MCB BANK LIMITED – SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS

1. REPORTING ENTITY

MCB Bank Limited - Sri Lanka Branch (the "Bank") is a foreign branch of MCB Bank Limited, incorporated in Pakistan and commenced its business in 1994. The bank was approved to carry out both domestic and off-shore banking under the Banking Act 30 of 1988 and amendments thereto. The registered office of the bank is located at No.8, Leyden Bastian Road, York Arcade Building, and Colombo 1.

The staff strength of the Bank as at 31st December 2013 is 123 (2012: 116).

1.1 Principal Activities and Nature of Operations

Principal activities of the Bank continued to be banking and related activities such as accepting deposits, corporate and retail banking, off shore banking, foreign currency operations, trade services etc.

2. BASIS OF PREPARATION

2.1 Statement of Compliance

The Financial Statements of the Bank have been prepared in accordance with Sri Lanka Accounting Standards (SLFRSs and LKASs) as issued by the Institute of Chartered Accountants of Sri Lanka (ICASL) and in compliance with the requirements of Companies Act No 7 of 2007 and Banking Act No. 30 of 1988 and subsequent amendments thereto.

2.2 Basis of Measurement

The Financial Statements have been prepared on the historical cost basis and applied consistently, with no adjustments being made for inflationary factors affecting the Financial Statements, except for the following;

- assets and liabilities held for trading are measured at fair value;
- financial instruments designated at fair value through profit or loss are measured at fair value;
- derivative financial instruments are measured at faire value;
- available for sale financial assets are measured at fair value;
- liability for defined benefit obligations is recognized as the present value of the defined benefit obligation.

2.3 Functional and Presentation Currency

Financial Statements are presented in Sri Lankan Rupees, which is the Bank's functional currency.

2. BASIS OF PREPARATION (CONTINUED)

2.4 Use of Estimates and Judgments

The preparation of the Financial Statements in conformity with Sri Lanka Accounting Standards (SLAS) requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expense. Actual amount may defer from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimate is revised and in any future periods affected.

Information about significant areas of estimation uncertainty and critical judgments in applying accounting policies that have the most significant effect on the amounts recognized in the Financial Statements are described in Note 3.6.1, 3.6.2, 3.6.8, 3.5 and 3.14 to the financial statements.

3. SIGNIFICANT ACCOUNTING POLICIES

The accounting policies set out below have been applied consistently to periods presented in these Financial Statements, unless otherwise indicated.

3.1 Foreign Currency

Transactions in foreign currencies are translated into the respective functional currencies of the operations at the spot exchange rates at the dates of the transactions. All differences arising on non-trading activities are taken to ‘Other Operating Income’ in the Statement of Comprehensive Income (Profit or loss).

Monetary assets and liabilities denominated in foreign currencies at the reporting date are translated into the functional currency at the spot exchange rate at that date. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction.

Forward foreign exchange contracts and currency swaps are valued at the forward market rate ruling on the date of the Statement of Financial Position. Unrealized gains and losses are dealt under ‘Other Operating Income’ in the Statement of Comprehensive Income (Profit or loss).

3.2 Interest

Interest income and expense are recognized in profit or loss using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or liability. When calculating the effective interest rate, the Bank estimates future cash flows considering all contractual terms of the financial instrument, but not future credit losses.

The calculation of the effective interest rate includes all transaction costs and fees and points paid or received that are an integral part of the effective interest rate. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial asset or liability.

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.2. Interest (Continued)

Interest income and expense presented in the Statement of Comprehensive Income include;

- interest on financial assets and financial liabilities measured at amortized cost calculated on an effective interest basis;
- fair value changes in qualifying derivatives;
- Interest income on available-for-sale investment securities calculated on an effective interest basis is also included in interest income.

3.3 Fees and commissions

Fees and commission income and expense that are integral to the effective interest rate on financial asset or liability are included in the measurement of the effective interest rate.

Other fees and commission income, including account servicing fees, Trade fees are recognized as the related services are performed. When a loan commitment is not expected to result in the draw-down of a loan, the related loan commitment fees are recognized on a straight-line basis over the commitment period. Other fees and commission expense relate mainly to transaction and service fees, which are expensed as the services are received.

3.4 Net Trading Income

Net trading income comprises gains less losses related to trading assets and liabilities, and includes all realized and unrealized fair value changes, interest, dividends and foreign exchange differences.

3.5 Tax Expense

Tax expense comprises current and deferred tax. Current tax and deferred tax are recognized in profit or loss except to the extent that it relates to items recognized directly in equity or in other comprehensive income.

Current tax is the expected tax payable or receivable on the taxable income or loss for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognized in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

Deferred tax is measured at the tax rates that are expected to be applied to the temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities against current tax assets, and they relate to taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

3 SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.5 Tax Expenses (Continued)

A deferred tax asset is recognized for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which they can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

3.6 Financial Assets and Financial Liabilities

3.6.1 Initial Recognition and Measurement

The Bank initially recognizes loans and advances, deposits, debt securities issued and subordinated liabilities on the date at which they are originated. All other financial assets and liabilities (including assets and liabilities designated at fair value through profit or loss) are initially recognized on the trade date at which the Bank becomes a party to the contractual provisions of the instrument.

A financial asset or financial liability is measured initially at fair value plus, for an item not at fair value through profit or loss, transaction costs that are directly attributable to its acquisition or issue.

3.6.2 Classification and subsequent Measurement

3.6.2.1 Financial Assets

At inception, financial assets are classified in one of the following categories.

- Financial assets at fair value through profit or loss
- Loans and receivables
- Held to maturity investments
- Available for sale financial assets or
- As derivatives designated as hedging instruments in an effective hedge as appropriate

Bank determines the classification of its financial assets at initial recognition. All financial assets are recognized at fair value plus, in the case of assets not for fair value through profit or loss, directly attributable transaction cost.

Purchases or sales of financial assets that require delivery of assets within a time frame established by regulation or convention in the marketplace (regular way trades) are recognized on the trade date, i.e., the date that the Bank commits to purchase or sell the asset. The Bank's financial assets include cash and short term deposits, trade and other receivables, loans and other receivables, quoted and unquoted financial instruments and derivative financial instruments.

3.6.2.2 Financial Liabilities

The Bank initially recognizes all financial liabilities on the date that they are originated and classifies its financial liabilities as measured at amortized cost or fair value through profit or loss.

3 SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.6 Financial Assets and Financial Liabilities (Continued)

3.6.3 Subsequent Measurement

The subsequent measurement of financial assets depends on their classification as follows:

3.6.3.1 Financial Assets at Fair Value Through Profit or Loss

Financial assets at fair value through profit or loss include financial assets held for trading and financial assets designated upon initial recognition at fair value through profit or loss. Financial assets are classified as held for trading if they are acquired for the purpose of selling or repurchasing in the near term. This category includes derivative financial instruments entered into by the Bank that are not designated as hedging instruments in hedge relationships as defined by LKAS 39. Derivatives, including separated embedded derivatives are also classified as held for trading unless they are designated as effective hedging instruments. Financial assets at fair value through profit and loss are carried in the statement of financial position at fair value with changes in fair value recognized in finance income or finance costs in the income statement.

The Bank has not designated any financial assets upon initial recognition as at fair value through profit or loss.

3.6.3.2 Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. After initial measurement, such financial assets are subsequently measured at amortized cost using the effective interest rate method (EIR), less impairment. Amortized cost is calculated by taking into account any discount or premium on acquisition and fees or costs that are an integral part of the EIR. The EIR amortization is included in finance income in the income statement. The losses arising from impairment are recognized in the income statement in finance costs.

3.6.3.3 Held-to-maturity investments

Non-derivative financial assets with fixed or determinable payments and fixed maturities are classified as held-to-maturity when the Bank has the positive intention and ability to hold them to maturity. After initial measurement, held-to-maturity investments are measured at amortized cost using the effective interest method, less impairment. Amortized cost is calculated by taking into account any discount or premium on acquisition and fees or costs that are an integral part of the EIR. The EIR amortization is included in finance income in the income statement. The losses arising from impairment are recognized in the income statement in finance costs.

3.6.3.4 Available-for-sale financial investments

Available-for-sale financial investments include equity and debt securities. Equity investments classified as available-for-sale are those, which are neither classified as held for trading nor designated at fair value through profit or loss. Debt securities in this category are those which are intended to be held for an indefinite period of time and which may be sold in response to needs for liquidity or in response to changes in the market conditions.
Bank has not designated any loan or receivable as available for sale.

3 SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.6 Financial Assets and Financial Liabilities (Continued)

3.6.3.4 Available-for-sale financial investments (Continued)

After initial measurement, available-for-sale financial investments are subsequently measured at fair value with unrealized gains or losses recognized as other comprehensive income in the available-for-sale reserve until the investment is derecognized, at which time the cumulative gain or loss is recognized in other operating income, or determined to be impaired, at which time the cumulative loss is reclassified to the income statement in finance costs and removed from the available-for-sale reserve. Interest income on available-for-sale debt securities is calculated using the effective interest method and is recognized in profit or loss.

3.6.3.5 Due from banks and loans and advances to customers

Due from banks and loans and advances to customers include non–derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:

- Those that the bank intends to sell immediately or in the near term and those that the bank upon initial recognition designates as at fair value through profit or loss.

- Those that the bank, upon initial recognition, designates as available for sale.

- Those for which the bank may not recover substantially all of its initial investment, other than because of credit deterioration.

After initial measurement, amounts 'Due from banks' and 'Loans and advances to customers' are subsequently measured at amortized cost using the EIR, less allowance for impairment. Amortized cost is calculated by taking into account any discount or premium on acquisition and fees and costs that are an integral part of the EIR. The amortization is included in 'Interest and similar income' in the income statement. The losses arising from impairment are recognized in the income statement in 'Credit loss expense'.

3.6.3.6 Repurchase and reverse repurchase agreements

Securities sold under agreements to repurchase at a specified future date are not derecognized from the statement of financial position as the bank retains substantially all the risks and rewards of ownership. The corresponding cash received is recognized in the consolidated statement of financial position as an asset with a corresponding obligation to return it, including accrued interest as a liability within 'Cash collateral on securities lent and repurchase agreements', reflecting the transaction's economic substance as a loan to the bank. The difference between the sale and repurchase prices is treated as interest expense and is accrued over the life of agreement using the EIR.

Conversely, securities purchased under agreements to resell at a specified future date are not recognized in the statement of financial position. The consideration paid, including accrued interest, is recorded in the statement of financial position, within 'Cash collateral on securities borrowed and reverse repurchase agreements', reflecting the transaction's economic substance as a loan by the bank. The difference between the purchase and resale prices is recorded in 'Net interest income' and is accrued over the life of the agreement using the EIR.

3 SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.6 Financial Assets and Financial Liabilities (Continued)

3.6.4 Derecognition of financial assets and financial liabilities

3.6.4.1 Financial Assets

A financial asset (or, where applicable a part of a financial asset or part of a Bank of similar financial assets) is derecognized when:

- The rights to receive cash flows from the asset have expired
- The Bank has transferred its rights to receive cash flows from the asset or has assumed an obligation to pay the received cash flows in full without material delay to a third party under a 'pass-through' arrangement; and either

  a) The Bank has transferred substantially all the risks and rewards of the asset, or

  b) The Bank has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

3.6.4.2 Financial Liabilities

A financial liability is derecognized when the obligation under the liability is discharged or cancelled or expires. Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability. The difference between the carrying value of the original financial liability and the consideration paid is recognized in profit or loss.

3.6.5 Offsetting

Financial assets and liabilities are offset and the net amount presented in the statement of financial position when, and only when, the Bank has a legal right to set off the recognized amounts and it intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis only when permitted under SLFRSs, or for gains and losses arising from a group of similar transactions such as in the Bank's trading activity.

3.6.6 Amortized Cost Measurement

The amortized cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between the initial amount recognized and the maturity amount, minus any reduction for impairment.

3.6.7 Fair Value Measurement

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction on the measurement date.

3 SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.6 Financial Assets and Financial Liabilities (Continued)

3.6.7 Fair Value Measurement (Continued)

When available, the Bank measures the fair value of an instrument using quoted prices in an active market for that instrument. A market is regarded as active if quoted prices are readily and regularly available and represent actual and regularly occurring market transactions on an arm's length basis.

If a market for a financial instrument is not active, then the Bank establishes fair value using a valuation technique. Valuation techniques include using recent arm's length transactions between knowledgeable, willing parties (if available), reference to the current fair value of other instruments that are substantially the same, discounted cash flow analyses and option pricing models. The chosen valuation technique makes maximum use of market inputs, relies as little as possible on estimates specific to the Bank, incorporates all factors that market participants would consider in setting a price, and is consistent with accepted economic methodologies for pricing financial instruments. Inputs to valuation techniques reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument. The Bank calibrates valuation techniques and tests them for validity using prices from observable current market transactions in the same instrument or based on other available observable market data.

Assets and long positions are measured at a bid price; liabilities and short positions are measured at an asking price. Where the Bank has positions with offsetting risks, mid-market prices are used to measure the offsetting risk positions and a bid or asking price adjustment is applied only to the net open position as appropriate. Fair values reflect the credit risk of the instrument and include adjustments to take account of the credit risk of the Group entity and the counterparty where appropriate.

3.6.7.1 Determining Fair Values

The determination of fair value for financial assets and financial liabilities for which there is no observable market price requires the use of valuation techniques as described in Note 3.6.7. For financial instruments that trade infrequently and have little price transparency, fair value is less objective, and requires varying degrees of judgment depending on liquidity, concentration, uncertainty of market factors, pricing assumptions and other risks affecting the specific instrument. Bank measures fair values using the following fair value hierarchy that reflects the significance of the inputs used in making the measurements.

Level 1: Quoted market price (unadjusted) in an active market for an identical instrument

Level 2: Valuation techniques based on observable inputs, either directly (i.e. prices) or indirectly (i.e. derived from prices). This category includes instruments valued using quoted market prices in active markets for similar instruments, quoted prices for identical or similar instruments in markets that are considered less than active or other valuation techniques where all significant inputs are directly or indirectly observable from market data.

Level 3: Valuation techniques using significant unobservable inputs. This category includes all instruments where the valuation technique includes inputs not based on observable data and the unobservable inputs have a significant effect on the instrument's valuation. This category includes instruments that are valued based on quoted prices for similar instruments where significant unobservable adjustments or assumptions are required to reflect differences between the instruments.

MCB BANK LIMITED - SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

3 SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.6 Financial Assets and Financial Liabilities (Continued)

3.6.7 Fair Value Measurement (Continued)

3.6.7.1 Determining Fair Values

The table below analyses financial instruments measured at fair value at the end of the reporting period, by the level of the fair value hierarchy.

	Level 1 Rs.	Level 2 Rs.	Level 3 Rs.	Total Rs.
31st December 2013				
Financial Assets				
Derivative financial instruments				
Currency swaps	-	**1,450,047**	-	**1,450,047**
Forward foreign exchange contracts	-	**2,203,027**	-	**2,203,027**
	-	**3,653,074**	-	**3,653,074**
Financial Investments available for sale				
Government of Sri Lanka treasury bills	-	**2,156,115,468**	-	**2,156,115,468**
	-	**2,156,115,468**	-	**2,156,115,468**
Financial Liabilities				
Derivative financial instruments				
Currency swaps	-	**11,753,442**	-	**11,753,442**
Forward foreign exchange contracts	-	**1,408,086**	-	**1,408,086**
	-	**13,161,528**	-	**13,161,528**
31st December 2012				
Financial Assets				
Derivative financial instruments				
Currency swaps	-	1,225,714	-	1,225,714
Forward foreign exchange contracts	-	3,096,291	-	3,096,291
	-	**4,322,005**	-	**4,322,005**
Financial Investments available for sale				
Government of Sri Lanka treasury bills	-	**1,106,859,759**	-	
	-	**1,106,859,759**	-	-
Financial Liabilities				
Derivative financial instruments				
Currency swaps	-	48,770,790		48,770,790.00
Forward foreign exchange contracts	-	2,694,755		2,694,755.00
	-	**51,465,545**	-	51,465,545

3 SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.6 Financial Assets and Financial Liabilities (Continued)

3.6.8 Impairment of Financial Assets

The Bank assesses at each Statement of Financial Position date whether there is any objective evidence that a financial asset or a group of financial assets is impaired. A financial asset or a group of financial assets is deemed to be impaired if, and only if, there is objective evidence of impairment as a result of one or more events that has occurred after the initial recognition of the asset (an incurred ‘loss event’) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or the group of financial assets that can be reliably estimated.

Evidence of impairment may include indications that the borrower or a group of borrowers is experiencing significant financial difficulty, the probability that they will enter bankruptcy or other financial reorganization, default or delinquency in interest or principal payments and where observable data indicates that there is a measurable decrease in the estimated future cash flows, such as changes in arrears or economic conditions that correlate with defaults.

3.6.8.1 Financial Assets Carried at Amortized Cost

For financial assets carried at amortized cost (such as amounts due from Banks, loans and advances to customers as well as held–to–maturity investments), the Bank first assesses individually whether objective evidence of impairment exists for financial assets that are individually significant, or collectively for financial assets that are not individually significant. If the Bank determines that no objective evidence of impairment exists for an individually assessed financial asset; it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is, or continues to be, recognized are not included in a collective assessment of impairment.

If there is objective evidence that an impairment loss has been incurred, the amount of the loss is measured as the difference between the asset’s carrying amount and the present value of estimated future cash flows (excluding future expected credit losses that have not yet been incurred). The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognized in the Statement of Comprehensive Income. Interest income continues to be accrued on the reduced carrying amount and is accrued using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss. The interest income is recorded as part of ‘Interest and similar income’. Loans together with the associated allowance are written off when there is no realistic prospect of future recovery and all collateral has been realized or has been transferred to the Bank. If, in a subsequent year, the amount of the estimated impairment loss increases or decreases because of an event occurring after the impairment was recognized, the previously recognized impairment loss is increased or reduced by adjusting the allowance account. If a future write–off is later recovered, the recovery is credited to the ’Credit loss expense’.

The present value of the estimated future cash flows is discounted at the financial asset’s original effective interest rate. If a loan has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate. If the Bank has reclassified trading assets to loans and advances, the discount rate for measuring any impairment loss is the new effective interest rate determined at the reclassification date. The calculation of the present value of the estimated future cash flows of a collateralized

3 SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.6 Financial Assets and Financial Liabilities (Continued)

3.6.8 Impairment of Financial Assets (Continued)

3.6.8.1 Financial Assets Carried at Amortized Cost (Continued)

financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

For the purpose of a collective evaluation of impairment, financial assets are grouped based on the nature and type of the asset. It also considers credit risk characteristics such as asset collateral type, past–due status and other relevant factors.

Future cash flows on a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect, and are directionally consistent with, changes in related observable data from year to year (such as changes in unemployment rates, property prices, commodity prices, payment status, or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

3.6.8.2 Available-For-Sale Financial Investments

For available–for–sale financial investments, the Bank assesses at each Statement of Financial Position date whether there is objective evidence that an investment is impaired.

In the case of debt instruments classified as available–for–sale, the Bank assesses individually whether there is objective evidence of impairment based on the same criteria as financial assets carried at amortized cost. However, the amount recorded for impairment is the cumulative loss measured as the difference between the amortized cost and the current fair value, less any impairment loss on that investment previously recognized in the Comprehensive Income. Future interest income is based on the reduced carrying amount and is accrued using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss. The interest income is recorded as part of 'Interest and similar income'. If, in a subsequent period, the fair value of a debt instrument increases and the increase can be objectively related to a credit event occurring after the impairment loss was recognized in the Comprehensive Income, the impairment loss is reversed through Comprehensive Income.

In the case of equity investments classified as available–for–sale, objective evidence would also include a 'significant' or 'prolonged' decline in the fair value of the investment below its cost.

3 SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.6 Financial Assets and Financial Liabilities (Continued)

3.6.8 Impairment of Financial Assets (Continued)

3.6.8.3 Re-negotiated Loans

Where possible, the Bank seeks to restructure loans rather than to take possession of collateral. This may involve extending the payment arrangements and the agreement of new loan conditions. Once the terms have been renegotiated any impairment is measured using the original effective interest rate as calculated before the modification of terms and the loan is no longer considered past due. Management continually reviews renegotiated loans to ensure that all criteria are met and that future payments are likely to occur. The loans continue to be subject to an individual or collective impairment assessment, calculated using the loan's original effective interest rate, unless there is a significant modification.

3.6.8.4 Offsetting financial instruments.

Financial assets and financial liabilities are offset and the net amount reported in the Statement of Financial Position if, and only if, there is a currently enforceable legal right to offset the recognized amounts and there is an intention to settle on a net basis, or to realize the asset and settle the liability simultaneously. This is not generally the case with master netting agreements, therefore, the related assets and liabilities are presented gross in Statement of Financial Position.

3.7 Cash and cash equivalents

Cash and cash equivalents as referred to in the Cash Flow Statement comprises cash on hand, non restricted current accounts with Central Banks and amounts due from Banks on demand or with an original maturity of three months or less.

3.8 Property, Plant and Equipment

Property, Plant and Equipment (including equipment under operating leases where the bank is the lessor) is stated at cost excluding the costs of day–to–day servicing, less accumulated depreciation and accumulated impairment in value. Changes in the expected useful life are accounted for by changing the amortization period or method, as appropriate, and treated as changes in accounting estimates.

Depreciation is calculated using the straight–line method to write down the cost of Property, Plant and Equipment to their residual values over their estimated useful lives. Land is not depreciated. The estimated useful lives are as follows:

<u>Straight-Line Basis</u>

Freehold building	2.5% per annum
Motor Vehicles	20% per annum (subject to 20% residual value)
Computer Equipment	25% per annum

<u>Reducing Balance Basis</u>

Leases hold Properties	10% per annum
Furniture and Fittings	10% per annum
Office and Other Equipment	20% per annum

Property, Plant and Equipment is derecognized on disposal or when no future economic benefits are expected from its use. Any gain or loss arising on derecognition of the asset

3 SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.8 Property, Plant and Equipment (Continued)

(calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is recognized in ‘Other operating income' in the Statement of Comprehensive Income in the year the asset is derecognized.

3.9 Intangible asset

The Bank’s intangible assets include the value of computer software.

An intangible asset is recognized only when its cost can be measured reliably and it is probable that the expected future economic benefits that are attributable to it will flow to the Bank. Intangible assets acquired separately are measured on initial recognition at cost. The cost of intangible assets acquired in a business combination is their fair value as at the date of acquisition. Following initial recognition, intangible assets are carried at cost less any accumulated amortization and any accumulated impairment losses.

The useful lives of intangible assets are assessed to be either finite or indefinite. Intangible assets with finite lives are amortized over the useful economic life. The amortization period and the amortization method for an intangible asset with a finite useful life are reviewed at least at each financial year–end. Changes in the expected useful life or the expected pattern of consumption of future economic benefits embodied in the asset are accounted for by changing the amortization period or method, as appropriate, and treated as changes in accounting estimates. The amortization expense on intangible assets with finite lives is recognized in the Comprehensive Income in the expense category consistent with the function of the intangible asset. Amortization is calculated using the straight–line method to write down the cost of intangible assets to their residual values over their estimated useful lives as follows:

Computer Software	33.33% per annum

Intangible Assets is derecognized on disposal or when no future economic benefits are expected from its use. Any gain or loss arising on derecognition of the asset (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is recognized in ‘Other operating income' in the Comprehensive Income in the year the asset is derecognized.

3.10 Impairment of Non–Financial Assets

The Bank assesses at each reporting date whether there is an indication that an asset may be impaired. If any indication exists, or when annual impairment testing for an asset is required, the Bank estimates the asset’s recoverable amount. An asset’s recoverable amount is the higher of an asset’s or cash generating units (CGU) fair value less costs to sell and its value in use. Where the carrying amount of an asset or CGU exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre–tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. In determining fair value less costs to sell, an appropriate valuation model is used. These calculations are corroborated by valuation multiples, quoted share prices for publicly traded subsidiaries or other available fair value indicators.

3 SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.11 Financial Guarantees

In the ordinary course of business, the Bank gives financial guarantees, consisting of letters of credit, guarantees and acceptances. Financial guarantees are initially recognized in the Financial Statements (within 'other liabilities') at fair value, being the premium received. Subsequent to initial recognition, the Bank's liability under each guarantee is measured at the higher of the amount initially recognized less, when appropriate, cumulative amortization recognized in the Comprehensive Income, and the best estimate of expenditure required settling any financial obligation arising as a result of the guarantee.

Any increase in the liability relating to financial guarantees is recorded in the income statement in 'Credit loss expense'. The premium received is recognized in the income statement in 'Net fees and commission income' on a straight line basis over the life of the guarantee.

3.12 Deposits from Customers

Deposits from customers include non interest bearing deposits, saving deposits, term deposits, and deposits payable at call and certificate of deposits. They are stated in the Statement of Financial Position at amounts payable. Interest paid/payable on these deposits is charged to the Comprehensive Income.

Details of the deposits from customers are given in the Note 26 to the Financial Statements.

3.13 Borrowings

Borrowings include refinance borrowings, call money bowings, and borrowings from financial institutions and are shown at the gross value of the outstanding balance. Interest paid/payable on these deposits is charged to the Comprehensive Income.

Details of borrowings are given in the Note 25 and Note 27 to the Financial Statements.

3.14 Retirement benefits

3.14.1 Defined benefit pension plan

The Bank operates a defined benefit pension plan, which requires contributions to be made to a separately administered fund. The cost of providing benefits under the defined benefit plan is determined separately using the projected unit credit actuarial valuation method. Actuarial gains and losses are recognized as income or expense when the net cumulative unrecognized actuarial gains and losses at the end of the previous reporting year exceed 10% of the higher of the defined benefit obligation and the fair value of plan assets at that date. These gains or losses are recognized over the expected average remaining working lives of the employees participating in the plan.

Past service cost is recognized as an expense on a straight–line basis over the average period until the benefits become vested. If the benefits vest immediately following the introduction of, or changes to, a pension plan, the past service cost is recognized immediately.

3 SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.14 Retirement benefits (Continued)

3.14.1 Defined benefit pension plan (Continued)

The principal assumptions used in the valuation are;

- Rate of interest - 11%
- Salary increment rate - 7%, 8% & 9% for year 2014, 2015, 2016 and 10% thereafter.
- Retirement age - 60 years

The liability is not externally funded.

However, according to the Payment of Gratuity Act No.12 of 1983, the liability for Gratuity Payment to an employee arises only after the completion of five years continued service with the Bank.

3.14.2 Defined contribution Plan

The Bank also operates a defined contribution pension plan. The contribution payable to a defined contribution plan is in proportion to the services rendered to the bank by the employees and is recorded as an expense under 'Personnel expenses'. Unpaid contributions are recorded as a liability.

3.15 Provisions

Provisions are recognized when the Bank has a present obligation (legal or constructive) as a result of a past event, and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. The expense relating to any provision is presented in the statement of comprehensive income net of any reimbursement.

3.16 Capital commitments and contingencies

Contingent liabilities are possible obligations whose existence will be confirmed only by occurrence or non-occurrence uncertain future events not wholly within the control of the Bank or present obligations where the transfer of economic benefit is not probable or cannot be reliably measured. Contingent liabilities are not accounted in the Statement of Financial Position but are disclosed unless they are remote.

Capital commitments and contingent liabilities of the Bank are disclosed in the respective Notes to the Financial Statements.

3.17 Events occurring after the Reporting Date

All material events after the reporting date have been considered and where appropriate adjustments or disclosures have been made in the respective Notes to the Financial Statements.

3 SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.18 Investment Fund Account

As proposed in the budget proposals of 2011 every person or partnership who is in the business of banking or financial services is required to establish and operate an Investment Fund Account.

As and when taxes are paid after 1st January 2011 Licensed Commercial Banks are required to transfer the following funds to the Investment Fund Account and build a permanent fund in the bank.

- 8% of the profits calculated for the payment of Value Added Tax (VAT) on financial services on dates as specified in the VAT Act for payment of VAT

- 5% of the profit before tax calculated for payment of income tax on dates specified in Section 113 of the Inland Revenue Act for the self-assessment payments of tax

Licensed Commercial Banks shall utilise the funds in the Investment Fund Account in the following manner.

- Invest in long term government securities and/or bonds with maturities not less than seven years

- Lend on maturities not less than five years at interest rates not exceeding 5 year treasury bond rates plus 2%

- Lend only for the following purposes:

  I. Long term loans for cultivation of plantation crops/agriculture crops including fruits, vegetables, cocoa and spices and for livestock and fisheries

  II. Factory/mills modernisation/establishment/expansion

  III. Small and medium enterprises
  Loans up to Rs. 200 Mn to enterprises with annual turnover less than Rs. 600 Mn

  IV. Information technology related activities and business process outsourcing

  V. Infrastructure development

  VI. Education – vocational training and tertiary education

  VII. Housing up to Rs. 2 Mn per customer for construction of a house for residential purposes

  VIII. Construction of hotels and for related purposes

  IX. Restructuring of loans extended for the above purposes

4 ACCOUNTING STANDARDS ISSUED BUT NOT EFFECTIVE AS REPORTING DATE

The following SLFRSs have been issued by the Institute of Chartered Accountants of Sri Lanka that have an effective date in the future. Those SLFRSs will have an effect on the accounting policies currently adopted by the Bank and may have an impact on the future Financial Statements.

4.1 SLFRS 9 – Financial Instruments: Classification and Measurement

SLFRS 9, as issued reflects the first phase of work on replacement of LKAS 39 and applies to classification and measurement of financial assets and liabilities.

The effective date for SLFRS 9 is yet to be announced by the Institute of Chartered Accountants of Sri Lanka.

4.2 SLFRS 13 -Fair Value Measurement

SLFRS 13 establishes a single source of guidance under SLFRS for all fair value measurements. SLFRS 13 provides guidance on all fair value measurements under SLFRS.

SLFRS 13 will be effective for financial periods beginning on or after 1st January 2014.

5. Financial Risk Management

5.1 Introduction and Overview

The Bank has exposure to the following risks from financial instruments:

- Credit Risk
- Market Risk
- Liquidity Risk
- Operational Risk

Risk Management Framework

The Bank executes its risk strategy and undertakes controlled risk-taking activities within its risk management framework. This framework combines core policies, procedures and process design with broad oversight and is supported by risk monitoring across the Bank. This framework is based on prudent risk identification, measurement, management and monitoring process which are closely aligned with the activities of the Bank so as to ensure that risks are kept within an acceptable level.

The Bank, at local level has its Risk Management structure in place to monitor the Bank wide risk. For this purpose the Bank has constituted the following Committees:

- Asset and Liability Management Committee (ALCO) which monitors the Asset Liability Structure and management of market risk of the Bank.
- Credit Committee (CC) which monitors the credit risk of the Bank.
- Integrated Risk Management Committee (IRMC) which monitors the overall risk of the Bank.

5. FINANCIAL RISK MANAGEMENT (CONTINUED)

Risk Management Framework (Continued)

These committees are established to assist the Board of Directors, its relevant committees and senior management at head office, i.e. head office ALCO, Risk Management and Portfolio Review Committee (RM and PRC), Management Committee (MC), Management Committee of Risk who are responsible to ensure the formulation and implementation of a comprehensive risk management framework.

The risk management function in Sri Lanka is headed by a designated Chief Risk Officer (CRO) reporting functionally to the Group Head Risk Management, who in turn reports to Risk Management and Portfolio Review Committee of the Board, and administratively to the Country General Manager. The role of the CRO is both as a strategic partner to the business units advising them on risk issues and on the best ways to identify and manage these risks.

The CRO performs following critical functions:

- Integrated risk management
- Credit risk management
- Market and liquidity risk management
- Operational risk management

5.2 Credit Risk

Credit risk arises from dealings with individuals, corporate borrowers, financial institutions, sovereigns etc. The Bank is exposed to credit risk through its lending and investment activities. It also stems from both on and off- Balance Sheet activities. Credit risk makes up the largest part of the Bank’s exposure. The Purpose of the credit risk function is to identify measure, manage, monitor and mitigate credit risk. Organizational structure of this function ensures pre and post-facto management of credit risk. There is a clear segregation of duties between transaction originators, credit administration and the risk function.

The credit risk management framework of the Bank encompasses the following:

- Reviewing the credit policies and procedures in line with the risk management policy and international best practices;

- Use of comprehensive credit appraisal process structured towards analyzing pertinent information at macro and micro levels.

- Delegated approval/ review authority assigned to officers/ executives with the necessary experience, judgment and integrity to properly evaluate the risks and rewards involved in the credit transactions.

- A hindsight review process to ensure the checks and balances has been instituted to ensure consistent application of the Bank’s credit policies.

- Monitoring of credits with deteriorating credit ratings and inclusion of those advances on a watch-list that is regularly reviewed by senior management.

- Centralized credit administration unit to support the extension and monitoring of credit by the business units.

5. FINANCIAL RISK MANAGEMENT (CONTINUED)

5.2 Credit Risk (Continued)

- Segregation of duties by independent units to carryout Credit approval, Risk Management, Credit administration, Credit review functions.
- Measurement and monitoring of credit risk at the counterparty level by using internal risk rating models.
- Development and adaptation of risk measurement techniques/models to suit the regulatory and industry requirements.
- Centralized Credit Administration unit to manage Problem credits and Non Performing Advances. This unit is responsible for all aspects of an overdue facility, follow up of rescheduled facilities, monitoring the value of the applicable collateral and liquidation, scrutiny of legal documents and liaising with the customer until all recovery matters are finalized.

5.2.1 Impairment Assessment

For accounting purposes, the Bank uses an incurred loss model for the recognition of losses on impaired financial assets. This means that losses can only be recognized when objective evidence of a specific loss event has been observed. Triggering events include the following:

- Significant financial difficulty of the customer
- A breach of contract such as a default of payment
- Where the Bank grants the customer a concession due to the customer experiencing financial difficulty
- It becomes probable that the customer will enter bankruptcy or other financial reorganization
- Observable data that suggests that there is a decrease in the estimated future cash flows from the credit granted

The Bank determines the allowances appropriate for each individually significant loan or advance on an individual basis, including any overdue payments of interests, credit rating downgrades, or infringement of the original terms of the contract. Items considered when determining allowance amounts include the sustainability of the counterparty's business plan, its ability to improve performance if it is in a financial difficulty, projected receipts and the expected payout should bankruptcy ensue, the availability of other financial support, the realizable value of collateral and the timing of the expected cash flows. Impairment allowances are evaluated at each reporting date, unless unforeseen circumstances require more careful attention.

5.2.2 Collectively Assessed Allowances

Allowances are assessed collectively for losses on loans and advances and for held to maturity debt investments that are not individually significant and for individually significant loans and advances that have been assessed individually and found not to be impaired.

The Bank generally bases its analyses on historical experience. However, when there are significant market developments, the Bank would include macro-economic factors within

5. FINANCIAL RISK MANAGEMENT (CONTINUED)

5.2 Credit Risk (Continued)

5.2.2 Collectively Assessed Allowances

its assessments. These factors include, depending on the characteristics of the individual or collective assessment unemployment rates, current levels of bad debts, changes in laws, changes in regulations, bankruptcy trends, and other consumer data. The Bank may use the aforementioned factors as appropriate to adjust the impairment allowances. Allowances are evaluated separately at each reporting date with each portfolio.

The collective assessment is made for groups of assets with similar risk characteristics, in order to determine whether provision should be made due to incurred loss events for which there is objective evidence, but the effects of which are not yet evident in the individual loans assessments. The collective assessment takes account of data from the loan portfolio or economic data. The approximate delay between the time a loss is likely to have been incurred and the time it will be identified as requiring an individually assessed impairment allowance is also taken into consideration. The management is responsible for deciding the length of this period, which can extend for as long as one year. The impairment allowance is then reviewed by credit management to ensure alignment with the Bank's overall policy.

The Bank also conducts stress testing of its portfolio, which includes all assets, i.e., advances as well as investments. This exercise is conducted on a quarterly basis through assigning shocks to all assets of the Bank and assessing its resulting affect on capital adequacy in line with Central Bank of Sri Lanka (CBSL) requirements.

5.2.3 Concentration of Credit Risk

In order to mitigate the credit risk, MCB regularly reviews its portfolio concentration across the various industrial sectors. Sector wise credit exposures are provided in the Note 19 to the financial statements.

5.2.4 Analysis of Fair Value of Collateral held Against Loans and Advances to Customers

Bank seeks to use collateral, where possible to mitigate its risk on financial assets. The collateral comes in various forms such as cash, securities, letter of credits, /guarantees, real estate, receivables, inventories, other non financial assets and credit enhancements such as netting arrangements. The fair value of collaterals is generally assessed, at a minimum, at inception and based on the bank's annual reporting schedules.

MCB BANK LIMITED - SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

5. FINANCIAL RISK MANAGEMENT (CONTINUED)

5.2 Credit Risk (Continued)

5.2.4 Analysis of Fair Value of Collateral held Against Loans and Advances to Customers (Continued)

As at		12/31/2013	
		Gross Loans & Advances	**Fair Value of Security**
		LKR	**LKR**
Against Individually Impaired			
	Immovable Property	85,030,437	113,373,916
	Others	86,907,295	-
	Unsecured (Covered with loan agreement)	78,425,496	-
Against Collectively Impaired			
	Immovable Property	1,760,160,049	2,346,880,065
	Deposits	2,198,633,012	2,198,633,012
	Others	2,858,536,075	-
	Unsecured (Covered with loan agreement)	1,858,029,281	-
Total		8,925,721,645	4,658,886,993
Leases		137,164,213	
Total		**9,062,885,858**	**4,658,886,993**

An updated valuation of collateral is generally not carried out unless the credit risk of a loan deteriorates significantly and the loan is monitored more closely. For impaired loans, the bank usually obtains appraisals of collateral as the current value of the collateral may be an input to the impairment measurement.

Others include loans secured by movable equipment and machinery, vehicle mortgages, inventory and book debts, shares, demand promissory notes / personal guarantees, corporate guarantees, trust certificates, negative pledge/ agreement to mortgage / undertaking to mortgage, insurance policy and power of attorney. However bank has not considered any value for such securities.

5. FINANCIAL RISK MANAGEMENT (CONTINUED)

5.2 Credit Risk (Continued)

5.2.4 Fair value of Financial Instruments carried at amortized cost

Set out below is a comparison, by class, of the carrying amounts and fair values of the bank's financial assets and liabilities that are not carried at the fair value in the financial statements. The fair values in the table below may be different from the actual amounts that will be received/paid on the settlement or maturity of the financial instrument. For certain instruments, the fair value may be determined using assumptions for which no observable prices are available.

As at 31st December		**2013**	
		Carrying amount	**Fair value**
Assets		**Rs.**	**Rs.**
Cash and Cash Equivalents		119,773,796	119,773,796
Balances with Central Banks		417,441,816	417,441,816
Placements with Banks		698,714,223	698,714,223
Loans and receivables to other customers		8,915,018,769	8,917,427,070
Financial Investments – Loans and Receivables		1,177,662,789	1,177,662,789
Liabilities			
Due to Banks		1,580,527,181	1,580,527,181
Due to Other Customers		7,445,894,516	7,445,894,516
Other Borrowings		83,060,761	83,060,761

Given below is the basis adopted by the Bank in order to establish the fair values of the financial instruments which are shown above.

Cash and cash equivalents, balances with central banks and placements with banks

The carrying amounts of cash and cash equivalents, balances with central banks and placements with banks approximate their fair value as those are short-term in nature. These balances have a contractual remaining maturity of less than three months from the reporting date.

Loans and receivables to other customers

More than 95% of the total portfolio of loans and receivables to other customers has a remaining contractual maturity of less than one year.

The fair value of loans and receivables to other customers with a residual maturity of less than one year generally approximates the carrying value, subject to any significant movement in credit spreads.
The estimated fair value of loans and advances with a residual maturity of more than one year is the present value of future cash flows expected to be received from such loans and advances calculated based on interest rates at the reporting date for similar types of loans and advances. Such loans include both fixed and floating rate loans. Majority of the floating rate loans can be re priced either quarterly or semi annually while for fixed rate loans, the loan contract allows the Bank to change the contracted rate if there is a material difference between the contracted rate and the market interest rate.

The Bank calculated the fair value of the term loans and leasing portfolio with a fixed interest rate and that will have a maturity of more than 12 months from the reporting date. Fair value of term loans and leasing portfolio as at 31st December 2013 was Rs 259.7 Mn and 384.3 Mn as against its carrying value which amounted to Rs 258.3 Mn and 381.9 Mn respectively.

5. FINANCIAL RISK MANAGEMENT (CONTINUED)

5.2 Credit Risk (Continued)

5.2.5 Fair value of Financial Instruments carried at amortized cost (continued)

Financial Investments - Held-to-Maturity

Financial investments **-** Loans and receivables include investments in Sri Lanka Development Bonds and quoted/ unquoted debentures.

All Sri Lanka Development Bonds and debentures are variable rate instruments where reprising happens semi annually. Thus, the carrying value of these bonds approximate to their fair value as at the reporting date.

Due to Banks

Approximately 50% of the amounts due to other banks as at the reporting date have a remaining contractual maturity of less than one year. Majority of the balance amount comprised of floating rate instruments where interest is reset either quarterly or semi annually. Therefore, fair value of amounts due to banks approximate to the carrying value as at the reporting date.

Due to other customers

More than 98% of the customer deposits are either repayable on demand or have a remaining contractual maturity of less than one year. Customer deposits with a contractual maturity of more than one year are subject to pre mature upliftment. Amounts paid to customers in the event of pre mature upliftment would not be materially different to its carrying value as at date. Therefore fair value of customer deposits approximates to their carrying value as at the reporting date.

Other Borrowings

Other borrowings mainly consist of securities sold under repurchase agreements which have a remaining contractual maturity of less than three months. Accordingly, carrying value of these borrowings would not be materially different to their fair values as at the reporting date.

5 FINANCIAL RISK MANAGEMENT (CONTINUED)

5.3 Market Risk

Market Risk is the risk of financial losses resulting from unfavorable changes in underlying market factors, including interest rates, foreign exchange rates, equity prices, commodity prices and market volatility.

Middle office monitors the treasury operating limits, including; open position limits, dealer limits, counter party limits, etc., which are regularly reviewed and updated as per the prevailing business requirements, and regulator guidelines.

The Bank measures and manages market risk by using conventional methods i.e. notional amounts, sensitivity and combinations of various limits. The Bank also uses VaR (Value at Risk) technique for market risk assessment of positions assumed by its treasury. In-house and vendor based solutions are used for calculating mark to market value of positions and generating VaR (value at risk) and PVBP (Price Value of a Basis Point) numbers.

Foreign exchange risk exposes the Bank to changes in the values of current holdings and future cash flows denominated in currencies other than the home currency due to the exchange rate fluctuation and volatility. The core objective of foreign exchange risk management is to ensure that the foreign exchange exposure of the Bank remains within defined risk parameters and insulates the Bank against undue losses that may arise due to volatile movements in foreign exchange rates or interest rates.

Limit structure to manage foreign exchange risk is in place. Net open position and gap limits on different tenors in major currencies are established and monitored on a regular basis. Stress testing of foreign exchange portfolio as per CBSL requirements is a regular feature of the foreign exchange risk management.

Following graph shows the assets which are exposed to market risk in the banking book.

	2013		
	Carrying Amount Rs 000'.	**Trading Portfolios Rs 000'**	**Non Trading Portfolios Rs 000'**
Assets subject to Market Risk			
Trading Assets	-	-	-
Derivative Financial Instruments	3,653	-	3,653
Loans & Receivables to Customers	8,915,019	-	8,915,019
Financial Instruments –Available for sale	2,158,145	-	2,158,145
Financial Investments – Loans & Receivables	1,177,663	-	1,177,663
	12,254,480	-	**12,254,480**
Liabilities subject to market risk			
Derivative Financial Instruments	13,162	-	13,162
Deposits	7,445,895	-	7,445,895
Borrowings	1,580,527	-	1,580,527
Other Borrowings	83,061	-	83,061
	9,122,645	-	**9,122,645**

5 FINANCIAL RISK MANAGEMENT (CONTINUED)

5.3 Market Risk

5.3.1 Interest Rate Sensitivity on interest bearing assets and liabilities

The table below depicts the interest rate sensitivity based on the interest rate sensitive positions as at 31st December 2013. In its cumulative position up to 12 month time bucket, Bank carries an asset sensitive position. This asset sensitive position will vary for each time bucket up to 12 months period in which during the time bucket of over 1 – up to 3 months, the Bank would experience a liability sensitive position of LKR 820 Mn. The interest rate sensitivity of the Bank indicates that in case of an interest rate decline, the Bank would tend to experience a loss of LKR 36 mn in its Net Interest Income (NII) while in case of interest rate increase the Bank would enhance its Net interest income by LKR 36 mn. This interest rate risk exposure is quantified based on the assumed change in the interest rates for each time period given in table shown below.

Parameter	**0 to 1 Month Rs.000'**	**Over 1- up to 3 Months Rs.000'**	**Over 3- up to 6 Months Rs.000'**	**Over 6 – up to 12 Months Rs.000'**
Total interest bearing assets	5,823,573	2,341,178	1,711,237	1,109,592
Total interest bearing liabilities	3,093,811	3,161,399	427,413	698,393
Net interest bearing assets (liabilities)	2,729,762	-820,221	1,283,824	411,199
Cumulative Gap	2,729,762	1,909,541	3,193,365	3,604,564
Assumed change in interest rates	1%	1%	1%	1%
Impact	27,298	-8,202	12,838	4,112
Net impact on NII if interest rates increase				**36,046**
Net impact on NII if interest rates decline				**(36,046)**

5.3.2 Foreign exchange position as of 31 December 2013

Currency	**Spot(Net)**	**Forward(Net)**	**Net Open Position**	**Overall position in LKR**
AUD	23	-	23	2,668
EUR	(321)	-	(321)	(57,990)
GBP	(767)	-	(767)	(165,566)
HKD	(5,073)	-	(5,073)	(85,689)
JPY	(1,485,059)	-	(1,485,059)	(1,854,245)
SGD	(10,158)	-	(10,158)	(1,051,575)
USD	(442,984)	423,880	(19,104)	(2,502,233)
Total Exposure				**(5,714,629)**
Total capital funds as per the latest Audited Financial Statements (Capital base as at 31 December 2012)				**3,485,494,634**
Total exposure as a % of total capital				**0.16%**

5 FINANCIAL RISK MANAGEMENT (CONTINUED)

5.3 Market Risk (Continued)

5.3.3 Forex Risk in Net Open Position (NOP)

The table indicates the exchange rate risk exposure based on its net open position to deferent currencies. As of 31st December 2013, bank carried USD net open “Long” position. The bank will be exposed to exchange rate risk in case, LKR appreciates against USD. The sensitivity analysis on this exposure at deferent shock level is presented below.

A sensitivity analysis of foreign currency net open position was carried out applying shock level increase of 1%, 3% and 5% level on the current exchange rate and the impact on USD equivalent NOP and the impact on income statement is as follows.

Sensitivity Analysis for the Exchange Rate Risk Exposure as at 31st December 2013

Position as at 31st December 2013	**Amount**
Net exposure - USD	(43,624)
Overall exposure in LKR	(5,714,629)
Exchange rate (USD/LKR)	130.98

Effect on income statement (LKR)	
- If Exchange rate appreciates by 1%	(57,139)
- If exchange rates appreciates by 3%	(171,416)
- If exchange rate appreciates by 5%	(285,694)

5.4 Liquidity Risk

To manage the liquidity, which represents the Bank’s ability to fund assets and meet obligations as they become due, the Bank’s asset-liability mismatches are monitored by preparing the asset liability statements on a regular basis enabling the senior management to take appropriate measures.

ALCO, headed by the Country General Manager, monitors and manages the Bank’s overall assets and liabilities structure through constant monitoring, and implementing corrective actions through various banking products and mechanisms such as the management of advances, deposits and investment portfolios.

A net liquidity asset to deposits from customers is depicted below.

	2013 **%**	**2012** **%**
Net liquid assets to deposits from customers		
At 31 December	51.92%	31.42%
Average for the year	43.1%	40.57%
Maximum for the year	52.74%	50.13%
Minimum for the year	29.97%	27.05%

5 FINANCIAL RISK MANAGEMENT (CONTINUED)

5.4 Liquidity Risk (Continued)

The Bank monitors the following liquidity ratios to assess funding requirements.

	2013	2012
Advances to Deposit Ratio		
Average for the Year ended	**129.79%**	139.86%
Minimum for the Year ended	**114.89%**	129.03%
Maximum for the Year ended	**147.25%**	158.96%
As at	**124.13%**	135.83%
Statutory Liquid Asset Ratio		
Average for the Year ended	**43.10%**	40.57%
Minimum for the Year ended	**29.97%**	27.05%
Maximum for the Year ended	**52.74%**	50.13%
As at	**51.92%**	31.42%

Liquid assets include Cash and Short term Funds, Bills purchased and Short term Investments. Liabilities to external stake holders include deposits, borrowing and other liabilities.

To manage the Liquidity Risk arising from Financial Liabilities, the Bank holds liquid assets comprising Cash and Cash Equivalents and Government treasury bills for which there is an active and liquid market. These assets can be readily sold to meet liquidity requirements.

5.5 Operational Risk

Operational Risk is the risk of a loss resulting from an inadequacy or a failure ascribable to people, processes, technology or external events. Currently the Bank is reporting operational risk capital charge under Basic Indicator Approach (BIA).

The Bank's objective is to manage operational risk so as to balance the avoidance of financial losses and damage to the Bank's reputation with overall cost effectiveness and to avoid control procedures that restrict initiative and creativity.

The primary responsibility for the development and implementation of controls to address operational risk is assigned to senior management within each business unit. This responsibility is supported by the development of overall Bank's standards for the management of operational risk in the following areas:

- requirements for appropriate segregation of duties, including the independent authorization of transactions
- requirements for the reconciliation and monitoring of the transaction
- compliance with regulatory and other legal requirements
- documentation of controls and procedures
- requirements for the periodic assessment of operational risk faced, and the adequacy of controls and procedures to address the risks identified
- requirements for the reporting of operational losses and proposed remedial action
- development of contingency plans
- training and professional development
- ethical and business standard, and

- risk mitigation, including insurance where this is effective.

5 FINANCIAL RISK MANAGEMENT (CONTINUED)

5.5 Operational Risk (Continued)

Compliance with Bank's standards is supported by a programme of periodic reviews undertaken by Internal Audit.

The results of Internal Audit reviews are discussed with the management of the business unit to which they relate, with summaries submitted to the senior management of the Bank.

5.6 Capital Management

The main objectives of managing banks' capital are as follows:

- maintain sufficient capital to meet minimum regulatory capital requirement.
- hold sufficient capital to support banks risk appetite
- allocate capital to business to support the bank's strategic objectives.

5.6.1 Statutory minimum capital requirement and capital management

As required by the circular issued by Central Bank of Sri Lanka on "Enhancement of Minimum Capital Requirement of Banks" the Bank is required to increase its capital as follows in the interest of a strong and sound banking system.

(a) Rs. 4 Billion by 31st December 2013
(b) Rs. 5 Billion by 31st December 2015

The Bank achieved the target Core Capital of Rs. 4 Bn. by 31st December 2013 complying with the capital requirements imposed the industry prudential regulator, and necessary measures have been taken to meet future requirements.

5.6.2 Regulatory Capital

The Bank manages its capital considering regulatory capital requirements. The Central Bank of Sri Lanka (CBSL) sets and monitors capital requirements for licensed banks in Sri Lanka based on the Basel Framework. Thus the Bank's operations are directly supervised by the CBSL and the Bank is required to comply with the Provisions of the Basel II framework in respect of regulatory capital. Commercial banks in Sri Lanka need to maintain a Total Capital Adequacy Ratio (CAR) of 10% and a Core Tier 1 Capital Ratio of at least 5%.

The Bank computes CAR as a ratio of its capital to its risk weighted assets. Calculations of the risk weightings defined under credit risk and market risk are based on the standardized approach whereas operational risk is computed by using the basic indicator approach.

As of 31st December 2013, Bank reported a Tier 1 ratio of 46.7% and a total CAR of 46.7% which remain comfortably above the CBSL's capital requirements.