

## MANAGEMENT DISCUSSION AND ANALYSIS

### ● EXECUTIVE DIRECTOR'S MESSAGE



Over the past two years, Seylan Bank has steadily regained public confidence to the point where it is viewed as an institution that can generate sustainable returns for depositors and shareholders. Under the guidance of the current Board, and following the roadmap set out in the new strategic plan, the Bank entered 2010 poised for growth and was able to continue that momentum throughout the year. The following discussion of financial results examines the year's performance indicators in detail.

As described at length in the opening chapters of this Report, in 2010 Seylan Bank faced a wide range of challenges, both within the organisation and in the broader landscape of the financial services industry and the overall economy. While the Bank had made great progress during the previous financial year in restoring public confidence, there was still a need to shore up those gains and build upon them. This task was made more daunting by the continuing effects of the global recession and a financial marketplace characterised by low interest rates and a reduced demand for credit in the first half of the year.

Equally significant were financial challenges within Seylan Bank, notably a non-performing loans (NPL) ratio that was the highest in the industry. This impediment to profitability, coupled with vigorous competition, made any gains all the more difficult to achieve – and all the more gratifying when they finally came.

There were other significant challenges within the Bank as well. The centralisation of many business functions at head office, while vital to achieving higher levels of efficiency and productivity, proved to be an onerous and time-consuming process. Also challenging have been two major human resources objectives: to remedy the costly disadvantages of overstaffing and to streamline a management structure that had become needlessly top-heavy.

All of these challenges, along with additional hurdles in marketing, sales and inventory management, required the reallocation of valuable resources and consumed a great deal of management attention. Nevertheless, the Bank was able to address all of them in the course of the year, making tangible progress on most fronts and putting in place processes that will continue to yield improvements to the benefit of all stakeholders (as detailed at length in Chapter 3 of this Report, 'Pro Bono Publico', beginning on page 25).

The lessons learned in the course of getting Seylan Bank back on track have been taken to heart. Teams across the organisation are now working in concert to better identify and meet customers' needs and build a strong, multi-faceted strategy for sustained future success. That this strategy is already taking hold, despite such a wide range of challenges, is evidenced by the strong results recorded in 2010. Profit after taxation, which surpassed the milestone of Rs. 1 Bn., is the highest ever posted by the Bank in its 23-year history. Further Bank has achieved a deposit growth of 4.8% over last year while growing the loan book by 10.56% over the year 2009.

The most significant key indicator of Capital Adequacy Ratio remains at 12.07% which is well above the minimum statutory requirement of 10% in the year under review.

Further details of the Bank's profitability, along with other aspects of its performance and financial position, are covered in the Financial Review beginning on page 79. (The audited Financial Statements for the year appear on pages 214 to 311). As the detailed review makes clear, the Bank is successfully addressing the main obstacles to further growth, including NPLs and the cost-to-income ratio, with a range of short-, medium- and long-term goals set out in a cohesive strategy. Moving ahead with what is now a comparatively strong Balance Sheet – and armed with the necessary resources, the support of regulators and the invaluable commitment of employees across the enterprise – Seylan Bank is well-positioned to achieve a dramatic leap forward in the coming year.

**Ramanathan Nadarajah**

*Executive Director*

18th February 2011

## ● OPERATIONAL REVIEW

### THE GLOBAL ECONOMIC LANDSCAPE

Economies in the West and USA are making heavy weather of their recovery processes impacted largely by poor consumption spending patterns. The GDP growth projections for the US in 2010 were downgraded from 3.3% to 2.6%. Growth in the EU countries for the same period stands even lower - at 1.7%.

In stark contrast, emerging and developing economies, particularly in the Asian Region are displaying strong growth prospects. Bank capitalisation amongst Asian Banks remains adequate to drive credit growth, whilst rises in capital inflows are leading to currency appreciation in the region.

In the South Asian Region, the obvious strong performer remains India, whose GDP is set to grow by 8.3% in 2011. Bangladesh too is a strong performer building on a 6.1% growth in the years of 2009/10, whilst Pakistan at 2.7% GDP growth is plagued by inflation. Indeed, the prognosis is that inflation will remain a concern for the region into the coming years.

### THE LOCAL ECONOMIC LANDSCAPE

The Sri Lankan economy posted a turnaround in 2010, with GDP growing by 8% - a result that has been achieved on the back of above average growth in the sectors of tourism, construction and banking.

The Colombo Bourse performed remarkably, growing by 106.7% in 2010. This growth momentum places our bourse amongst the world's top performers. This result can be attributed to the economic turnaround arising from returning peace after the 30-year war in the North and the East of the country and the resultant acceleration in growth taking place domestically.

For the banking sector too, 2010 was a good year. An overall growth in deposit base and an attendant healthy liquidity scenario, which at present exceeds Rs. 100 Bn. will be well supported by the beneficial effects of reductions in VAT and

corporate taxes, to ensure the growth momentum carries forward to 2011. The anticipated growth in loans should also soak up much of the substantial excess liquidity seen at present in the local market.

In terms of the future, the Sri Lankan economy is expected to record growth of 8.5% in 2011, 9% in 2012 and 9.5% by end 2013. The sectors that will fuel this growth are tourism, infrastructure and retail. Also, an interesting trend that has already begun should see more foreign investment inflows to the Colombo Bourse as overseas investors see more advantage in the fast growing Asian region as opposed to low performing Western markets.

### Review of Operating Results

The year 2010 was one of great success and achievement for Seylan Bank. We continued to grow key business fundamentals whilst consolidating and realigning processes to keep growth momentum on track.

The performance of key divisions of the Bank contributed to this success story.

The salient highlights of the Bank's overall performance appear on page 72 of this Report.

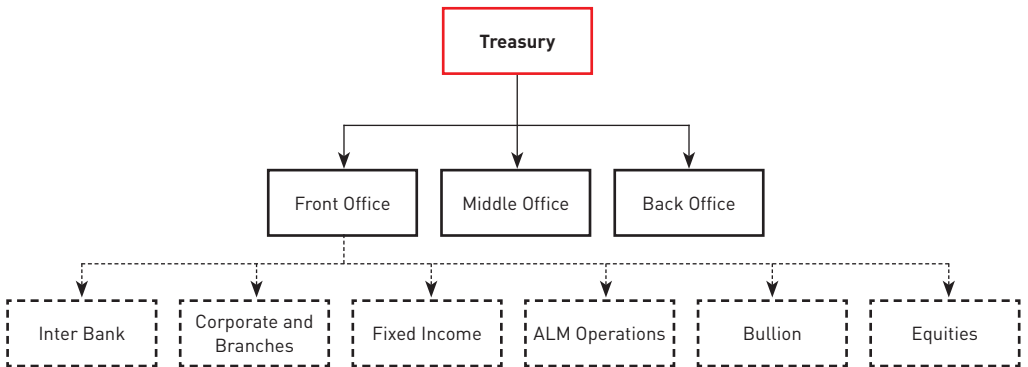
### PERFORMANCE BY DIVISION

#### Treasury

Astute interpretation of market direction in both foreign exchange and money markets enabled our Treasury division to significantly better its results during the year. In addition to the exchange profit contribution, Treasury managed to improve the Bank's net interest income by investing excess Sri Lanka Rupee funds in tax efficient Treasury Bills and Bonds and trading such securities.

Treasury is entrusted with managing the Bank's interest rate, liquidity and foreign exchange risks, mobilising resources from domestic as well as international markets, achieving an optimum Balance Sheet mix and maximising the returns therefrom while minimising risk to the Bank.

The chart below illustrates the footprint of the Treasury division:



**Key Operational Initiatives and Achievements**

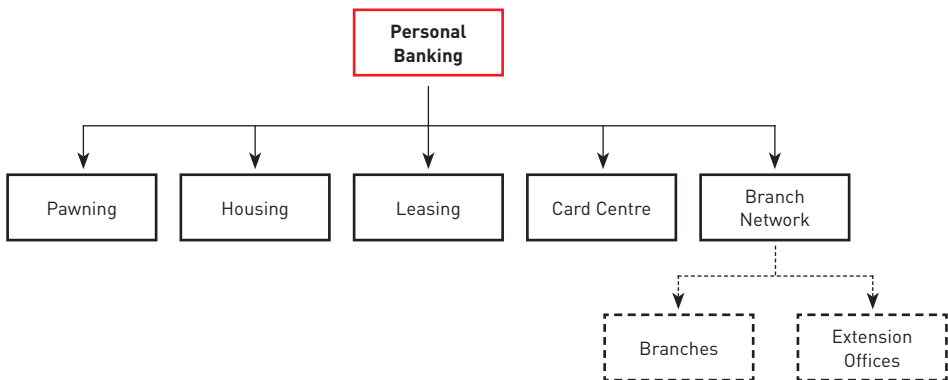
- Recorded significant income from foreign exchange and interest income by positioning the Bank to benefit from declining interest rates.
- Aggressively invested in tax-efficient foreign currency bonds and Sri Lanka Development Bonds which delivered profit margins sufficient to negate the negative effect of high cost of foreign currency deposits.

- Initiated action to streamline the funds transfer pricing system to improve its effectiveness as a business management tool and to assist the ALCO in an effective fund management process.
- Bank share trading portfolio recorded significant gains in line with the market.

**Personal Banking**

The Personal Banking Division closed the year under review with a growth in profitability when compared with the previous financial year.

The diagram that appears below describes the composition of activity that constitutes the Bank’s Personal Banking Division.



## Pawning

Pawning as a product has emerged as a focal line of business in the retail sector. It is a significant contributor to the profitability of the Bank and its positive influence on the bottom line has been steadily prominent over the past few years.

During the year under review, the Bank's pawning portfolio increased significantly culminating in a net growth of about Rs. 4.6 Bn. in business for the year.

The Bank's pawning portfolio is characterised by its quality.

Whilst aggressively marketing the product, the Bank is conscious of the need to promote responsible lending and thus we conscientiously follow a series of quality evaluations prior to lending. This unwillingness to compromise on the quality of the portfolio is evident in that the Bank enjoys a Non-Performing Advances (NPA) ratio of around 0.05%. As a result, capital losses have been very low.

These factors have firmly established pawning as one of the Bank's main products, in its retail product line.

## Leasing

The vehicle industry in 2010 experienced considerable downward revision of import taxation which affected the leasing businesses. The Bank performed above average due to the quality of its leasing portfolio wherein effective monitoring and credit evaluations rendered low NPA levels. The consistent focus on portfolio quality and recoveries enabled the Bank to overcome the challenges posed by the external environment. Enhanced customer relations and a series of tactical promotions worked hand in hand to strengthen the brand and to consolidate the business.

## Credit Card Services

The Bank's key objective for the year was to consolidate the existing credit card base whilst deploying incentives to generate increased revenue. Focused promotions at a variety of merchant locations helped to maintain card profitability

despite the challenging market environment. These promotions also helped to significantly increase our merchant base. Stringent control measures enabled the Bank to maintain portfolio quality, a commendable achievement from an industry perspective.

The Bank's performance in respect of **Branch Network, Card Centre, Housing Loans and Leasing** appears on pages 33, 37, 40 and 41 respectively.

## Corporate Banking

The Corporate Banking division is equipped to offer its customers a total financial solutions package under one roof. Further, it is in a position to cater to the requirements of large multinationals due to its higher single borrower limit at competitive rates, utilising the funds mobilised through the well-spread branch network of the Bank.

### Core Competencies of the Division

Wide spectrum of investment banking products

Cost effective operations

Large single borrower limit

High Level of professionalism

### Products/Services

Letters of Credit

Shipping and other Guarantees

Import and Export Finance

SWIFT facilities

Syndicated Loans

Project Financing

Securitisation

Company Valuations, Restructuring and Rehabilitation

Investment Advice and Evaluation

Working Capital Financing

Leasing

Off-Shore Banking Facilities

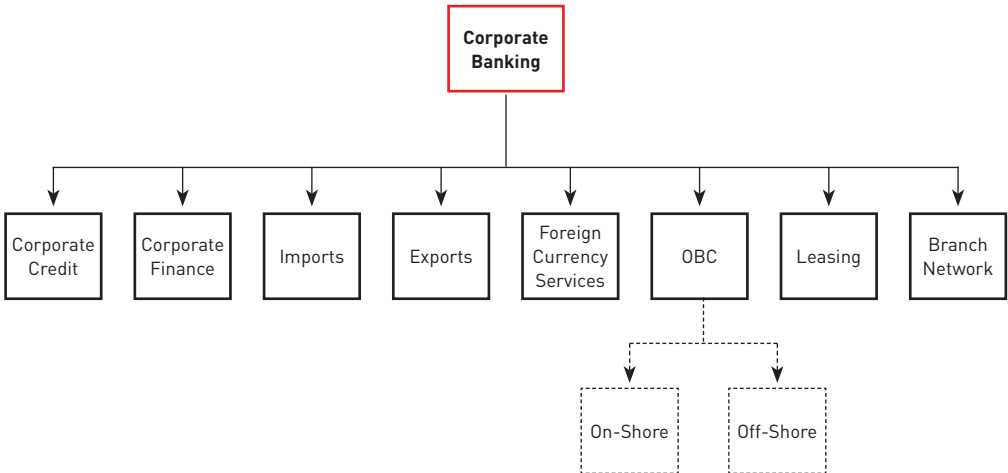
Internet Banking

Payment Solutions to Corporate Clients

Margin Trading

## REVENUE DRIVERS

The Corporate Banking division is supported by many sub-divisions in its endeavour to deliver the desired performance, The chart below illustrates this network of sub-divisions, which directly contribute to the revenue of the Corporate Banking division:



## OUTLOOK 2011

We enter 2011 with a strong income momentum in Consumer Banking business, driven by high levels of customer activity and good risk control. Looking to the future, it is clear that the economic and business environment will remain challenging, and the quality of our assets and risk management capability will again be tested. Our ambition is to make Consumer Banking a force to be reckoned with in the industry.

The strategies that will be recognised to enhance the performance by divisions are summarised as follows:

### 1. International Operations

The Bank is fully-committed and focused towards expanding remittance actively in anticipated markets of growth through mutually beneficial relationships and business models ensuring speed of delivery whilst simultaneously minimising cost. From a domestic economic perspective, the infrastructure, agriculture and commercial activity in the Northern and Eastern Provinces are expected to drive the economy to higher levels of growth in the upcoming financial year.

### 2. Marketing

Increasing competition and fragmentation of the marketplace will call for greater focus on marketing in the years ahead. Whilst maintenance of loyalty and consolidation of existing customer bases will be critical for the Bank, consumer relevant advertising and shaping of promotional activity will lead the approach towards customer retention.

### 3. Business Expansion

In the post-conflict scenario, the Bank expects to play a key role in the reconstruction and development of the Northern and Eastern provinces and other areas of the country, which will be delivered via an expanding network of branches and extension offices in these regions. This has been described more fully in chapter 3 appearing on page 33.

## STRATEGIES

The Bank's strategy has been extensively spelled out in Chapter 5. It is our view that encapsulation of strategy in any other shape or form would not adequately illustrate its importance/validity and

application across the Bank's enterprise, hence we kindly request that the readers refer to the pages mentioned for full details.

Bank's Strategies and its outlook for 2011 referred in our previous chapter are summarised and tabulated for easy reference.

Core Area/ Division	Strategies Discussed	Chapter No.	Page No.
Personal Banking and Corporate Banking	Improving credit quality	1	14
	Bringing down the NPA		
	Recovery drives		
	Centralisation of back office functions making speedy delivery, quality and improving the value added service	5	68
	Expansion of Net work	3	33
	<b>Performance by products</b>		
	Housing Loans		40
	Students Loans		40 - 41
	Leasing		41 - 42
	Margin Trading		43
Remittance Services		44	
International Presence		44	
Treasury Functions	Effective pricing Strategy through Implementation of Transfer pricing system	5	69
Supporting Services	<b>Effective use of Human Resources</b>		
	Employee Training and Development	3	47 - 48
	Welfare Activities	3	48 - 49
	Regulatory Compliance	3	49
	Moving forward with marketing challenges	2	21
	Improve the quality of sales staff and delivery of products	2	22
	Customer growth and retention	3	31
	<b>Marketing promotions</b>		
	ATM, Credit card Promotion	3	37
	Sustainability and Community Services	3	51 - 53
e-Services	Phone-based services	3	39
	Web-based services	3	40
	Inventory Management Module		22

### Financial Review

Please refer to the comprehensive Financial Review which appears on pages 79 to 83 in this Report.

### Risk Management

Please refer to the separate chapter on Risk Management which appears on pages 84 to 110 of this Report.

● **FINANCIAL REVIEW**

The financial year 2010 was wrought with uncertainties. As the year began, the economy confronted a multitude of challenges both on the internal and external fronts.

**FINANCIAL PERFORMANCE**

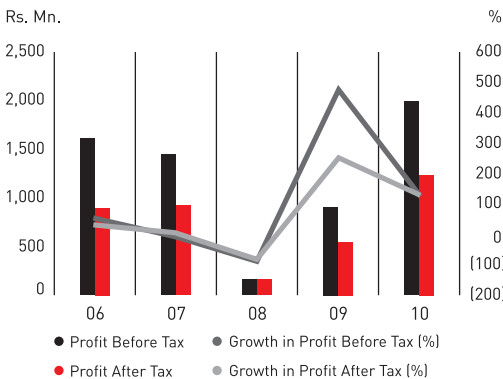
Despite the challenging macroeconomic climate, the Bank continued to perform commendably in the financial year 2010. The Bank's financial performance exceeded expectations for the year with Pre-Tax Profit for 2010 growing by as much as 124% from that of 2009.

Likewise, surmounting the growth momentum of the previous year, the Bank was successful in surpassing Post Tax Profit of Rs. 1.2 Bn. The Bank recorded a growth in Post Tax Profit of 126% for the year positing a Profit after Tax of Rs. 1.2 Bn. at the end of the financial year.

A combination of several internal and external factors facilitated this improvement in Net Interest Income. The foremost internal factor was the Bank's success in managing its fund base and the interest rates structure in a prudent and professional manner through the ALCO. In addition, steps were taken to manage the NPA Ratio, by recovering some of the loans and advances already classified as non-performing and by closely monitoring borderline cases which helped to enhance the net interest margin.

Total Other Income for the Bank recorded a growth of 40% compared to 2009 and stood at Rs. 3.4 Bn. as at end December 2010. This was mainly due to increase in Bad Debts Written Back and Recoveries made during the year which was an increase of Rs. 437 Mn. compared to 2009. The exchange income witnessed a fall of Rs. 118 Mn. mainly due to static exchange rates whilst fee and commission income recorded an increase of Rs. 153 Mn.

Profit Before & After Tax



Movement and Composition of Total Income



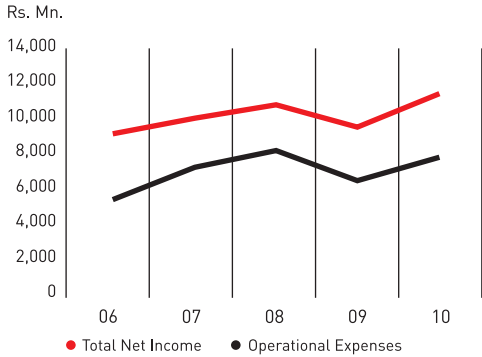
**INTEREST INCOME AND OTHER INCOME**

Total interest income in 2010 stood at Rs. 16.6 Bn. Interest expenses for the year decreased to Rs. 8.5 Bn. from Rs. 13.5 Bn. in 2009. The resultant Net Interest Income (NII) grew by 12% to Rs. 8.0 Bn. in 2010.

**Operating Expenses**

The overall operating expenses for the year increased by 21% to stand at Rs. 7.8 Bn., of which staff expenses amounted to Rs. 2.9 Bn., an increase of 22% over 2009.

### Income vs Cost



However, the Bank continued its efforts towards cost management and productivity improvements as it managed to reduce headcount by 3% despite the expansion of operations by opening five new customer service centres during the year.

The Cost to Income ratio (including VAT on Financial Services) stood almost flat at 69% in 2010 compared to 68% in 2009. Despite a marginal increase, the Bank will continue its pursuit of achieving the medium-term goal of containing the Cost to Income ratio below 60%.

### Operational Expenses and Cost/Income Ratio

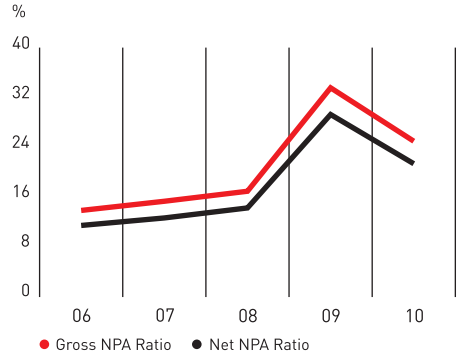


### Provision and NPL

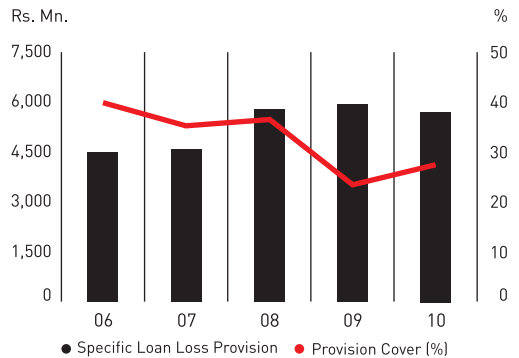
Withstanding the slowdown in the economy, the Bank managed to reduce its Non-Performing Loans and Advances (NPA) ratio Net of Interest in Suspense from 29.29% in 2009 to 21.36% by end 2010

as a result of responsible lending policies, careful post sanction monitoring, aggressive collections and recoveries made. The specific provision for loan losses decreased in 2010 by 4% to stand at Rs. 5.7 Bn. whilst managing to increase the Provision Cover to 27.41% from 23.37% of last year.

### Gross and Net NPA Ratio



### Specific Loan Loss Provision and Provision Cover



Taxation continued to be a heavy burden to the banking and financial services industry. As emphasised in previous years the taxation regime remains grossly non-conducive for industry vigour and capital formation. In 2010 as in previous years, taxation imposed considerable strain on the Bank's bottom line.

During the year Financial VAT accounted for Rs. 857 Mn. whilst Corporate Tax too accounted for Rs. 768 Mn. The total charge to the Income Statement in 2010 for taxation stood at a staggering Rs. 1.6 Bn.

However, the banking sector is looking forward to a favourable change in 2011 in light of the proposed tax reforms on the financial sector which is to be implemented by the Government.

**BUSINESS VOLUMES AND EXPANSIONS**

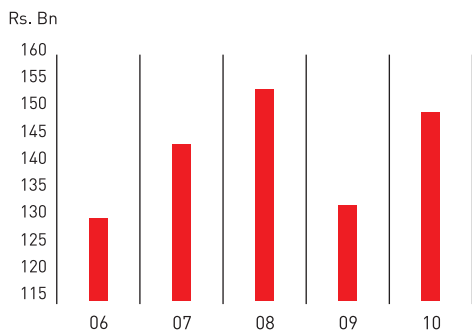
**Balance Sheet**

The Bank’s Balance Sheet in the year under review, continued to reflect strength and stability, proving that sound fundamentals, astute financial policies and strategies are the core to sustainable business.

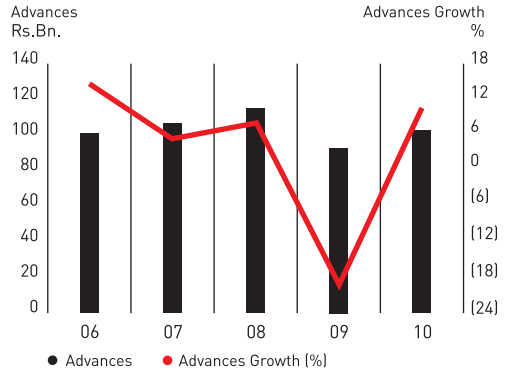
**Asset Growth**

The Bank’s total asset value increased by 13% to a value of Rs. 149.9 Bn. in comparison to Rs. 132.7 Bn. in 2009. The Bank successfully managed its asset mix to optimize asset growth and stability. Despite the fact that the Bank mainly focused on a quality portfolio as opposed to growth, the year 2010 shows a lending growth of 10.56% [An increase of Rs. 9.8 Bn. leading to a total loans and advances portfolio of Rs. 102.5 Bn. by end 2010]. Further, the Bank was able to balance its interest margins effectively to overcome a scenario of deterioration of net interest income.

**Total Assets**



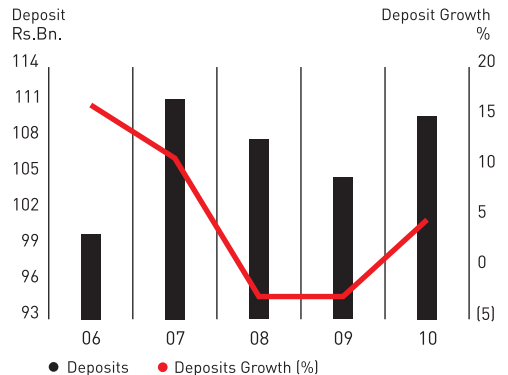
**Advances and Advances Growth**



**Deposits Growth**

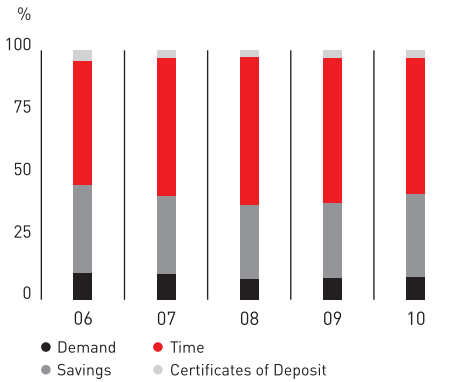
Deposit mobilization in the first half of the year proved to be less complex predominantly due to conditions within the industry wherein customers migrated their funds to more financially stable deposit taking institutions. The deposit portfolio witnessed a growth of 4.8% from the previous year to settle at Rs. 109.9 Bn. from Rs. 104.8 Bn. in 2009.

**Deposits and Deposits Growth**

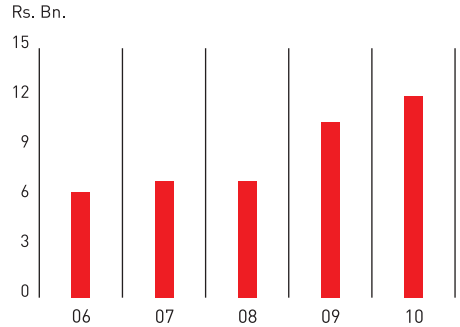


Demand deposits grew by 15% year-on-year to Rs. 10.4 Bn. in 2010. Time deposits continued to be the highest contributor for the overall composition of deposits accounting for over 55% of the deposit base. However, growth mainly stemmed from savings accounts in the deposit base which expanded by 14% to Rs. 36.1 Bn., up from Rs. 31.8 Bn. the previous year.

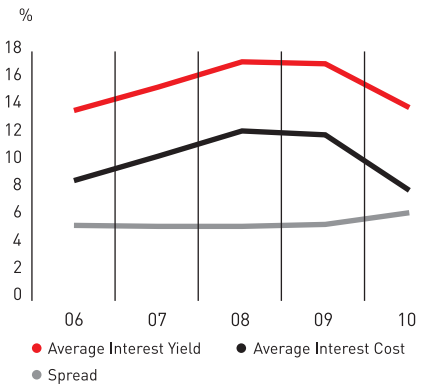
### Growth in Deposits Mix



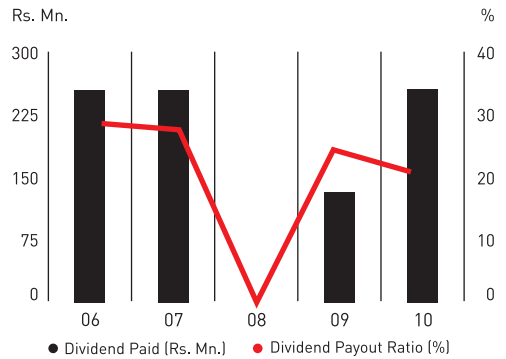
### Shareholders' Funds



### Yield, Cost & Spread



### Dividend Paid and Dividend Payout Ratio



## MARKET CAPITALIZATION AND INVESTORS' INTEREST

### Shareholders' Funds

Shareholders' funds grew by 14 % in the financial year, enhanced primarily by retained profits from 2010. The fund base grew from Rs. 10.5 Bn. to Rs. 12.1 Bn. during the year. The Bank proposes a final dividend of Rs. 1.00 per share on profits for the year under review, which will amount to a total ordinary dividend payment of Rs. 253 Mn.

## STABILITY AND CONFIDENCE

### Capital Adequacy

The total Capital Adequacy Ratio was 12.07% as at end December 2010, well above the minimum statutory requirement of 10%. Tier I ratio stood at 10.58% compared to 10.25% in 2009 which is also well above the minimum requirement of 5%.

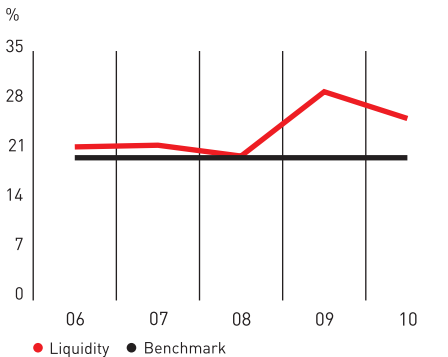
### Capital Adequacy Ratio



### Liquidity

Even after redemption of debentures and settlement of a large parcel of borrowings, the Bank's overall Liquidity Ratio stood at 25.56 % at end December 2010, well above the minimum statutory requirement of 20%.

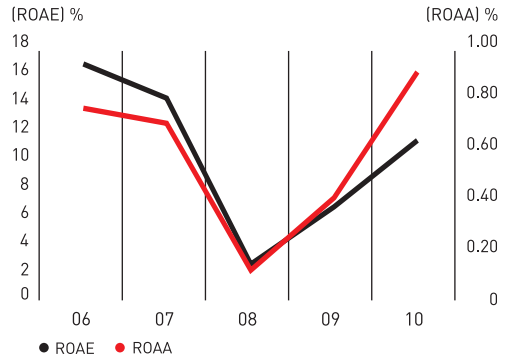
### Liquidity Ratio



### Return on Average Assets (ROAA)/ Return on Average Equity (ROAE)

The Return on Average Assets (ROAA) in 2010 increased to 0.87% from 0.38 % in 2009 moving in a positive direction with the Return on Average Equity (ROAE) increasing to 10.88% from 6.2% in 2009.

### Return on Average Assets & Equity



### GROUP PERFORMANCE

Seylan Bank and its subsidiary Seylan Developments PLC posted a Pre-Tax Profit of Rs. 1.9 Bn. in 2010 as against Rs. 906 Mn. in 2009, recording a Pre-Tax Profit growth of Rs. 1 Bn. in absolute terms and a growth of 115% as a percentage compared to 2009. The Post Tax Profit of the Group for the twelve months period ended 31st December 2010 amounted to Rs. 1.16 Bn., a 176% growth from Rs. 421.0 Mn. of the previous year.