OUR VALUE CREATION PROCESS

As a conventional commercial bank, the Commercial Bank's business model is primarily centred around **financial intermediation** and **maturity transformation**.

Financial intermediation and maturity transformation

Financial intermediation entails the Bank acting as an intermediary between various stakeholders – depositors and borrowers, importers and exporters, those who remit money and beneficiaries, entrepreneurs and investors, to name a few. Maturity transformation on the other hand, is borrowing funds on short-term maturities and lending such funds for longer tenures. Financial intermediation and maturity transformation are two activities that are central to the economic development of the country.

These two activities enable the Bank to earn two broader categories of income – net interest income from **fund based operations** and fee and commission income from **fee based operations**. Fund based operations involve the process of borrowing from those who save money incurring interest expenses and lending such funds to those who need money for investments and consumption earning interest income. The difference between the lending rate and the borrowing rate, which is the interest margin, compensates the Bank for credit risk, funding risk and the interest rate risk. All other services provided by the Bank not involving funds are fee based operations. Reflecting efficient financial intermediation, the Bank generated 78.02% of its total operating income by way of net interest income (74.43% in 2016) and the balance from fee based sources, exchange profit, trading gains and recoveries of loans written off/provisions reversals for the year 2017.

Gearing

Financial intermediation and maturity transformation cause the business model of banks to substantially differ from other business organisations. Principal difference is the substantially lower Return on Assets (ROA) that tends to be as low as 2% in general in stark contrast to between 10% – 20% earned by corporates in other sectors. Hence, the banks resort to the process of gearing in order to make the returns to the investors attractive in terms of Return on Equity (ROE). Gearing involves expanding the business volumes by mobilising more and more funding from depositors and other providers of funds to the banks and lending or investing such funds to grow the loan book, and investment portfolios on the strength of a given amount of capital.

Gearing primarily remains the cornerstone of our business model, which enables us to operate at around 10 times higher business volumes compared to the shareholders' equity. Our license to mobilise deposits from the public has made it possible. However, we are well aware that gearing exposes the Bank to a multitude of internal as well as external risks. In addition, certain emerging global developments are now threatening to disrupt the conventional business models of banks. As you would read later in this Report, the Bank has established a sound risk management framework with necessary oversight of the Board of Directors and thereby has been able to successfully manage such risks.

Gearing and Profitability Table – 04

	2017	2016	2015	2014	2013
ROA (%)	1.54	1.53	1.42	1.60	1.87
Gearing (Times)	11.61	12.76	11.90	10.63	9.84
ROE (%)	17.88	19.52	16.90	17.01	18.40

Stakeholder returns

As shown in the table below, Commercial Bank has been able to improve its profitability over the years while maintaining gearing at acceptable levels. This improvement in profitability reflects the net impact of the value we have been able to create by delivering value to and by deriving value from our stakeholders. From investors' perspective, this value creation is reflected in the returns the Bank has been able to generate for them in terms of earnings, dividends and appreciation in market price of shares. Subject to adjustments for scrip shares and the rights issue, the market price of a ordinary voting share grew from Rs. 120.40 to Rs. 135.80 over the past five years with a Price to Book Value of 1.26 times as at December 31, 2017, the highest among the corporates in the Bank, Finance and Insurance Sector of the Colombo Stock Exchange.

While growing organically and in the domestic market, the Bank has taken steps to leverage the inorganic and regional growth opportunities, primarily to geographically diversify its risk exposures and sources of revenue and thereby enhance its sustainability of operations and long-term value creation.

Our business model

Figure – 05

Sources of inputs

Financial capital
Over 14,000 investors in shares/ debentures
Over 50 other lenders

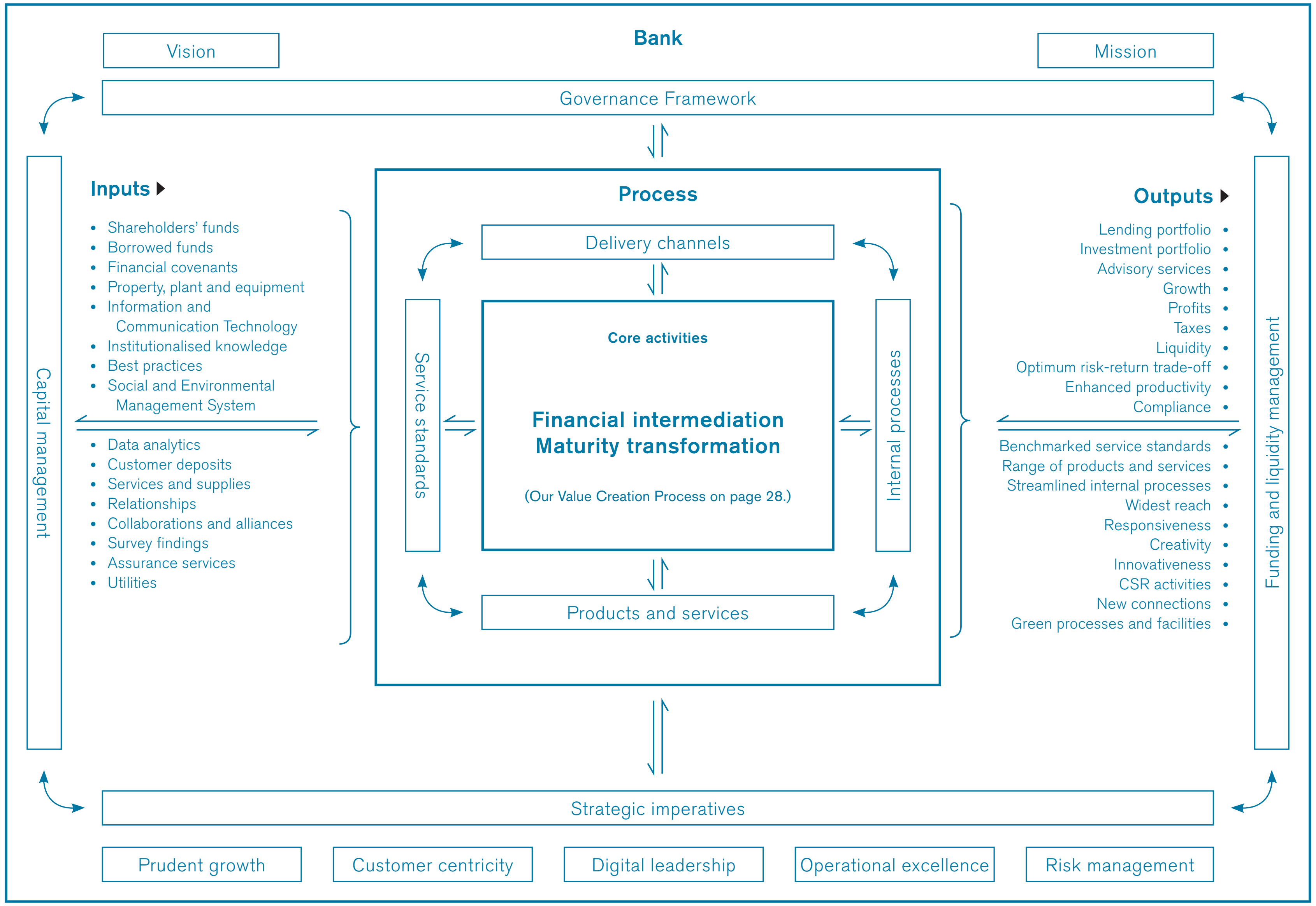
Manufactured capital
Procured by investing over Rs. 15 Bn. of financial capital

Intellectual capital
Institutionalised knowledge in terms of systems, processes, procedures and competencies

Human capital
4,982 employees with a cumulative service of 57,852 years

Social and network capital
Over 2 Mn. deposit customers
Over 600 suppliers
55 correspondent banks

Natural capital
Land
Water
Energy
Air



Operating environment

Beneficiaries and outcomes

Investors
Dividends, Interest, and capital gains
Higher Price to Book Value
A loyal investor base with a long-term view

Customers
Realised growth opportunities
Safety and security for savings
Financial inclusion
Unparalleled convenience and unprecedented choice
A satisfied and growing customer base

Employees
Remuneration and benefits
Career development
Job satisfaction
Great Place to Work

Suppliers and business partners
An integrated supplier chain
Supplier success and growth
Long-term relationships

Government
Revenue and tax collection facilities
Economic growth
Financial sector stability
Economic opportunities
Compliance

Community
Responsible banking
Financial inclusion
Community development
Social "Licence" to operate
Sustainability Development Goals

(KPIs relating to above outcomes are given in Highlights on pages 10 and 12)