MANAGING DIRECTOR'S REVIEW

OUR JOURNEY HAS BEEN REMARKABLE, TOUCHING MANY LIVES AND BEING PART OF THEIR GROWTH AS A TRUSTED PARTNER. COMMERCIAL BANK IS ACKNOWLEDGED AS ONE OF THE WORLD'S TOP 1000 BANKS AND IS THE LARGEST PRIVATE SECTOR FINANCIAL SERVICES ORGANISATION IN SRI LANKA. WE SEEK TO BUILD ON THIS HERITAGE, MAINTAINING STAKEHOLDER COVENANTS TO SHAPE THE FUTURE OF BANKING.

Delivering Growth

Commercial Bank of Ceylon PLC maintained its growth trajectory in 2016 with increased penetration in Sri Lanka and Bangladesh while venturing into new geographies, having obtained necessary regulatory approvals in the previous year. Commercial Bank of Maldives Private Limited commenced operations as a Tier I Bank in September 2016 with the Bank owning a controlling stake with the vision of becoming the most technologically advanced, innovative, customer friendly and most sought-after financial services organisation in Maldives. Commex, our fully-owned Italian Subsidiary located in Rome, commenced money transfer operations in 2016 under the supervision of the Bank of Italy expanding our horizons and strengthening our remittance operations in Sri Lanka and Bangladesh. Both new ventures were built on expertise gained in our home market to realise opportunities for growth in new geographies, using tested technology platforms and processes.

Our product portfolio and delivery channels continue to grow supporting customers throughout their life cycle. Convenience and security have been key areas of focus in design and delivery of products which has resonated in the market, facilitating onboarding of customers to electronic channels and positioning the Bank for scalable growth.

Delivering 42 years of growth in the five years to 2016, we doubled Total Assets, Loans and Advances and Deposits building on investments in people, networks, technology and processes. Improvement in asset quality and a stable rating are testimony to balanced growth while overall performance stands testimony to the direction of growth in our 48th year. A commitment to responsible banking has been key to building our strong customer franchise and is a core value maintained when charting our course. It has enabled us to differentiate our products and services in markets offering sound customer value propositions to a diverse clientele. Inclusive policies allowed for early identification and management of risks, increasing our relevance to customers and driving growth. Sound governance and prudent risk management underpin our growth, enabling us to remain resilient amidst multiple macroeconomic challenges.

The Bank has been an early champion of sustainability principles, taking a holistic view of our outputs and impacts from an economic, social and environmental perspective. Product responsibility, financial inclusion, employee relations and concern for the environment have been part of our DNA and implementing a comprehensive sustainability agenda has given structure to embed the principles throughout the Bank in a consistent manner. Our sustainability agenda has been formulated using the GRI G4 Guidelines for Sustainability Reporting and the UN Global Compact Principles. Establishment of the CSR Trust Fund, screening loans for social and environmental compliance, introducing green loans and installation of solar panels at branches are a few initiatives that underline our commitment to sustainability. This year we also undertook a mapping of the Bank's impact on Sustainable Development Goals, as stated on page 62. Extending the broader sustainability agenda to other countries will commence starting with Bangladesh.

A Resilient Performance

Commercial Bank recorded Rs. 14.513 Bn. in profit after tax in 2016, delivering profit growth of 21.92%. We also became the first private bank to reach Rs. 1 Trillion in assets with an asset growth of 15.05% marking yet another milestone in our journey. NII growth of 8.17% in 2016 was supported by strong loan growth of 20.38% which compensated for narrowing net interest margins. Interest rates increased sharply during the year as liquidity tightened and policy rates increased resulting in intense price competition for both deposits and loans. The CASA ratio also declined across the industry as funds shifted to higher yielding term deposits. NII continues to be the main contributor to operating profit, accounting for 74.43% of operating income. Net Fee and Commission income growth of 30.54% was driven by strong growth in credit cards, remittances and trade finance as we increased market share in all three business lines. Impairment charges declined by 61.20% from Rs. 3.943 Bn. in 2015 to Rs. 1.530 Bn. in 2016 as asset quality improved due to increased rigour of credit processes significantly improving profitability. Operating cost increases were curtailed to 8.73% necessary to support growth. The cost to income ratio increased to 51.06% reflecting increased rates for VAT on financial services.

Deposit growth of 18.50% was particularly gratifying as it is attributable to a strong customer covenant built up over decades of prudent banking and deep relationships. Commercial Bank maintained a calming presence in an intensely competitive market as customers remained loyal reflected in high customer retention rates. Our focus on customer convenience also played a key role in customer retention as many customers retained balances in savings accounts for easy access.

Improvements in asset quality was key to improving profitability and reflect strong credit processes and an improved risk culture, particularly in our front lines which are responsible for accepting risk. Non-performing loans declined from Rs. 16.370 Bn. in 2015 to Rs. 15.999 Bn. in 2016 for the second consecutive year despite portfolio growth of 24.57% and 20.38% in 2015 and 2016 supporting the reduced impairment charge. While a turning of the credit cycle is imminent, exerting pressure on the non-performing loans, we are confident that the Bank is well positioned to manage this vital aspect with the sound progress made during the year.

Tier II capital was strengthened during the year with two debenture issues which facilitated high levels of liquidity as well. Maintaining stability, strength and liquidity required balancing potential short-term gains with long-term outcomes, strengthening our customer covenant for responsible banking. Capital adequacy ratios (Tier I and Tier I & II) and the Statutory Liquid Assets Ratio were maintained well above regulatory requirements at 11.56%, 15.90% and 27.41% respectively in line with the Bank's Risk Appetite which is 3% higher than regulatory thresholds.

Business Line Review

Retail Banking operations were the highest contributor to earnings and growth accounting for 56.87% of profits from operations, 34.10% of asset growth and 63.86% of liability growth. Growth in this key segment was delivered through focused efforts to grow the SME sector by providing access to finance, consolidating the learnings gained as the largest lender for over the past several years to this underbanked sector. Deposit growth was particularly gratifying as we maintained high levels of customer retention and attracted deposits although competition in this segment intensified with tightening liquidity.

Corporate Banking delivered solid growth of 23.72% on assets and 16.80% on liabilities by Investing in active sectors of the economy such as trading, tourism, apparel and construction, as we focused on delivering customised solutions through a deeper understanding of client growth aspirations and needs. NII and fee-based income came under pressure from intensifying competition resulting in a marginal decline in total operating income. Corporate Banking earnings declined by 0.68% and as a result its contribution accounted for only 27.22% of profits from operations compared to 32.19% in 2015.

Contribution to earnings from International operations kept pace with growth increasing marginally to 15.66% during the year from 14.86% in 2015. Results comprise operations in Bangladesh and remittances as new ventures in Italy and Maldives commenced operations during the year. It is noteworthy that asset and liability growth for this segment was encouraging at 11.01% and 9.16% respectively reflecting stability in operations in the two key areas. Operations in Myanmar are yet to realise their potential and will be a key focus area in 2017 together with the new strategies.

Investment Banking maintained a low profile as equity market conditions were not conducive to high levels of activity but increased its presence in debt market to enhance earnings during the year. Managing two debenture issues for the Bank this year, this division raised Rs. 13.179 Bn. for the Bank. A pipeline of projects is being built up awaiting a favourable turn in equity markets.

Our treasury focused continuously on maintaining liquidity in a market that was struggling to stay afloat. Prudential policies were prioritised with a conscious decision to pay the price of doing what is right for the time, maintaining a calm presence in an otherwise turbulent financial market. Treasury portfolios account for 25.19% of assets and 9.87% of liabilities and the direction of movement will be determined principally by the Bank's Asset and Liability Management strategy.

Digitisation and Operational Excellence

With 4,987 employees located in 274 branches, branch automation is pivotal to achieving overall operational excellence, realising our investments in people and technology. Consequently, branch automation has started taking form which includes streamlining branch processes and extending efficiencies gained through centralised processes. Technology at the branch plays a key role and solutions include installation of CDMs, CRMs and kiosks. The launch of e-passbook for savings customers is one that is expected to transform how they interact with the Bank, putting banking literally at their fingertips. As the vast majority of banking customers are savings account holders, this innovation is key to transforming banking and is the only such product in South Asia. As customer migration to technology is a key component of realising our goal, we have commenced pilots for assisted customer migration to familiarise customers with operating the machines. Our digitalisation has also considered the need for trilingual customer interfaces ensuring that all customers benefit from our progress. We see this as part of our customer covenant and aspire to share our digital journey with them, sharing the benefits of our investments.

We have also invested in shoring up security of our technology platforms in response to the global escalation of cyber threats. As part of these initiatives, Commercial Bank became the first bank in Sri Lanka to become EMV compliant, a prerequisite for ATMs to accept internationally issued cards. This supports tourism enabling cash withdrawals from our network of 657 ATMs using their credit or debit cards.

A highly motivated team drives our growth and together they are the advocates, architects, builders and movers in our transformation as a technology driven regional player. We continue to invest in facilitating the transition to a new era of banking and grooming the next generation of leaders, using a combination of well-established curricular, innovative tools and a mentoring culture. Our growth continues to offer career progression opportunities to our people, maintaining high levels of satisfaction and motivation.

Our cost to income ratio remains one of the lowest in the industry, testimony to our employee productivity and integration of technology. Improving customer satisfaction scores clearly demonstrate that operational efficiency has not been at the expense of customers and that they are beneficiaries of our investments. Customer growth has also been high during this period in accordance with our inclusive banking principles and improving customer satisfaction during this high growth phase is the result of an unwavering commitment to responsible banking. The indicators combine to affirm that value created is shared across multiple stakeholder segments in keeping with our commitment to sustainable development.

Our Prospects

Our transformation as Sri Lanka's leading international bank will continue as we seek to grow the markets we have entered, in to profitable concerns and realise their potential. The Bank's positioning in the industry as the largest private sector bank, a strong Balance Sheet, liquidity, a relatively lean operational model, global and local networks that connect people to markets gives us a strong foundation for future growth. We will focus on profitable growth as affordability is key to market leadership, increasing penetration in established markets and driving financial inclusion. Automation will play a key role in driving operational excellence and cost savings in the future as we look to further enhance our customer value proposition. We are re-thinking the role of branches in our business model and branch processes to ensure these vital front lines are future ready. Assisted customer migration will play a key role in driving operational excellence and customer convenience for sustained customer satisfaction.

We are encouraged by the credit growth witnessed in 2016 as demand for credit came from more development oriented sectors such as import substitution industries and is a trend expected to continue in to the coming year. The Bank will continue to invest in SME and the private sector partnering their growth while supporting responsible lending to individuals for wealth creation rather than consumption-based lending.

Fiscal policy direction of the Government raises some concerns, even apprehensions, about future taxation. Further taxation of financial services will deter credit growth, increase transaction costs and decelerate progress on financial inclusion as affordability of formal financial services decreases. Banks will need to balance affordability and high capital requirements as we commence our transition to compliance with Basel III requirements in July 2017 with full compliance set for January 2019. While Commercial Bank is well positioned for compliance, we are cognisant of the fact that a combination of increased taxes and increased regulation is likely to impact overall profitability and growth.

Acknowledgements

Building our brand, maintaining high standards and driving growth has been a collective effort. We are deeply appreciative of the loyalty shown by our customers and look to strengthen our relationships in the coming years. The Board has directed the affairs of the Bank with visionary leadership and sound principles, carefully balancing stakeholder interests and I wish to thank them for their guidance. I also wish to acknowledge the co-operation extended by officials of the Central Bank of Sri Lanka, the Bangladesh Bank, the Bank of Italy and the Maldives Monetary Authority in management of regulatory matters critical to our operations.

It has been my privilege to lead a high performing team of talented individuals who come together to work towards a common goal. The results set out in this 48th Annual Report stand testimony to their achievements and I extend my sincere appreciation of their efforts.

Our journey has been remarkable, touching many lives and being part of their growth as a trusted partner. Commercial Bank is acknowledged as one of the World's Top 1000 Banks and is the largest private sector financial services organisation in Sri Lanka. We seek to build on this heritage, maintaining stakeholder covenants to shape the future of banking.

Jegan Durairatnam
Managing Director/CEO

Colombo
February 22, 2017