	–
Non-Performing Assets (NPAs)	–	–	23,774	–	–	2,798,141	4,067,876	–	6,889,792
Higher-risk categories	–	–	–	–	–	–	–	–	–
Cash items and other assets	23,577,061	6,150,379	–	–	–	28,508,207	–	–	58,235,647
Total	319,609,473	30,281,519	81,484,544	8,063,619	133,111,405	567,928,859	4,067,876	–	1,144,547,296

Exposures by Asset Classes and Risk Weights (Post CCF and CRM) – Bank

As at December 31, 2017	Risk weight								
	0%	20%	50%	60%	75%	100%	150%	>150%	Total credit exposures amount
Asset class	Rs. '000	Rs. '000	Rs. '000	Rs. '000	Rs. '000	Rs. '000	Rs. '000	Rs. '000	Rs. '000
Claims on Central Government and Central Bank of Sri Lanka	295,229,765	–	–	–	–	–	–	–	295,229,765
Claims on foreign sovereigns and their central banks	–	–	–	–	–	13,649,722	–	–	13,649,722
Claims on Public Sector Entities (PSEs)	–	–	–	–	–	16,913	–	–	16,913
Claims on official entities and Multilateral Development Banks(MDBs)	–	–	–	–	–	–	–	–	–
Claims on banks exposures	–	6,187,529	14,542,236	–	–	9,978,412	–	–	30,708,177
Claims on financial institutions	–	2,919,555	25,621,814	–	–	552,481	–	–	29,093,851
Claims on corporates	–	14,406,322	12,253,508	–	–	398,009,833	–	–	424,669,663
Retail claims	603,259	617,735	–	8,063,619	133,111,405	70,206,784	–	–	212,602,802
Claims secured by residential property	–	–	29,043,211	–	–	32,235,749	–	–	61,278,959
Claims secured by Commercial real estate	–	–	–	–	–	–	–	–	–
Non-Performing Assets (NPAs)	–	–	23,774	–	–	2,421,382	4,067,876	–	6,513,033
Higher-risk categories	–	–	–	–	–	–	–	957,101	957,101
Cash items and other assets	23,280,599	6,150,379	–	–	–	26,729,227	–	–	56,160,204
Total	319,113,623	30,281,519	81,484,544	8,063,619	133,111,405	553,800,503	4,067,876	957,101	1,130,880,190

Template 09

Market Risk under Standardised Measurement Method

As at December 31,	GROUP		BANK	
	2017	2016	**2017**	2016
	Rs. '000	Rs. '000	**Rs. '000**	Rs. '000
(a) Capital charge for interest rate risk	354,758	226,153	354,758	226,153
General interest rate risk	150,553	107,288	150,553	107,288
i. Net long or short position	150,553	107,288	150,553	107,288
ii. Horizontal disallowance	–	–	–	–
iii. Vertical disallowance	–	–	–	–
iv. Options	–	–	–	–
Specific Interest rate risk	204,205	118,865	204,205	118,865
(b) Capital charge for equity	58,849	54,683	58,849	54,683
i. General equity risk	31,474	29,381	31,474	29,381
ii. Specific equity risk	27,375	25,302	27,375	25,302
(c) Capital charge for foreign exchange & gold	327,079	151,979	327,079	151,979
(d) Capital charge for market risk [(a) + (b) + (c)]	740,686	432,815	740,686	432,815
Total risk-weighted amount for market risk [(d) x CAR]	6,303,710	3,683,529	6,303,710	3,683,529

Template 10

Operational Risk under Basic Indicator Approach/The Standardised Approach/ The Alternative Standardised Approach – Bank Only

			Gross income		
As at December 31, 2017	Capital charge factor	Fixed factor	1st year	2nd year	3rd year
	%		Rs. '000	Rs. '000	Rs. '000
The basic indicator approach	15		**40,773,807**	**44,057,659**	**49,959,921**
The standardised approach			**40,773,807**	**44,057,659**	**49,959,921**
Corporate finance	18		641,679	402,397	273,036
Trading and sales	18		3,281,656	3,771,864	766,081
Payment and settlement	18		437,001	511,789	591,811
Agency services	15		–	–	–
Asset management	12		–	–	–
Retail brokerage	12		–	–	–
Retail banking	12		23,056,626	27,157,713	34,266,353
Commercial banking	15		13,356,845	12,213,896	14,062,640
The alternative standardised approach			**710,934,264**	**805,169,696**	**935,463,626**
Corporate finance	18		641,679	402,396	273,037
Trading and sales	18		3,281,656	3,771,864	766,081
Payment and settlement	18		437,001	511,789	591,811
Agency services	15		–	–	–
Asset management	12		–	–	–
Retail brokerage	12		–	–	–
Retail banking	12	0.035	265,321,140	320,537,695	379,027,523
Commercial banking	15	0.035	441,252,788	479,945,953	554,805,175
Capital charges for operational risk (Rs. '000)					
The basic indicator approach	6,739,569				
The standardised approach	6,001,536				
The alternative standardised approach	4,574,487				
Risk-weighted amount for operational risk (Rs. '000)					
The basic indicator approach	57,358,037				
The standardised approach	51,076,898				
The alternative standardised approach	38,931,801				

Template 11

Differences between Accounting and Regulatory Scopes and Mapping of Financial Statement Categories with Regulatory Risk Categories – Bank Only

As at December 31, 2017	Bank				
	a	b	c	d	e
	Carrying values as reported in published Financial Statements	Carrying values under scope of regulatory reporting	Subject to credit risk framework	Subject to market risk framework	Not subject to capital requirements or subject to deduction from capital
Assets	**1,143,373,765**	**1,141,585,508**	**1,046,731,182**	**4,725,657**	**93,884,054**
Cash and cash equivalents	33,224,619	33,224,329	33,224,329	–	–
Balances with central banks	44,801,446	44,801,446	44,801,446	–	–
Placements with banks	17,633,269	17,587,206	17,587,206	–	–
Derivative financial assets	2,334,536	–	–	–	–
Other financial instruments – Held for trading	4,410,913	4,410,913	–	4,410,913	–
Loans and receivables to banks	640,512	640,512	–	–	–
Loans and receivables to other customers	737,446,567	737,582,655	650,635,697	–	91,342,852
Financial investments – Available for sale	154,714,132	155,367,667	155,052,924	314,744	–
Financial investments – Held to maturity	63,562,752	65,363,679	65,363,679	–	–
Financial investments – Loans and receivables	48,712,477	48,371,776	48,371,776	–	–
Investments in subsidiaries	3,065,935	3,065,935	1,301,544	–	1,764,391
Investments in associates and joint ventures	44,331	44,331	44,331	–	–
Property, plant and equipment	14,707,304	14,707,304	14,707,306	–	–
Intangible assets	776,810	776,810		–	776,810
Other assets	17,298,162	15,640,944	15,640,944	–	–
Liabilities	**1,036,274,405**	**1,034,494,748**		–	–
Due to banks	57,120,991	56,586,879	–	–	–
Derivative financial liabilities	3,678,494	–	–	–	–
Securities sold under repurchase agreements	49,676,767	49,686,123	–	–	–
Due to other customers	850,127,511	833,073,338	–	–	–
Other borrowings	23,786,094	23,776,205	–	–	–
Current tax liabilities	4,143,911	3,874,521	–	–	–
Deferred tax liabilities	3,274,826	4,287,468	–	–	–
Other liabilities	19,225,364	38,499,855	–	–	–
Due to subsidiaries	74,523	74,523	–	–	–
Subordinated term debts	25,165,924	24,635,836	–	–	–
Off-balance sheet liabilities	**564,794,885**	**564,794,885**	**84,149,008**	–	**7,398,931**
Guarantees	64,869,608	64,869,608	33,677,132	–	5,949,807
Performance bonds	30,601,521	30,601,521	14,022,674	–	1,278,087
Letter of credit	45,078,313	45,078,313	8,845,421	–	170,242
Other contingent items	297,904,583	297,904,583	13,202,877	–	796
Undrawn loan commitments	29,740,830	29,740,830	14,400,904	–	–
Other commitments	96,600,030	96,600,030	–	–	–
Shareholders' equity	**107,099,360**	**107,090,763**	–	–	–
Equity capital (stated capital)/assigned capital			–	–	–
of which amount eligible for CET 1	37,143,541	37,143,541	–	–	–
of which amount eligible for AT I	–	–	–	–	–
Retained earnings	4,987,446	2,931,176	–	–	–
Accumulated other comprehensive income	(1,707,494)	–	–	–	–
Other reserves	66,675,867	67,016,047	–	–	–

Template 12

Explanations of Differences between Accounting and Regulatory Exposure Amounts

As at December 31, 2017	Differences observed between accounting carrying value and amounts considered for regulatory purposes	Reasons for differences						
		Net impact arising from individual and collective impairment	Fair value adjustment	Effective Interest Rate (EIR) adjustment	Re-classification of receivables and payables	Unamortised cost on staff loans (day 1 difference)	Other SLFRS adjustments	Tax Impact on SLFRS adjustments
	Rs. '000	Rs. '000	Rs. '000	Rs. '000	Rs. '000	Rs. '000	Rs. '000	Rs. '000
Assets								
Cash and cash equivalents	290	–	–	–	290	–	–	–
Placements with banks	46,063	–	–	–	46,063	–	–	–
Derivative financial assets	2,334,536	–	–	–	2,334,536	–	–	–
Loans and receivables to other customers	(136,088)	2,528,528	–	–	1,012,349	(3,676,965)	–	–
Financial investments – Available for sale	(653,535)	–	(660,250)	–	6,715	–	–	–
Financial investments – Held to maturity	(1,800,927)	–	(2,125,089)	–	324,163	–	–	–
Financial investments – Loans and receivables	340,701	–	–	–	340,701	–	–	–
Other assets	1,657,218	–	–	–	(2,019,747)	3,676,965	–	–
Liabilities								
Due to banks	534,112	–	–	–	534,112	–	–	–
Derivative financial liabilities	3,678,494	–	–	–	3,678,494	–	–	–
Securities sold under repurchase agreements	(9,356)	–	–	–	(9,356)	–	–	–
Due to other customers	17,054,173	–	–	(429,343)	17,483,516	–	–	–
Other borrowings	9,889	–	–	–	9,889	–	–	–
Current tax liabilities	269,390	–	–	–	–	–	–	269,390
Deferred tax liabilities	(1,012,642)	–	–	–	–	–	–	(1,012,642)
Other liabilities	(19,274,491)	–	–	–	(20,195,892)	–	921,401	–
Subordinated term debts	530,088	–	–	(4,863)	534,951	–	–	–
Shareholders' equity								
Retained earnings	2,056,270	2,528,524	–	443,561	–		(800,048)	(115,767)
Accumulated other comprehensive income	(1,707,494)	–	(1,707,494)	–	–	–	–	–
Other reserves	(340,180)	–	(340,180)	–	–	–	–	–

Explanations of differences between accounting and regulatory exposure amounts

Under LKAS 39 on "Financial Instruments: Recognition and Measurement", the Bank first assesses whether objective evidence of impairment exists for individually significant financial assets or collectively for financial assets that are not individually significant, based on the principles of "Incurred loss" (Refer Note 18 on page 201 for details). However, the regulatory provisions made on loans and advances under the Direction No. 3 of 2008 on "Classification of Loans and Advances, Income Recognition and Provisioning" (and subsequent amendments thereto) issued by the CBSL are "time/delinquency based". As a result, the LKAS 39 recognises delinquency pattern of a loan much earlier when compared to the CBSL Guidelines and also computes the impairment provision based on the historical loss experience of loans.

Investment securities are carried at "Cost" for regulatory reporting purposes while they classified as "Available for sale" carried at fair value or "Held to maturity" carried at amortised cost under the LKAS 39. The "Fair value" is defined as the best estimate of the price that would be received to sell an asset or be paid to transfer a liability in an orderly transaction between market participants at the measurement date. A variety of valuation techniques combined with the range of plausible market parameters as at a given point in time may still generate unexpected uncertainty beyond fair value. An "amortised cost" of a financial asset or financial liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortisation using the EIR method of any difference between the initial amount recognised and the maturity amount, minus any reduction for impairment. Hence, the amortised cost of Financial investments – Held to maturity, Due to other customers, Debentures, etc under the LKAS 39 is different to the carrying value for regulatory reporting which is the "cost". Refer Notes 26, 34 and 35 on pages 214 to 219 and 232 to 238 for details.

As per LKAS 39, a "Day 1 difference" is recognised, when the transaction price differs from the fair value of other observable current market transactions in the same instrument. E.g. Employee loans below market rates. Refer Note 7.1.2.1 on page 183 for details. However, the carrying value of such transactions for regulatory reporting purposes is equal to cost/transaction price.

Template 13

Bank risk management approach

Effective risk management is at the core of the Bank's value creation model as we accept risk in the normal course of business. Significant resources are devoted to this critical function to ensure that it is well articulated, communicated and understood by all employees of the Bank as it is a shared responsibility. It is a dynamic and disciplined function increasing in sophistication and subject to stringent oversight by regulators and other stakeholders. The overarching objectives are to ensure that risks accepted are in line with the Bank's risk appetite and strategic priorities and that there is an appropriate trade-off between risk and reward enabling delivery of value to key stakeholders.

"The risk governance structure,responsibilities attributed throughout the bank, risk management framework, objectives, strategies, policy framework, risk appetite and tolerance limits for key risk types, and the overall risk management approach of the Bank are discussed under three main sections of this Report namely the Risk Review, Managing Risk: An Overview, and Risk Management Report".

Template 14

Risk management related to key risk exposures

The quantitative disclosures relating to key risk areas such as credit, market, liquidity, operational, and interest rate risk in the banking book are presented and discussed in the Financial Risk Management Report on page 303 to 332 and Annex: Risk Management Report on page 372 to 417.