OUTLOOK FOR 2018 AND BEYOND

Throughout this Annual Report, particularly in the section on Financial Capital section (page 54 to 72) we discuss the strengths and achievements of the Bank in the context of the operating environment that prevailed. They are good indicators of the Bank's prowess in the financial services arena and reflect healthy growth and financial stability. Yet, given the unprecedented pace of change in the operating environment and the potential challenges the conventional banking business models face, the Bank is cognisant that historical performance does not necessarily provide an assurance about the Bank's future potential and prospects.

Hence, this section summarises the Bank's plans to deliver value to stakeholders in 2018 and beyond, in the context of the forecast operating environment, based on publicly available information. Naturally, its extremely volatile nature makes the future hard to predict. As the statements below are forward looking, we urge you to keep in mind that all opinions, forecasts and plans given here are subject to change based on how the future unfolds. Such changes will in turn impact the risks and rewards outlined here.

Global economy

As we move into 2018, global growth is set to continue with some momentum, reaching a projected 3.9%, compared to 3.6% growth in 2017, led by India and other emerging market and developing economies. A unified domestic market and other structural reforms are expected to improve economic growth in India to 7.4% in 2018 up from a projected 6.7% for 2017. China is expected to experience a growth of 6.8% in 2017. Investment, trade, and industrial production are expected to maintain good growth, with rising confidence from businesses and consumers boosting recovery.

Advanced economies are expected to grow by 2.3% in 2018, thereby maintaining the growth of 2.3% estimated for 2017. The United Kingdom's outlook for 2018 appears uncertain as it attempts to redefine its economic relationship with the EU in relation to Brexit, with growth projected to fall to 1.5% from 1.7%.

South Asia growth decelerated but remained strong in 2017, at an estimated 6.5% – mainly due to temporary disruptions in India with the new goods and services tax. Growth is expected to pick up to 6.9% in 2018 and stabilise around 7.2% on average, in 2019-20, as consumption remains strong, exports recover, and investment revives with ongoing policy reforms and infrastructure improvements. Main risks to the outlook include setbacks in reviving investment, fiscal slippages, and disruptions to activity resulting from natural disasters.

Bangladesh is projected to grow at an average of 6.7% a year over the next three years, benefiting from strong domestic demand and strengthening exports, low interest rate and improved infrastructure. Remittances are expected to rebound as the growth firms in Gulf Cooperation Council (GCC) countries.

Sri Lankan economy

Reflecting strong private consumption and investment growth for the most part, Sri Lanka's economic growth is projected to average 5.1% a year over 2018-2020 with exports supported by the reinstatement of the GSP+ with the European Union. Reducing Government debt to a sustainable level is a priority with plans in place to reduce the budget deficit to 3.5% of GDP by 2020. For the first time since 1987, a surplus in the current account is expected in 2018.

In its "Vision 2025 – A Country Enriched", the Government outlines plans to transform Sri Lanka into an Indian Ocean Hub, with a knowledge-based, highly competitive, social-market economy. Development of the Colombo International Financial Centre (CIFC) within the Colombo Port City Development has already begun. Its completion along with the proposed National Logistics Policy for Shipping and Air Transportation, and the Telecommunication Connectivity Policy is expected to propel the CIFC as a financial hub strategically located between Dubai and Singapore.

Buoyed by World Bank and IMF programmes, Sri Lanka's economic reform agenda is projected to boost macroeconomic stability in the medium term. Widening regulatory provisions for the trading of derivatives and commodities, and introducing investment products to a larger customer base are also part of the Government's plan for 2018 and beyond.

On the socio-political front, local government elections held in February of 2018 has caused some political instability, adversely affecting economic activities, perhaps leading investors to take a wait and see approach as they did in 2015.

Adverse weather conditions have affected the agriculture sector in the recent past and there is good reason to believe that climate change will continue to impact this sector. The ripples caused by such events are likely to have a knock-on effect on the economy in the near future as well.

Central Bank's Road Map 2018 details a range of planned measures to sustain the theme of "Building on Stability" and strengthen Sri Lanka's long-term economic performance which include:

- A Flexible Inflation Targeting framework by 2020 to help ensure that monetary policy is conducted in a proactive manner, targeting an inflation range of 4-6%.
- A revenue-based fiscal consolidation programme to reduce budget deficits and debt levels.
- The Fiscal Management (Responsibility) Act to include effective sanctions for breaching targets, specify instances when targets can be breached and guide how to get back on target after such a breach. Sri Lanka is currently at 5.2% of GDP for fiscal deficit and 79% of GDP for public debt, against the targets of 3.5% for deficit and 60% for debt.
- Speeding up amendments to the Securities and Exchange Commission (SEC) Act and the Demutualisation Bill, helping to bring Sri Lanka's capital market in line with global norms.
- Through the Debt Management Bill Sri Lanka's public debt sustainability is to be managed at a national level. Foreign liability is a priority with the country facing its largest ever foreign debt servicing requirements during 2019-2022 amounting to almost USD 15 Bn.
- Encouraging market-based reforms to support private sector investments, the Government will be working to correct the country's legal and regulatory frameworks, financial market infrastructure, and institutions, in a bid to attract FDI and portfolio investment.
- The Electronic Transactions (Amendment) Act aims to ensure that Sri Lanka's e-commerce legislative framework is on par with those of Singapore, Australia, and China. The country's cyber security framework will also be further strengthened.

Banking sector

Digital disruptions challenging conventional business models and changing user expectations with demographic shifts coupled with tightening regulations requiring higher and quality capital and liquidity are expected to have profound implications on financial institutions world over. Banks in particular will need to adapt themselves innovatively to face the potential impact of these headwinds and sustain their value creation.

With the macro-economic environment expected to improve and stabilise in the medium term making it a conducive environment for achieving sustainable economic growth, Sri Lankan banking sector too is expected to continue its growth momentum. Both interest rates and inflation are expected to remain stable at the current levels. In the meantime, Sri Lanka will move towards the upper middle income category within the next three years. Historically, Sri Lanka's economic growth has been driven by the services sector, banking industry in particular. Given the strong correlation between the banking industry and the economic activity, this augurs well for the banking sector, generating opportunities to grow its business volumes.

With a fairly developed regulatory regime, Sri Lanka has been enjoying financial system stability. We have witnessed how resilient Sri Lanka's banking sector is in the wake of external shocks in the past mainly due to stringent regulations and prudent industry practices. The banking sector has a fairly diversified loan portfolio at present with exposure to any particular sector not exceeding 20% on average. Several regulatory measures were taken in the recent past to further strengthen the sector, mostly in compliance with the Basel III requirements relating to capital and liquidity which will come into effect in full from January 1, 2019. These are however expected to reduce banks' ability to leverage their balance sheets in terms of risk-weighted assets.

Banks will aggressively concentrate on channel optimisation with physical branch expansion expected to slow down while online and mobile channels expanded to offer contextual banking (i.e., seamless banking through mobiles where financial services are offered to customers at the place and time of their choice). These factors are expected to have a positive impact on the cost to income ratio as well.

Emerging trends are expected to have a significant impact on the banking business model. In order to respond to the accompanying challenges and meet ever growing customer expectations, banks will have to revamp their offering in terms of products and services, delivery channels, service standards and internal processes, making significant investments in technology.

Move from collateral Based lending to cash flow-based lending will continue. There will be demands for and regulatory pressures on banks to be more transparent in their tariff structures. Data analytics will play an important role to overcome these challenges.

Transaction banking (cash management, correspondent banking, international trade finance, factoring and related currency services) will increasingly become the basis for corporate banking relationships rather than previous investment banking considerations (such as corporate financing, M&A, equity financing and debt issuance.)

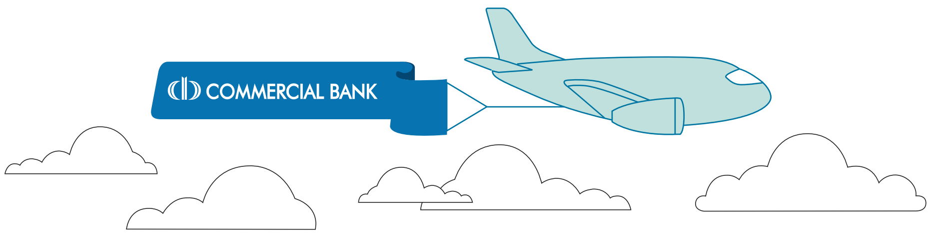
Despite tax exemptions being no longer available on investments in listed debentures, banking sector will increasingly rely on capital market for meeting capital requirements by way of rights issue of shares and Basel III compliant debt securities.

Government Budget 2018 had a proposal to set up a development bank. Given the fact that the country does not currently have a sizable development bank and commercial banks have limitations in funding development lending, this is certainly a welcome proposal.

The Debt Repayment Levy proposed in the 2018 Budget and removal of most of the tax concessions currently available on investments in Government Securities are expected to negatively impact the internal capital generation of banks. Increased minimum capital requirement of Rs. 20 Bn. by December 31, 2020 will exert pressure on smaller banks.

Main Regulatory Changes that will affect the banking industry in future.

- Adoption of the "expected loss model" in place of the "incurred loss model" for impairment testing upon implementation of SLFRS 9 is expected to substantially increase the impairment provision of banks.
- Upon full implementation of Basel III, the minimum total capital adequacy ratio for domestic systemically important banks will be 14% from January 2019.
- Banks will come under pressure with the proposed increase in minimum capital requirements.
- Removal of most of the tax concessions currently available and the imposition of the debt repayment levy under the new Inland Revenue Act/Budget proposals for 2018 are expected to significantly increase tax liability of banks.



Taking banking to the "unbanked"

Our plans

We are cognisant of the duality and the strong interconnectedness between the value delivered to the stakeholders and the value derived from them in turn. In fact, we know that the more value we deliver to our stakeholders, the more value we will be able to derive from them. Accordingly, taking the emerging trends and developments too into account, we will do our utmost to deliver enhanced value to all our stakeholders. Our focus remains fixed on the long term while balancing the demands of the short and medium term.

Consistent growth: Stability and reputation has enabled the Bank to record a consistent growth throughout its history spanning close to 50 years in its present name. We enjoyed compounded annual growth rates in excess of 16% on average over the past five years, in business volumes. Our growth rates have been in excess of the industry averages, signifying gains in market share. As at December 31, 2017, we accounted for over 11% in loans, deposits and total assets of the banking industry. Our aim is to continue to maintain a consistent growth over the next several years and based on the strategies we have implemented/will be implementing shortly, we are confident of achieving the targeted growth.

The table below outlines our financial goals for the medium term:

Our goals — Table – 07

Performance indicator	Goal
Return on average assets	Over 2%
Return on average shareholders' funds	Over 20%
Growth in income	Over 20%
Growth in profit	Over 20%
Growth in total assets	Over 20%
Dividends per share	Over Rs. 5
Capital adequacy:	
CET 1 – Minimum 6.25%	10%
Total Tier 1 – Minimum 7.75%	10%
Total capital – Minimum 11.75%	15%

Financial inclusion: Providing banking services to the unbanked remains one of our priorities as we push further out into the peripheries beyond urban centres. We are proud of our reputation as Sri Lanka's largest financier to the SME sector. Our 16 Agriculture and Micro-Finance Units work hand-in-hand with hard-to-reach communities, connecting rural households to our branch network and in turn providing us with invaluable insights on how to serve these customers better.

The concept of a "Bank on Wheels", for instance, is a result of our in depth insights into this segment. When our planned mobile branch receives significant demand from a particular area we are then able to establish a brick and mortar branch for the convenience of these customers.

Digital connectivity: All our customers, in both rural and urban areas, are fast becoming or indeed have already become a long-established part of the digital revolution. Even our Corporate Social Responsibility Trust focuses on improving the digital savviness of children in rural and urban areas (refer pages 78 to 89 under Social and Network Capital). Indeed, many households in the peripheries have a family member or neighbour working abroad. For them, being connected to Commercial Bank means having direct and ready access to remittances from abroad and being able to significantly improve their lives.

For our urban customers, our service must match the experience they have with international giants in the consumer business, but we are up for the challenge. We look forward to rolling out many new technological innovations and conveniences that our new digital platform will bring in 2018 and beyond. These include the digitalisation and centralisation of processes, the strengthening and increased security of core businesses, and a customer experience that is ever greater in value. Such outcomes will be achieved through mutually beneficial partnerships with global, regional, and local partners following due diligence.

International footprint: By expanding beyond the shores of Sri Lanka we diversify our geographical portfolio, minimise risk, and increase stability. For our customers – particularly in the corporate sector – it means greater access to their trusted Bank in the region. Our international operations have yielded many successes as outlined in Social and Network Capital (refer pages 78 to 89) and will continue to do so into the future.

Our operations in Bangladesh, Maldives and Italy are already providing sound returns and opening many exciting new opportunities for expansion. Our representative office in Myanmar too is already providing considerable support for our corporate customers operating in the country and shows much promise for the future.

Grooming talent: With the Bank able to attract school leavers who can then be groomed to lead, we take seriously our role in developing the professional skills and talents of our people. The Bank as University is a concept that has stood the test of time with employees given every encouragement – including financial incentives – to learn through internal and external education and development programmes and an extensive culture of mentorship. Long term succession plans are in place for all key roles to ensure that the Bank continues to be a leader in its field.

Trusted brand: Our brand is built on a track record that spans close to half a century but, more importantly, it is our brand promise that ensures the loyalty and trust of our stakeholders. Our brand is built on a foundation of sound corporate governance practices. Competent risk management processes ensure that confidence in the brand remains strong. Our efficient processes and a performance culture that drives excellence ensure that corporate governance and risk management remain part of our core strength supporting our strategic initiatives well into the future.