Commercial Bank of Ceylon PLC is the largest private sector Bank in Sri Lanka and the 3rd largest foreign Bank in Bangladesh, in terms of its assets. This section of the Report provides context to our performance in both Sri Lanka and Bangladesh which contributes for over 99% of revenue and assets of the Group.

Our Relevance to the Sri Lankan Economy

	Bank Rs. Bn.	Banking Sector Rs. Bn.	Bank's Share %
Assets	872.9	7,706.4	11.33
Gross Loans and Advances	500.3	4,495.3	11.13
Deposits	588.9	5,125.4	11.49
No. of Branches (Nos.)	244	3,547	6.88
No. of ATM's (Nos.)	617	3,447	17.90

Table – 17

As of the date of this report the industry comparators available from the country's regulator (CBSL) were only up to September 30, 2015. Consequently, the comparatives given for the Bank are also as per the Financial Statements circulated to shareholders as at September 30, 2015.

Global Economy

Global growth, currently estimated at 3.1% in 2015, is projected at 3.4% in 2016 and 3.6% in 2017. Growth in emerging markets and developing economies while still accounting for over 70% of global growth-declined for the fifth consecutive year, while a modest recovery continued in advanced economies. (Table 18)

Risks to the global outlook remain tilted to the downside and relate to ongoing adjustments in the global economy, a generalised slowdown in emerging market economies, China's rebalancing, lower commodity prices, and the gradual exit from extraordinarily accommodative monetary conditions in the United States. If these key challenges are not successfully managed, global growth could be derailed.

Advanced Economies

A modest and uneven recovery is expected to continue, with a gradual further narrowing of output gaps. Overall activity remains resilient in the United States, supported by still-easy financial conditions and strengthening housing and labour markets. In the euro area, stronger private consumption supported by lower oil prices and easy financial conditions is outweighing a weakening in net exports. Overall, financial conditions within advanced economies remain very accommodative.

Emerging Economies

The picture for emerging market and developing economies is diverse but in many cases challenging. The slowdown and rebalancing of the Chinese economy, lower commodity prices, and strains in some large emerging market economies will continue to weigh on growth prospects in 2016/17.

The projected pick up in growth in the next two years despite ongoing slowdown in China, primarily reflects forecasts of a gradual improvement of growth rates in countries currently in economic distress, notably Brazil, Russia, and some countries in the Middle East, however this projected partial recovery could be frustrated by new economic or political shocks.

Source: IMF World Economic Outlook Update – January 2016

World Economic Outlook Projections

	2014 %	2015 (Estimated) %	2016 (Projected) %
World Output	3.4	3.1	3.4
Advanced Economies	1.8	1.9	2.1
United States	2.4	2.5	2.6
Euro Area	0.9	1.5	1.7
Japan	0.0	0.6	1.0
United Kingdom	2.9	2.2	2.2
Emerging Market and Developing Economies	4.6	4.0	4.3
Russia	0.6	-3.7	-1.0
China	7.3	6.9	6.3
India	7.3	7.3	7.5
ASEAN-5	4.6	4.7	4.8

→ *Table – 18*

Source: IMF World Economic Outlook Update – January 2016

Sri Lanka

Sri Lanka adopted a new methodology to measure GDP in July, 2015. As per the new series, GDP recorded a growth of 5.2% during the first nine months of 2015, driven by improved performance in all three sectors (Table 19), namely Agriculture, Industry and Services.

Service sector activity continues to be the highest contributor to GDP growth and recorded a growth of 5.18% in the first nine months of 2015, led by the improvement in wholesale and retail activities.

	Contribution to GDP Growth (%)		Share of GDP (%)	
Sector	9M 2014	9M 2015	9M 2014	9M 2015
Agriculture	**(3.5)**	8.7	**7.4**	7.5
Industry	**(15.5)**	18.9	**27.2**	26.8
Services	**99.3**	57.9	**58.5**	58.4
Taxes less subsidies on products	**19.7**	14.5	**6.9**	7.3

→ *Table – 19*

Representing around 70% of GDP, private consumption is the biggest contributor to growth and is expected to be the key driver of growth in 2016 as well. Improvement in consumption driven demand was supported by an increase in per capita income with a salary increase to the Government sector, increased public sector pension payments and low inflation.

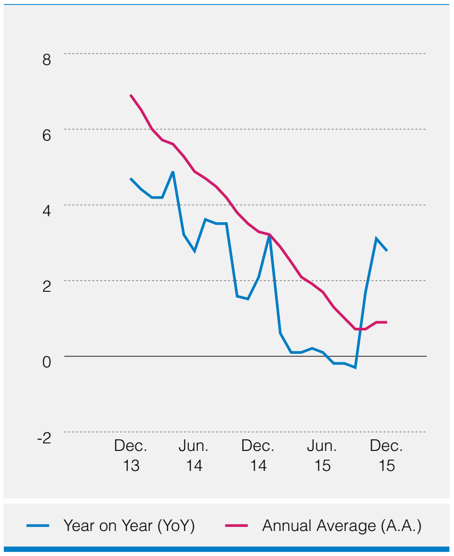
Financial and insurance activities recorded a growth of 12.2% in the first nine months of 2015 supported by increased demand for credit by the private sector.

Inflation

Inflation (YoY) as measured by the Colombo Consumers' Price Index (CCPI) (2006/07=100) turned negative since July 2015 and recorded -0.3 % by the end of September, which is the lowest level recorded since February 2004[1], primarily due to sharp reductions in energy costs and improved food supply. However, inflation reached positive territory in October 2015, to record 1.7% and further increased to 2.8% by end of 2015.

[1]*Fiscal Management Report 2015*

Movement of Inflation (Based on CCPI)

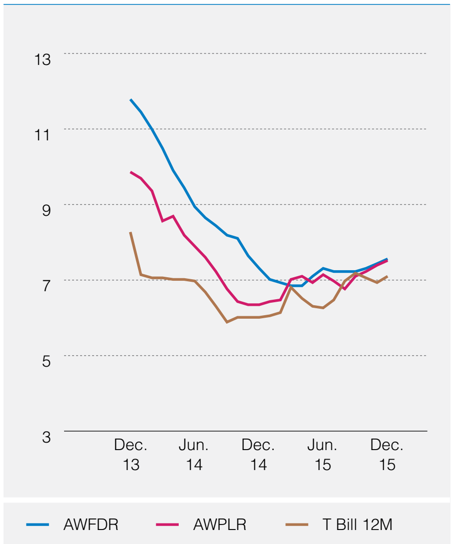


→ Graph – 31

Interest Rates

Interest rates continued the declining trend which commenced in 2013, with slight fluctuations due to easing of monetary policy by the CBSL since December 2012. However, the greater reliance on domestic credit to finance the budget deficit, which exceeded the target 4.4% of GDP by end July 2015, applied upward pressures on interest rates.

Interest Rates



→ Graph – 32

Low interest rates have contributed to increased imports and a significant outflow of foreign investments in Government Securities, which has contributed to the depreciation of the rupee during the year.

Credit to the Private Sector

Credit to the private sector increased by 27% (YoY) by November 2015, compared to 6.5% for the same period in 2014, as low interest rates, low inflation and increased disposable income made credit more affordable. Concessions given for vehicle financing contributed significantly to the increase in credit to the private sector.

Credit Granted by Commercial Banks to the Private-Sector

%/Rs. Bn.

Graph – 33

External Sector

Subdued growth in Sri Lanka's major export destinations, reduced the demand for exports in 2015. The leading markets for merchandise exports of Sri Lanka, during the first eleven months of 2015 were USA, UK, India, Germany, Italy and China, which accounted for about 54% of total exports.

The trade deficit marginally widened during the first eleven months of 2015, driven by the continued increase in import of vehicles and consumer goods, reversing the favourable impact of a reduced petroleum bill.

Exchange Rate

The Sri Lankan Rupee, depreciated only by 2.4% against the US Dollar during the first eight months of 2015. However, the Sri Lankan Rupee depreciated against the US Dollar by 9.03% for the full year of 2015 with the CBSL's decision to accommodate greater flexibility in the determination of the exchange rate, commencing from September 04, 2015. This was largely attributable to the outflow of foreign funds invested in rupee denominated Government Securities, interest and loan repayments of foreign debt and a surge in vehicle imports.

Rs./Other Currencies & Gross Official Reserves in US$ Mn.

Rs./US$ Mn

Graph – 34

International Reserves Position

Gross official reserves of the country reduced significantly in 2015, mainly due to foreign exchange outflows resulting from the settlement of the matured International Sovereign Bond, IMF-SBA repayments and foreign currency debt service payments. This was managed to some extent with a US $ 1.1 Mn. SWAP arrangement with India and receipts from the ninth International Sovereign Bond issuance for US $ 1.5 Bn. Consequently, gross official reserves, which stood at US $ 8.2 Bn. at end 2014, were estimated at US $ 7.3 Bn. by end 2015 (Graph 34).

*We aim to be the **preferred corporate banking solutions provider** by assuring quality of service through a deeper understanding of our clients' needs*

Sanath Manatunge
Deputy General Manager
Corporate Banking

5.2%

GDP Growth

(During first nine months of 2015)

12.2%

Growth in Financial and Insurance Activities

(During first nine months of 2015)

Outlook for 2016

The Budget for 2016 has encouraged construction activity, exports, investments and tourism and the proposed revisions to import taxes on a range of consumer goods and luxury goods is likely to increase consumer demand in the country and the demand for private sector credit.

Downward pressures on lending include increased taxes on vehicle imports and the reduction in Loan To Value (LTV) ratio, which are likely to have a negative impact on leasing.

Thrust is on negotiated settlements and restructuring.
Converting non performing businesses into performing ones

According to the IMF, with the recent acceleration in private sector credit growth and rising core inflation, there is now little scope for further monetary easing. The IMF has further pointed out that most factors including the deterioration in the balance of payments and pressures on the rupee suggest that the CBSL should be prepared to tighten monetary policy in the coming months, albeit at a gradual pace.

Overview of the Global Banking Sector

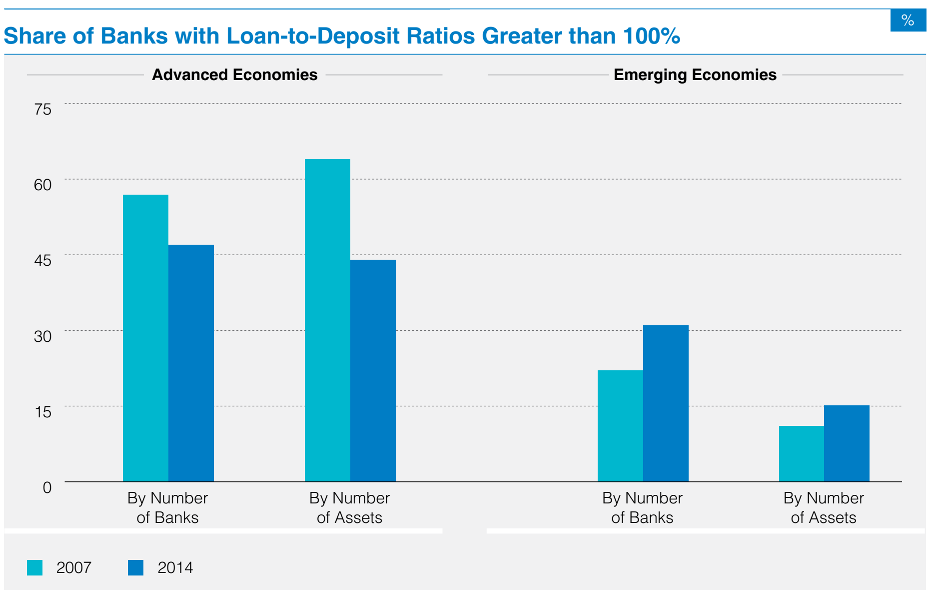
Banking system capital dynamics differ between advanced and emerging market economies. Capital ratios in most advanced economy banking systems have improved during the past five years, mainly through a combination of very low credit growth and modest profitability. Despite their more robust profitability, emerging market systems much faster new asset growth has absorbed essentially all of the retained earnings and new capital raised during the past five years.

As emerging market economies approach the late stage of the credit cycle, banks have thinner capital cushions relative to advanced economy banks and non-performing loans are set to rise as corporate earnings and asset quality deteriorate. Increasing loss-absorbing buffers will require raising additional capital, because higher provisioning and lower profitability will hinder the ability of banks to generate internal capital.

Rapid credit growth also underlies a significant increase in emerging market banks' loan-to-deposit ratios during the past eight years. Their loan-to-deposit ratios are now converging with those of advanced economy banks, whose funding positions have improved in the same period.

Source: Global Financial Stability Report, October 2015

Share of Banks with Loan-to-Deposit Ratios Greater than 100%



Graph – 35

Felician Perera
Deputy General Manager
Credit Supervision & Recoveries

Despite the prospect of continued low economic growth, Ernst & Young see four areas where banks will be able to generate higher revenues over the next decade: targeting new customers in emerging markets; developing new products and acquiring market share in developed markets; funding infrastructure investment; and partnering with non-banks.

Source: Global Banking Outlook 2015, Ernst & Young

Key Economic Indicators and their Impact on Commercial Bank

Economic Indicator	Movement During 2015	Cause of Movement	Impact on Commercial Bank
The world economy (World output)	The world economy is estimated to have recorded a growth of 3.1% in 2015	US, UK and the Euro area, which are Sri Lanka's key export destinations, experienced mixed fortunes in 2015	The country's exports reduced. Nevertheless, the Bank's share of exports increased
Local Economy (GDP)	The Sri Lankan economy recorded a growth rate of 5.2% during the first nine months of 2015	An improved performance was recorded in all three sectors, i.e. services, industry and agriculture	Helped the Bank to increase its business volumes substantially
Inflation and interest rates	Inflation (YoY) and the interest rates were maintained at low levels	Lower energy costs and an improvement in food supply helped to maintain the rate of inflation at low levels	Helped the Bank to record substantial growth in loans and advances
Exchange Rate (LKR/USD)	The LKR depreciated by 9.03% against the USD in 2015	Largely attributable to the outflow of foreign funds invested in Rupee denominated Government Securities, interest and loan repayments of foreign debt and a surge in vehicle imports.	Enhanced exchange profits

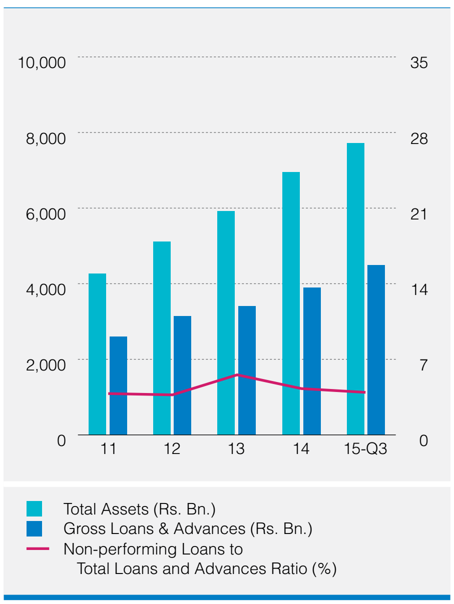
Table – 20

Banking Sector: Sri Lanka

The Sri Lankan Banking sector witnessed a healthy expansion of its asset base (Graphs 36) in 2015, supported by increased demand for credit from both state and private sectors due to lower interest rates. However, the pawning portfolio contracted during the same period, continuing the trend prevailed in the previous years, due to the decline in global gold prices.

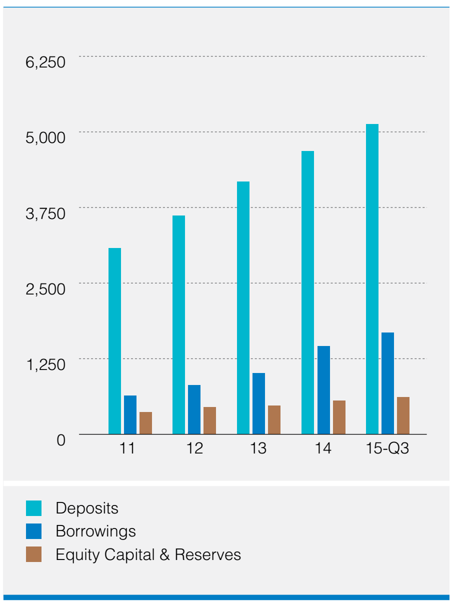
Asset quality of the banking sector improved as observed by the improvement in the NPA ratio, which stood at 4% as at end September 2015, compared to 4.2% in December 2014, mainly due to a higher growth in loans and advances.

Banking Sector Asset Growth



Graph – 36

Banking Sector Liability Growth



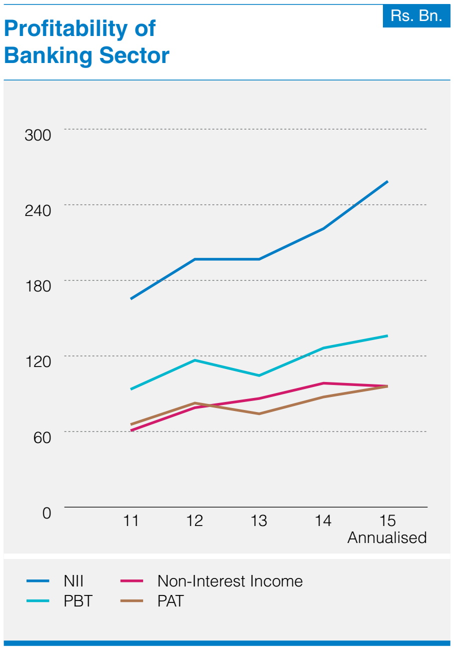
Graph – 37

Deposits growth was 9% in the first nine months of 2015 and continued to be the main source of funds for banks contributing to 66.5% of the total assets of the banking sector. Borrowings too increased by 15% during the first nine months of 2015 (Graph 37).

Liquidity levels of the banking sector, remained healthy with Rs. 2.2 Bn. in excess of the Statutory Liquid Assets as at end of September 30, 2015. The ratio of liquid assets to total assets stood at 29% as at end September 2015, at a healthy level although lower than the 32.2% observed at the close of 2014. The loans to deposit ratio increased from 83.1% as at end 2014, to 87.7% as at end of September 30, 2015, due to increased growth in loans and advances.

Profits of the sector increased from Rs.106 Bn. for the nine months ended September 2014, to Rs.120 Bn. for the same period in 2015. This performance was mainly due to the higher Net Interest Income, as Non-Interest Income remained relatively flat during this period. Overall business expansion, increased lending and investment activity, resulted in a favourable increase in Net Interest Income.

Profitability of Banking Sector

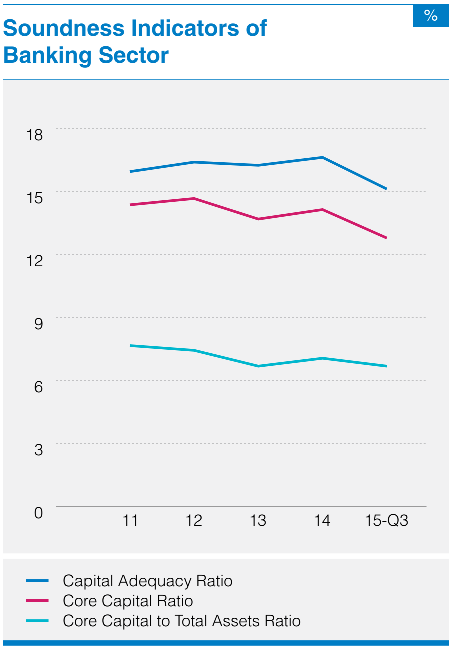


Graph – 38

ROE declined from 16.6% as at December 2014, to 16.2% for the nine months ended September 2015, due to lower margins on both fees and fee-based operations and increased operating costs.

The banking sector continued to maintain sufficient capital as evinced by the Core Capital Adequacy Ratio (CAR) and Total CAR, which were at 12.8% and 15.2%, respectively as at September 30, 2015, well above the regulatory minimum of 5% and 10% respectively.

Soundness Indicators of Banking Sector



Graph – 39

The Banks branch network increased by 18 outlets and 60 new ATMs during the first seven months of 2015.

New Banking Regulations Adopted in 2015

Implementation of the Liquidity Coverage Ratio (LCR)	Directions were issued to licensed banks to implement the LCR under Basel III Liquidity Standards, requiring banks to maintain a minimum LCR of 60%, effective from April 01, 2015.
Implementation of Basel III Minimum Capital Requirements and Leverage Ratio	A Consultation Paper on the Implementation of Basel III Minimum Capital Requirements and Leverage Ratio was issued to banks and the regulations on same will be issued in due course with a phase by phase implementation from 2016.
Maximum loan-to-value (LTV) ratio	A maximum LTV ratio of 70.0% was imposed on loans and advances granted by licensed banks for the purpose of purchase or utilisation of motor vehicles.
Limits on share ownership of banks and criteria of Fitness and Propriety of Board of Directors	Existing limits on share ownership of banks and assessment criteria of fitness and propriety of Board of Directors are being reviewed to further strengthen the governance and resilience of the banking sector.

Table – 21

13.2%

Growth in Banking Sector Profit

During first nine months of 2015, profits increased from Rs. 106 Bn. to Rs. 120 Bn. due to business expansion, and increased lending and investment activity

27%

Credit Growth (YoY) to Private Sector

Low interest rates, low inflation and increased disposable income made credit more affordable