



**HNB**

Hatton National Bank PLC

Corporate Governance &  
Risk Management Report 2017



navigating  
uncertainty

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## **NAVIGATING UNCERTAINTY: CORPORATE GOVERNANCE & RISK MANAGEMENT REPORT 2017**

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# ABOUT OUR REPORT

HNB provides a complete suite of reports enabling our stakeholders to conveniently find the information required by them, drilling down to more detailed information signposted throughout our Annual Report.

		FRAMEWORKS APPLIED	ASSURANCE
ANNUAL REPORT	<p><b>NAVIGATING UNCERTAINTY - CORPORATE GOVERNANCE AND RISK REPORT [CG&amp;RR]</b></p> <p>This is our Corporate Governance and Risk Management Report intended for providers of financial capital and regulators who require deeper insights to the Bank's governance framework and approach to managing risk</p>	<ul style="list-style-type: none"> <li>» Code of Best Practice on Corporate Governance issued jointly by the Securities &amp; Exchange Commission of Sri Lanka (SEC) and the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) in 2013</li> <li>» Banking Act Direction No. 11 of 2007 (as amended)</li> <li>» Companies Act No.7 of 2007</li> <li>» Sri Lanka Financial Reporting Standards issued by the Institute of Chartered Accountants of Sri Lanka</li> <li>» Integrated Risk Management Framework, Direction No 07 of 2011</li> <li>» Baseline Security Standards for Information Security Management</li> <li>» Banking Act Direction No. 1 of 2016 Basel Capital Accord (III)</li> <li>» ISO 27001:2013 Information Security</li> </ul>	<p>The external auditors, Ernst &amp; Young has performed procedures set out in Sri Lanka Standards on Related Service 4400 issued by the Institute of Chartered Accountants of Sri Lanka (SLSRS 4400), to meet the compliance requirement of the Banking Act Direction No.11 of 2007 and subsequent amendments thereto, and provided a report to the Board.</p>
	<p><b>INTEGRATED ANNUAL REPORT 2017 (IR)</b></p> <p>This report is primarily for providers of financial capital and will be of interest to other stakeholders as it summarises information on all material issues impacting our performance.</p>	<ul style="list-style-type: none"> <li>» IR Framework issued by the International Integrated Reporting Council</li> <li>» Sri Lanka Financial Reporting Standards issued by the Institute of Chartered Accountants of Sri Lanka</li> <li>» Companies Act No.7 of 2007</li> <li>» Banking Act No 30 of 1988</li> </ul>	<p>Assurance has been provided by Ernst &amp; Young on the Financial Statements including the Notes to the Accounts.</p> <p>DNV-GL has provided assurance on non financial sections of the report</p>
SUSTAINABILITY SUPPLEMENT	<p>This report caters to a wide range of stakeholders and provides a balanced review of our economic, environment and social impact and the governance mechanisms in place to measure, monitor and manage the same</p> <p><a href="https://www.hnb.net/2017#sustainability-report-2017">https://www.hnb.net/2017#sustainability-report-2017</a></p>	<ul style="list-style-type: none"> <li>» United Nations' Sustainable Development Goals</li> <li>» GRI Standards</li> </ul>	<p>DNV-GL has provided assurance on non financial sections of the Sustainability supplement</p>

## MESSAGE FROM CHAIRMAN

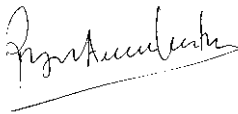
The Board of Directors of HNB is committed to maintain high standards of corporate governance which has underpinned the Bank's long-term competitiveness, growth and sustainability. Built on a set of well-established values which forms the core of HNB's culture, we strive to ensure fairness, integrity and accountability in our decision making across the Bank, enhancing trust and confidence in the organisation. This has been the bedrock of the legacy of HNB, its strength and stability.

The Bank's Corporate Governance Framework is clearly defined and embodies strong business ethics, sound policies and procedures and effective and efficient monitoring systems. We regularly review and benchmark the Group's governance structures and processes, to ensure compliance with all statutory and regulatory requirements and that they are applied in the best interests of the Bank and stakeholders. Enhancing fair and open communication further in our engagement with stakeholders, the Board reviewed the Bank's External and Internal Communication Policy in 2017, improving clarity and transparency. The Board encourages the application of sound corporate governance principles across the Group, supported by the "Charter for Management/Good Governance for Group Companies of Hatton National Bank PLC" policy introduced in 2016.

We welcome the release of the revised Code of Best Practice on Corporate Governance 2017 by the Institute of Chartered Accountants of Sri Lanka [CA Sri Lanka] in December 2017. We will review its impact on the Bank's governance framework, policies and practices in 2018, in order to ensure the incorporation of the latest corporate governance developments.

This report describes how the Board has applied principles of good governance in practice and its compliance status with the Corporate Governance regulations made under the Banking Act Direction No 11 of 2007 as amended issued by the Central Bank of Sri Lanka for Licensed Commercial Banks and with the Code of Best Practice on Corporate Governance issued jointly by the Securities and Exchange Commission of Sri Lanka and the Institute of Chartered Accountants of Sri Lanka [CA Sri Lanka] in 2013.

As required by the above Code, I hereby confirm that, I am not aware of any material violations of any of the provisions embodied [i] in the Board Charter, by the Board of Directors of the Bank; or [ii] in the Bank's Codes of Conduct and Ethics, by any member of the Corporate Management team of the Hatton National Bank PLC.



**Rienzie Arseculeratne**  
*Chairman*

Colombo, Sri Lanka  
20th February 2018

# CORPORATE GOVERNANCE

## THE SPEED READ

The Bank's Corporate Governance Framework is well structured and primarily based on the doctrine and principles of Accountability, Fairness, and Transparency. We strive to achieve the highest level of standards in Corporate Governance Practices in the industry as well as in the country.

Mr Dinesh Weerakkody was appointed to the Board in July 2017.

Ms Rose Cooray, Mr Palitha Pelpola and Mr Duliksha Soosaipillai will retire by rotation at the AGM. They have offered themselves for re-election by shareholders at the next AGM, with the support of the Board.

## 1. CORPORATE GOVERNANCE

Good Corporate Governance is fundamental to sustainable growth and HNB is committed towards upholding high standards of Corporate Governance, beyond regulatory requirements. The Governance framework drives accountability, fairness & transparency and is regularly reviewed to adapt to internal developments and reflect national and international best practice, ensuring it remains robust and relevant in a highly regulated industry operating in a challenging business environment. All entities within the HNB Group adhere to high standards of governance enforced by the common Directors and representation by the Bank's Corporate Management. The Board of Directors bears responsibility for setting up a sound governance structure together with a comprehensive policy framework to guide the executive management across the Group.

### 1.1 Board Mandate

As set out in the Board Charter, the fundamental role of the Board is to provide entrepreneurial and coherent leadership within a framework of prudent and efficient controls, which enables risk to be assessed and managed. The Board determines the overall strategy to enhance long term value of the Bank and oversees implementation. Providing independent, informed and effective judgment and leadership to decision making, the Board ensures that strategy, risk, performance and sustainable development considerations are effectively integrated and appropriately balanced.

The Board is responsible for ensuring effective systems and controls are in place to secure integrity of information, safeguard assets, guarantee business continuity and manage risk. The Board is also responsible for a sound human resource strategy and to ensure all stakeholder rights and obligations are safeguarded whilst complying with laws, regulations and ethical standards. All Directors contribute meaningfully to leading the Group and commit sufficient time to fulfill their duties.

The Board is satisfied with the integrity of financial information and the robustness of the financial controls and systems of risk management of the Bank.

### 1.2 Governance Structure

The Bank's evolving Corporate Governance framework is shaped by the regulatory

## SUMMARY OF KEY RESPONSIBILITIES OF THE BOARD

### As Per Board Charter

- Provide strategic direction for Bank.
- Monitor implementation of strategic targets
- Set and promote HNB's brand values and code of conduct
- Determine Bank's Risk appetite & establish systems of risk management and internal control
- Present a balanced and understandable assessment of the Bank's position and prospects
- Safeguard assets and ensure legitimate use
- Proactively promote regulatory and statutory compliance
- Promote ethical behaviour amongst employees
- Assess effectiveness of the Board through self-evaluation
- Meet shareholders, employees and other stakeholders' obligations, balancing their interests in a fair manner
- Be responsive to the needs of society

framework, stakeholder interests, the operating environment and the Bank's corporate values. Regulatory compliance is a key priority with internal policy documents, typically seeking to go beyond regulatory requirements modelling international best practice as appropriate to the size and complexity of the Bank's operations.

The Bank has a two-tier management structure consisting of the Board of Directors and the Executive Management. The Corporate Management led by the MD/CEO, is responsible for the Bank's daily operations in implementation of strategy. A clearly defined governance framework provides for the delegation of authority to the MD/CEO, executive committees and corporate/senior management of the Bank without renouncing the Board's responsibility.

The Board has delegated certain functions warranting greater attention, to nine (9) Board Sub-Committees with oversight responsibility for same. This enables the Board to allocate sufficient time to matters within its scope, particularly execution of strategy and forward-looking agenda items, enhancing effectiveness. Reports of the five (5) mandatory Sub-Committees are given on pages 90 to 102 in IR. The Board reviews and approves the delegation arrangements, annually.

Compliance with the requirements of the Banking Act Directions No.11 of 2007 (as amended) and the Code of Best Practice on Corporate Governance issued jointly by the Securities & Exchange Commission of Sri Lanka (SEC) and the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) in 2013 are given on pages 12 to 24 and pages 25 to 27 in CG&RR, respectively.

The External Auditors, Messrs Ernst and Young have performed procedures set out in Sri Lanka Standards on Related Service 4400 (SLFRS 4400) issued by Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) to meet the compliance requirement of the Corporate

# Corporate Governance

Governance directive. Compliance with the CSE listing rules on Corporate Governance has not been disclosed as Listed Banks are exempted from complying with the said rules from 2010 onwards, since such governance requirements have been adequately covered in the Banking Act Directions No.11 of 2007 (as amended) on Corporate Governance for Licensed Commercial Banks in Sri Lanka.

## 1.3 Company Secretary

The Company Secretary, Mrs Thushari Ranaweera, Attorney-at-law, appointed to the Board in January 2012, guides the Board on discharging its duties and responsibilities. She keeps them abreast of relevant changes in legislation and facilitates adherence to best practices in Corporate Governance. All Directors have access to the services of the Company Secretary. Her responsibilities include ensuring the conduct of Board & General Meetings in accordance with the Articles of Association and relevant legislation, maintaining statutory registers, prompt communication to regulators & shareholders, filing statutory returns and facilitating access

### KEY ELEMENTS OF REGULATORY FRAMEWORK RELATED TO CORPORATE GOVERNANCE

#### External

- Banking Act No.30 of 1988 and amendments thereto
- Directions, Determinations, and Circulars issued to Commercial Banks by CBSL
- Companies Act No.7 of 2007
- Continued Listing Rules of the Colombo Stock Exchange
- Code of Best Practice on Related Party Transactions issued by the Securities & Exchange Commission
- Code of Best Practice on Corporate Governance issued jointly by the Securities & Exchange Commission of Sri Lanka (SEC) and the Institute of Chartered Accountants of Sri Lanka [CA Sri Lanka] in 2013.

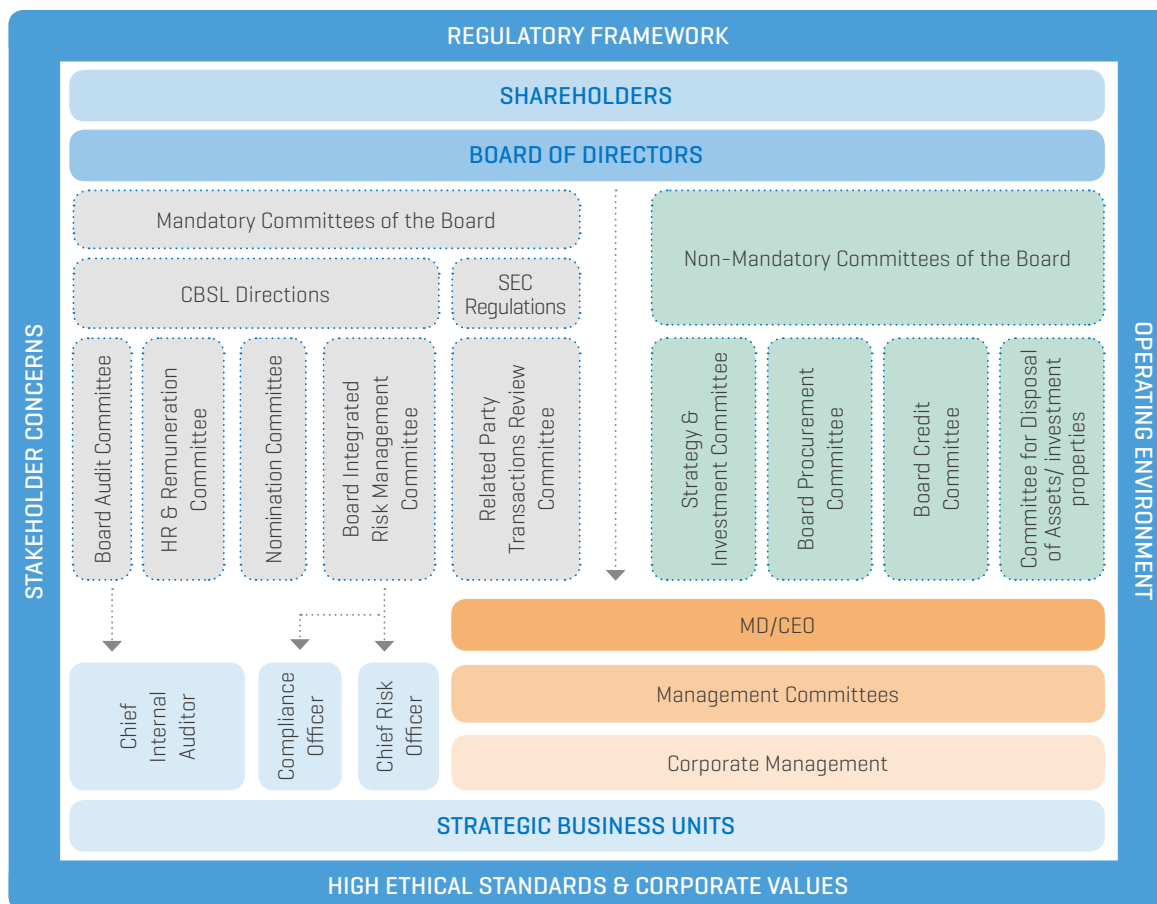
#### Internal

- Board Charter
- Sub Committee Charters
- Charter for Management / Good Governance for group companies
- Code of Conduct and Ethics for Employees
- Policies and Procedures
- Delegation of Authority Limits
- Risk Appetite Statement
- Customer Charter

to legal advice in consultation with the Board, where necessary.

The Company Secretary maintains the minutes of Board meetings, which are open

for inspection by any Director at any time. Appointment and removal of the Company Secretary is a matter for the Board as a whole.



## 2 BOARD CALENDAR AND ACTIVITIES

The Board calendar with tentative dates for Board and Sub-committee meetings for the following year is sent to all members approximately 2-3 months before the end of the current year. The agenda and Board papers for the next meeting are sent 7 days before the meeting, allowing members sufficient time to review the same. Urgent Board papers are included on an exceptional basis.

The Chairman sets the Board agenda, assisted by the Company Secretary and MD/CEO. Care is taken to ensure that the Board spends sufficient time on matters critical to the Bank's success, as well as compliance matters. The Board is aware of other commitments of its Directors and is satisfied that all Directors allocate sufficient time to enable them to discharge their responsibilities at HNB effectively.

Directors have access to Corporate/Senior Management to seek clarifications and obtain additional information on matters presented to the Board. Further, Corporate/Senior Management are invited to attend Board meetings in order to brief Directors and make presentations on agenda items.

### KEY AREAS OF BOARD FOCUS IN 2017

#### Strategy & Business

- Review and approval of policies, key metrics and structural changes as per Strategic plan 2016-2020,
- Approval of significant investments
- Digitization and Upgrade of IT systems per IT strategy
- Approval of annual budget
- Funding arrangements
- Review of strategies of key subsidiaries

#### Risk & Oversight

- Review of overall risk policy of Bank and Subsidiaries
- Approval of the Financial Statements and the Annual Report
- Compliance review
- Review of impacts from operating environment

#### Governance

- Board Sub-Committee composition, resignations, nominations and appointments
- Board evaluations and action plan to implement recommendations
- Review of policy frameworks
- Succession planning

#### Stakeholder Engagement

- Review of shareholder communications and Annual General Meeting
- Review of feedback from institutional investors
- Review of regulatory reviews
- Engagement with CBSL

Directors unable to attend a meeting are updated on proceedings through the circulation of formally documented minutes, which are to be discussed at the next meeting for approval, by those who were present, and follow up.

### 2.1 Key areas and activities considered in 2017

During the year, the Board held seventeen (17) meetings. Key matters discussed are listed in the above table.

### 2.2 Board and Sub-Committee Meeting Attendance

Board Member	Directorship Status	Date of Appointed to the Board	Board	Board Audit Committee	HR & Remuneration Committee	Nomination Committee	Board Integrated Risk Management Committee	Related Party Transactions Review Committee	Strategy & Investment Committee	Board Procurement Committee	Board Credit Committee
Total Meetings Held			17	7	7	6	9	5	8	12	6
Mr Rienzie Arseculeratne, [Chairman]	●	30th April 2015	17/17		7/7	6/6			1 <sup>a</sup>		
Mr Jonathan Alles [MD/CEO]	●	01st May 2013	*15/17	6 <sup>a</sup>	7 <sup>a</sup>	6 <sup>a</sup>	4/9	4/5	8 <sup>a</sup>		4 <sup>a</sup>
Ms Rose Cooray	●	15th February 2010	17/17	7 <sup>a</sup>	1 <sup>a</sup>	6/6	9/9		7/8		
Dr Rohan Karunaratne	●	06th October 2011	15/17	7/7				2/5		10/12	3/6
Mr Damien Fernando [Resigned w.e.f 3rd April 2017]	●	02nd April 2012	5/5		2/2		2/2				
Mr Sujeewa Mudalige	●	02nd April 2012	17/17	7/7	7/7		5 <sup>a</sup>		6/8		
Ms Sanjivani Jayawardena	●	02nd April 2012	16/17				8/9			12/12	
Mr Rusi Captain	●	02nd April 2012	*16/17		*1/4	*6/6					
Mr Amal Cabraal	●	01st April 2014	15/17	7/7	7/7				8/8		
Mr Palitha Pelpola	●	30th April 2015	*17/17			6/6		5/5			6/6
Mr Duliksha Soosaipillai	●	30th April 2015	17/17				9/9		8/8	12/12	
Mr A N de Silva	●	30th April 2015	17/17	7/7				5/5			6/6
Mr Dinesh Weerakkody	●	29th June 2017	7/9								

● Executive Director ● Independent Non-Executive Director ● Non-Executive Director

■ Chairman/Chairperson of the Board/ Sub-committee as at 31st December 2017

<sup>a</sup> Meetings attended by invitation

\* includes meeting/s attended by an alternative Director/s

# Corporate Governance

## 3 BOARD EFFECTIVENESS

### 3.1 Board Composition

The Board comprises of twelve [12] Directors of whom 11 are Non-Executive Directors, including the Chairman whose profiles are given on pages 22 to 25 in IR. There are seven [7] Independent Non-Executive Directors whose tenures vary from two [2] to seven [7] years ensuring that there is sufficient knowledge of the Bank's operations amongst them on a collective basis facilitating their active participation. Non-Executive Directors are eminent professionals in their respective fields, bringing diverse perspectives to Board deliberations and constructively challenging management on matters set before the Board. The sole Executive Director is the MD/CEO who is an experienced banker.

Seven [7] Non-Executive Directors, including the Chairman are deemed independent based on the criteria specified in the Banking Act Directions No.11 of 2007. The Directors submit annual declarations to this effect which are evaluated to ensure compliance with the criteria. Each Directors' demonstrated independence in judgment and character is reviewed by the Board on an annual basis, as part of the Directors' performance evaluation. When appointing Alternate Directors the requirement of the Code has been complied with. Appointment of a Senior Independent Director has not been considered, as the roles of the Chairman and Chief Executive Officer are segregated.

The Chairman meets with the Non-Executive Directors without the presence of the Executive Director on a need basis. The Non-Executive Directors met twice [2] without the presence of the Executive Director during 2017. Directors' concerns regarding matters which are not resolved unanimously are recorded in the minutes.

#### BOARD COMPOSITION

Chairman [Independent Non-Executive]



Independent Directors



Non-Independent Non-Executive Directors



Executive Director



### 3.2 Diversity and Financial Acumen

The Bank's Board is diverse in its experience, expertise, age and gender and exercises their independent judgment to bear on matters set before the Board. Bringing together regulatory, banking, investor and entrepreneurs' perspectives, the Board is able to explore matters from diverse point of view to facilitate long term value creation.

All Directors possess financial acumen and knowledge through the experience gained from leading large private and public enterprises coupled with their academic and professional background. The details of their qualifications and experience have been set out on pages 22 to 25 in IR.

### 3.3 Role of Chairman and MD/CEO

The role of Chairman is separate from that of the MD/CEO as detailed in the Board Charter, in line with best practices in Corporate Governance ensuring that no one Director has unfettered power and authority. The Chairman is an Independent Non-Executive Director while the MD/CEO is an Executive Director appointed by the Board.

### 3.4 Board appointment Process and Re-Election of Directors

The Board has a formal and transparent process in place for the succession and appointment of Directors. In the event of

**"THE BANK SHALL AT ALL TIMES BE HEADED BY AN EFFECTIVE BOARD WHICH IS COLLECTIVELY RESPONSIBLE FOR THE LONG TERM SUCCESS OF THE BANK"**

HNB Board Charter

#### ROLES OF CHAIRMAN & MD/CEO

- The Chairman is an Independent Non-Executive Director who leads the Board ensuring that it works effectively and acts in the best interest of the Bank.
- MD/CEO is accountable to the Board for the exercise of authorities delegated by the Board and for the performance of the Bank.

a vacancy of a Non-Executive Director, the Nomination Committee processes and shortlists candidates, and makes recommendations to the Board for approval. The attributes and experience required from potential appointees are identified and agreed prior to the search process having considered the combined knowledge, experience and diversity of the Board in relation to the Bank's strategic plans and any gaps thereof. The candidate's other Directorships and commitments are also considered to

Chairman's Responsibilities	MD/CEO Responsibilities
<ul style="list-style-type: none"> <li>» Setting the ethical tone for the Board and Bank;</li> <li>» Setting the Board's annual work plan and the agendas, in consultation with the company secretary and the MD/CEO;</li> <li>» Building and maintaining stakeholder trust and confidence;</li> <li>» Ensuring effective participation of all Board members during Board meetings;</li> <li>» Facilitating and encouraging discussions amongst all Directors of matters set before the Board and ensuring a balance of power is maintained between Executive and Non-Executive Directors;</li> <li>» Monitoring the effectiveness of the Board and assessing individual performance of Directors and</li> <li>» Maintaining open lines of communication with Key Management Personnel, acting as a sounding board on strategic matters.</li> </ul>	<ul style="list-style-type: none"> <li>» Developing and implementing the Bank's strategy for consideration and approval by the Board;</li> <li>» Developing and recommending budgets to the Board to support the Bank's mid &amp; long-term strategy;</li> <li>» Monitoring and reporting to the Board on the performance of the bank and its compliance with applicable legal and regulatory obligations;</li> <li>» Establishing an organizational structure for the Bank which is appropriate for the execution of strategy;</li> <li>» Ensuring a culture that is based on the Bank's values;</li> <li>» Ensuring that the Bank operates within the approved risk appetite and</li> <li>» Ensuring proper succession planning of the executive team and assessing their performance.</li> </ul>



## RESIGNATIONS & APPOINTMENTS IN 2017

- Resignation of Mr Damien Fernando with effect from 3rd April 2017
- Appointment of Mr Dinesh Weerakody with effect from 29th June 2017
- Four (4) Directors offer themselves for re-election at AGM on 28th March 2018, including Mr Dinesh Weerakody

ensure sufficient time to discharge their role effectively.

Appointments of new Directors are submitted to the Central Bank of Sri Lanka (CBSL) for assessment under the Fit and Proper Criteria for Directors. Appointments are limited to a maximum term of nine (9) years and an age limit of up to seventy (70) years, whichever comes first in line with the provisions of the Banking Act Directions No.11 of 2007. Appointments are thereafter communicated to the CSE and shareholders through press releases. These communications include a brief resume of the Director disclosing relevant expertise, key appointments, shareholding and independent status.

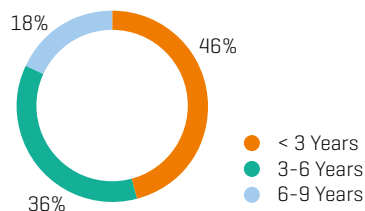
Articles of Association of the Bank require 1/3 of the Directors (other than the MD/CEO) to retire from office at each Annual General Meeting. These Directors are eligible to stand for re-election by the shareholders at the Annual General Meeting. The proposed re-election of Directors is subject to prior recommendation by the full Board. Ms Rose Cooray, Mr Palitha Pelpola and Mr Duliksha Soosaipillai will retire by rotation at the AGM under the Articles of Association of the Bank. Ms Rose Cooray, Mr Palitha Pelpola and Mr Duliksha Soosaipillai have offered themselves for re-election, with the support of the Board.

A Director appointed by the Board to fill a casual vacancy arisen since the previous AGM, will offer himself for re-election at the next AGM. Resignations or removal, if any, of Directors and the reasons are promptly informed to the regulatory authorities and shareholders as per CSE requirements together with a statement confirming whether or not there are any matters that need to be brought to the attention of shareholders.

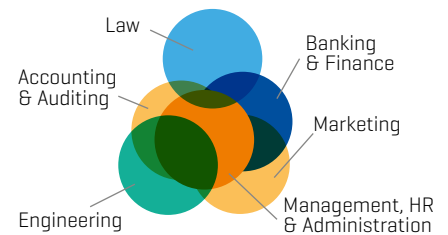
### 3.5 Other Business Commitments and Conflicts of Interests

In compliance with the Companies Act No 7 of 2007, Directors declare their outside

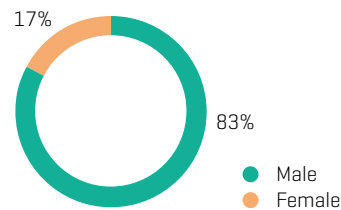
## NON-EXECUTIVE DIRECTOR TENURE



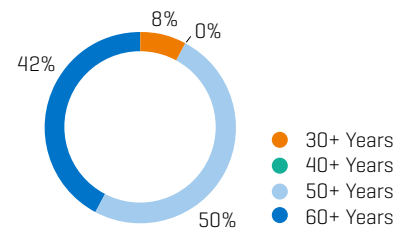
## EXPERIENCE AND EXPERTISE



## GENDER DIVERSITY



## AGE DIVERSITY



business interests at appointment and quarterly thereafter. The Company Secretary maintains a register of Directors' interests, which is tabled to the board annually. The Register is available for inspection in terms of the Companies Act. Key appointments of the Directors are included in their profiles on pages 22 to 25 in IR.

Directors do not participate in, and excuse themselves from, the meeting when the Board considers any matters in which a conflict may arise. As declared by the Directors, no relationships including financial, business, family, or any other, prevail between the Chairman, MD/CEO or amongst other Board members.

The total number of Board seats (excluding Directorship in HNB) held by each Director as at 31st December 2017 are as follows;

### Directorships in other companies

Name of Director	Directorship Status	No of Board seats held in listed companies		No of Board seats held in unlisted companies	
		Executive Capacity	Non-Executive Capacity	Executive Capacity	Non-Executive Capacity
Mr Rienzie Arseculeratne	●	-	-	-	2
Mr Jonathan Alles	●	-	1	-	4
Ms Rose Cooray	●	-	4	-	3
Dr Rohan Karunaratne	●	-	1	1	6
Mr Damien Fernando (Resigned w.e.f 3rd April 2017)	●	-	-	-	-
Mr Sujeewa Mudalige	●	-	-	-	-
Ms Sanjivani Jayawardena	●	-	1	-	13
Mr Rusi Captain	●	-	1	15	1
Mr Amal Cabraal	●	-	4	-	8
Mr Palitha Pelpola	●	-	1	-	-
Mr Duliksha Soosaipillai	●	-	3	-	-
Mr A N de Silva	●	-	1	-	1
Mr Dinesh Weerakody (Appointed w.e.f 29th June 2017)	●	-	4	-	4

● Executive Director ● Independent Non-Executive Director ● Non-Executive Director

# Corporate Governance

## 3.6 Board Access to Information and Resources

Directors have unrestricted access to Bank's Corporate/Senior management and organization information, as well as the resources required to carry out their duties and responsibilities, independently and effectively. Access to independent professional advice, coordinated through the company secretary, is available to Directors at the Bank's expense. During the year, Directors attended seminars conducted by Sri Lanka Institute of Directors and Director Forums organized by the CBSL. Members of the Corporate Management and External experts make regular presentations with regard to the business environment and in relation to the operations of the Bank.

## 3.7 Induction and Ongoing Director Training

On appointment, an induction programme is organized for the Director to familiarize with the Bank strategy, risk appetite, operational and internal controls. The newly appointed Directors are provided with a folder containing all relevant governance information, including the Bank's founding documents, charters, governance structures, significant reports, relevant legislation and policies.

The Board of Directors recognizes the need for continuous training and expansion of knowledge and undertakes such professional development as they consider necessary in assisting them to carry out their duties as Directors.

The training and continuous professional development undertaken by Directors in 2017 includes attending seminars/workshops/conferences/formal training programme, participating as speakers at events, using web based learning resources and reading regulatory updates etc.

### DIRECTOR TRAINING FOCUS AREA 2017

- Governance.
- New development in Financial Reporting.
- New regulatory pronouncements
- Taxation
- Cyber Security

## 3.8 Board Sub-Committees

The Board has established nine (9) Board Sub-Committees of which 5 are constituted under regulatory requirements while the others have been established considering the business, governance and risk management needs of the Bank. Each Sub-Committee comprises Independent Non-Executive Directors. In determining the composition of the Committees, the Board considers the skills and experience of its members, applicable regulations, and the committee mandate. The Sub-Committee Chairmen/Chairperson are accountable for the effective functioning of the committees and report to the Board on the activities of their respective Sub-Committee, highlighting matters for the Board attention. Refer Table 1: Board Sub-Committees & Areas of Oversight as at 31st December 2017.

## 3.9 Executive Management

The MD/CEO and other Key Management Personnel are accountable to the Board for the Bank's operational and financial performance.

Key Management Personnel are defined in the Sri Lanka Accounting Standards as those having authority and responsibility for planning, directing and controlling the activities of the Bank. Individual areas of authority and key responsibilities are stated in their respective job descriptions. All appointments of designated Key Management Personnel are recommended by the Nomination Committee and approved by the Board. Succession planning for Key Management Personnel is carried out by the Nomination Committee.

The Board maintains interactions with the Corporate/Senior Management who in turn assists the Board to develop structures, processes and practices that fit the Bank and its business needs. Several Executive Committees also have been established to facilitate sufficient deliberation, co-operation across department and healthy debate on matters considered critical for the Bank's operations.

## 3.10 Risk Management and Internal control

The Board is responsible for formulating and implementing appropriate and adequate processes for risk management and sound internal control systems to safeguard shareholder interests and assets of the Bank.

The Board Integrated Risk Management Committee [BIRMC] assists the Board in the discharge of duties in relation to risk management whilst the Board Audit Committee assists in the discharge of its duties with regards to internal controls. Their roles and responsibilities have been formulated with reference to the requirements of the Code of Best Practice on Corporate Governance issued jointly by the Securities & Exchange Commission of Sri Lanka [SEC] and the Institute of Chartered Accountants of Sri Lanka [CA Sri Lanka] in 2013, the Banking Act Directions No.11 of 2007 on Corporate Governance and the Bank's business needs and are provided in the committee reports given on pages 90 to 102 in IR.

The Risk Department supports the BIRMC in execution of responsibilities. A comprehensive report of how the Bank manages risk is included on pages 28 to 52 in CG&RR. The Internal Audit Department supports the Board Audit Committee, reviewing the adequacy and effectiveness of the internal control systems and reporting to the Board Audit Committee on a regular basis.

## 3.11 Board Evaluation

Goals and targets of the Board of Directors have been clearly set out and evaluated at the end of the year by the members.

Further, each member of the Board carries out a self-assessment of his / her own effectiveness as an individual as well as effectiveness of the Board as a team. The outcome of the assessment carried out in 2017 was tabled at the Board meeting held in February 2018. The Sub-Committees, except for the Board Audit Committee, carries out a self-assessment process annually, in accordance with the pre-set criteria, to ensure they function effectively and efficiently with the objective of facilitating continuous improvement individually and collectively in the performance of the Board.

The Board Audit Committee evaluation was conducted by the Non-Executive Chairman, with individual assessments from the members of the Board Audit Committee, MD / CEO, COO, CFO, and the Chief Internal Auditor, in accordance with international best practices.

## 3.12 Appraisal of MD/CEO

The Board assesses the performance of the MD/CEO annually. Assessment criteria aligned to the short, medium and long-term

**Board Sub-Committees & Areas of Oversight as at 31st December 2017**

	Board Committee	Composition of Directors	Areas of oversight	Report Reference [Page No.]
Mandatory	Board Audit Committee Constituted according to CBSL regulations	Mr Sujeewa Mudalige - (Chairman) ● Dr Rohan Karunaratne ● Mr Amal Cabraal ● Mr A N de Silva ●	» Integrity of Financial reporting and disclosures » Internal controls and audit » External audit » Compliance	IR 97-100
	Board Integrated Risk Management Committee Constituted according to CBSL regulations	Ms Rose Cooray - (Chairperson) ● Mr Jonathan Alles ● Ms Sanjivani Jayawardena ● Mr Duliksha Soosaipillai ●	» Comprehensive Risk Management Framework » Risk measurement, monitoring and management » Compliance with regulatory and internal prudential requirements » Review Basel III implementation	IR 94-96
	Nomination Committee Constituted according to CBSL regulations	Mr Rienzie Arseculeratne - (Chairman) ● Ms Rose Cooray ● Mr Rusi Captain ● Mr Palitha Pelpola ●	» Selection and appointment of Directors, MD/CEO and Key Management Personnel » Expertise gaps, Succession, and Re-Election » Board Corporate Governance	IR 92-93
	HR & Remuneration Committee Constituted according to CBSL regulations	Mr Rienzie Arseculeratne- (Chairman) ● Mr Sujeewa Mudalige ● Mr Amal Cabraal ● Mr Rusi Captain [appointed w.e.f. 15th May 2017] ●	» HR Policies including Remuneration » Organization values and code of conduct » Compliance with labour laws » HR Systems including Performance Evaluation, talent management, succession	IR 90-91
	Related Party Transactions Review Committee Constituted according to SEC/CSE requirements for listed companies	Mr A N de Silva - (Chairman) ● Mr Jonathan Alles ● Dr Rohan Karunaratne ● Mr Palitha Pelpola ●	» Related Party Transaction Policy » Scrutiny all Related Party transactions » Market disclosures on Related Party transactions » Quarterly and annual disclosures of Related Party transactions » Avoidance of conflict of interest	IR 101-102
Non-Mandatory	Board Credit Committee	Mr A N de Silva - (Chairman) ● Dr Rohan Karunaratne ● Mr Palitha Pelpola ●	» Credit policy and Lending Guidelines » Credit risk control measures including pricing of credit risk » Performance of credit risk indicators » Formulate and periodically review the credit policy. » Authorize credit facilities over and above the delegated limits of specified categories	-
	Strategy & Investment Review Committee	Mr Amal Cabraal - (Chairman) ● Ms Rose Cooray ● Mr Sujeewa Mudalige ● Mr Duliksha Soosaipillai ●	» Review of economic climate, capital markets activity and economic and monetary policy direction, emerging trends and their potential/ impact » Investment policy » Review Bank's investment portfolios and their performance	-
	Board Procurement Committee	Dr Rohan Karunaratne - (Chairman) ● Ms Sanjivani Jayawardena ● Mr Duliksha Soosaipillai ●	» Procurement policy » Approve procurements in line with delegation	-
	Committee For Disposal of Assets/Investment Properties	Ms Rose Cooray ● Mr Jonathan Alles ● Dr Rohan Karunaratne ● Ms Sanjivani Jayawardena ● Mr Sujeewa Mudalige ●	» Disposal policy » Approve disposals in line with delegation	-

● Executive Director ● Independent Non-Executive Director ● Non-Executive Director

objectives of the Bank, is agreed with the MD/ CEO at the beginning of the year. Performance is reviewed at the end of the financial year against the backdrop of the operating environment. The evaluation is discussed by Chairman with MD/CEO and responses documented prior to approval by Board as

a whole. The HRRC assists the Board in the above evaluation process

**3.13 Directors' and Executive Remuneration**

**3.13.1 Policy and Procedure**

HNB's Remuneration Policy for the Board of Directors and Key Management Personnel

seeks to motivate and reward performance while reinforcing the importance of complying with regulatory requirements, stakeholder expectations and corporate values. HRRC is responsible for making recommendations to the Board regarding the remuneration of the Executive Director and Corporate Management team within agreed terms

## CODE OF CONDUCT & ETHICS

- Act ethically, responsibly, honestly and with integrity, in the best interest of the Bank
- Safeguard Bank from fraud, corruption, collusion and coercion
- Compliance with Laws, Rules and Regulations
- Avoidance of Conflicts of Interest
- Anti-discrimination and Anti-harassment
- Anti-bribery and Anti-corruption
- Confidentiality of information
- Customer relationship

of reference and in accordance with the remuneration policies of the Bank. HRRC consists entirely of Non- Executive Directors and is led by the Chairman. The report of the HRRC is given on pages 90 to 91 in IR. MD / CEO participate at meetings when deciding the remuneration of the Corporate Management team.

### 3.13.2 Level and Make Up of Remuneration

The Board is mindful of the fact that the remuneration of Executive and the Non-Executive Directors should reflect market expectations and be sufficient to attract and retain eminent professionals as Directors. The remuneration package of the MD/CEO is structured to link rewards to corporate and individual performance. Further, the Bank's remuneration framework for the MD/CEO is designed to create and enhance value for all HNB's stakeholders and to ensure there is strong alignment between the short term and long term interest of the Bank.

The HR & Remuneration Committee in deciding the remuneration of the Directors (including the compensation package of the MD/CEO) takes into consideration the level of remuneration paid by the other comparable companies, performance and risk factors entailed in his job.

Share options were offered to the Executive Director as part of the scheme offered to Senior and Corporate Management which was approved by the shareholders of the Bank. Total remuneration of the Executive Director and Key Management Personnel are made up of two components, namely fixed remuneration and variable remuneration comprising of an annual performance bonus.

The Non-Executive Directors receive a fee in line with the market practices. Non-Executive

Directors do not participate in any share option plans of the Bank and / or other performance related incentive schemes.

The Board and the HRRC engage the services of HR professionals to assist in structuring remuneration packages and to benchmark against the market.

### 3.14 Code of Conduct and Ethics

Our values and code of ethics ensure that we do the right business in the right way, by complying with relevant laws. This is imperative to retain the trust of our stakeholders. As such, the Bank has an internally developed Code of Conduct & Ethics available in all three languages, Policy on Anti-Bribery & Corruption, Anti-harassment Policy and a Whistle Blowing Policy which applies to all employees and covers all banking operations. It is aligned to HNB values, standards, policies and procedures and addresses conduct, conflict of interest, bribery and corruption, entertainment and gifts, accurate accounting and record-keeping, corporate opportunities, confidentiality, fair dealing, protection and proper use of Bank assets, compliance with laws, rules and regulations (including insider trading laws) and encourages the reporting of any illegal or unethical behaviour. This Code is communicated to all staff members throughout the Bank. The Code of Conduct and Ethics for Directors is embodied in the Board Charter.

The Board is not aware of any material violations of any of the provisions of the Code of Conduct and Ethics by any Director or Corporate Management Member of the Bank. Please refer to Chairman's statement in CG&RR page 2 for details for affirmation that there is no violation of the code of conduct & ethics.

### 3.15 Whistleblowing

Guided by framework of the Whistleblowing policy, mechanisms are in place for employees to report concerns anonymously about unethical or unlawful behaviour in relation to possible inappropriate financial reporting, internal controls or other matters. Information on accessibility, anonymity, processes and the policy relating to the whistle-blowing is communicated to all employees. Ms. Rose Cooray, Non-Executive Director was appointed as the Director to whom staff could report any irregularities.

## 4 INTERNAL AND EXTERNAL COMMUNICATION

The Bank's External and Internal Communication Policy was reformulated in 2016 [revised in 2017] by the Board to ensure effective and timely communication of material matters to key stakeholders, fostering sustainable relationships founded on trust and integrity.

### 4.1 Constructive use of the Annual General Meeting (AGM)

The Bank recognises that engagement with shareholders is a key element of good corporate governance. The AGM is the main mechanism for shareholders' views to be heard and provides an opportunity for the Board to interact with and account to shareholders. Notice of the AGM, the Annual Report and Accounts and any other resolution together with the corresponding information that may be set before the shareholders at the AGM, are circulated to shareholders 15 days prior to the AGM. Voting procedures at the AGM are circulated to the shareholders in advance. The Bank has a mechanism to record all proxy votes which are lodged for each resolution prior to the AGM.

The Board remains mindful of being accountable to the shareholders and the need for transparency at all levels, striving to maintain its value framework in all shareholder dealings and communications. HNB proposes a separate resolution for each item of business, giving shareholders the opportunity to vote on each of such issue, separately.

At the AGM, the Board provides an update to shareholders on the Bank's performance and shareholders ask questions and vote on resolutions. It is the key forum for shareholders to engage in decision making matters reserved for the shareholders which typically include proposals to adopt the Annual Report and Accounts, appointment of Directors and auditors and other matters requiring special resolutions. The Board Chairman, Board members particularly Chairmen/Chairperson of the mandatory Sub-Committees such as Audit, BRIMC, HR & Remuneration, Nomination and RPT and Key Management Personnel and external auditor, were present and available to answer questions.

All Shareholders are encouraged to participate at the AGMs and exercise their voting rights. HNB has a history of well

attended AGMs. A total of 183 (Voting and Non Voting) shareholders attended the Annual General Meeting held in March 2017 and 82 shareholders exercised their right to vote through proxy.

#### 4.2 Communication with Shareholders

Shareholders are engaged through multiple channels of communication, including the AGM, a dedicated investor relations page on the Bank's website, press releases in 3 languages in the main newspapers, notification of key events through announcements in the CSE and regular structured meetings with the large institutional investors.

The primary modes of communication between HNB and the shareholders are the Annual Report and Annual General Meeting (AGM) or other General Meetings. Information is provided to the shareholders prior to the AGM to give them an opportunity to exercise the prerogative to raise any issues relating to the business of HNB, either verbally or in writing prior to the AGM.

The Bank will post on its website (www.hnb.net) copies of annual reports, interim reports, stock information, stock exchange announcements, shareholder circular etc. These will be posted on the website as soon as practicable after they have been released to the stock exchange.

The Bank focuses on open communication and fair disclosure, with emphasis on the integrity, timeliness and relevance of the information provided. The Bank will ensure information is communicated accurately and in such a way as to avoid the creation of a false market.

With a view of formulating clear and precious communication with all stakeholders and general public, a Corporate Communication Policy was reformulated during the year 2016 (revised in 2017). The Corporate Communication Policy is guided by the principles of efficiency, transparency, proactivity, clarity and feedback. This policy has been communicated to all staff members. Shareholders are consulted on their preference to receive the Annual Report from the Bank either by means of a CD or in hard copy form. Shareholders may at any time elect to receive the Annual Report from the Bank in printed form. Printed copies will be provided without charge.

Shareholders may, at any time, direct questions, request for publicly available information and provide comments and suggestions to Directors or Management of the Bank. Such questions, requests and comments should be addressed to the Company Secretary. The Company Secretary shall maintain a record of all correspondence received and will deliver as soon as practicable such correspondence to the Board or individual Director/s as applicable. The Board or individual Director/s, as applicable, will generate an appropriate response to all validly received shareholder correspondence and will direct the Company Secretary to send the response to the particular shareholder.

#### 4.3 Customers

A formal customer communication management process is in place including a centralized dedicated unit set up to manage and resolve customer complaints. The Unit is headed by the Customer Experience Officer. The 24 hour trilingual customer hotline is also available for handling customer complaints. Reports are reviewed by the BIRMC on a periodic basis.

#### 4.4 Staff

An open-door policy is actively pursued by the Bank Management and encouraged by the Board.

### 5 SUBSIDIARY GOVERNANCE FRAMEWORK

The Board has overall responsibility for adequate Corporate Governance across the group and ensuring that there are governance policies and mechanisms appropriate to the structure, business and risks of the group and its entities. In this light, a Group Corporate Governance Policy was formulated during the year 2016 to ensure consistent application of sound governance practices, thereby creating long-term value for the group and its stakeholders.

### 6 EXTERNAL AUDITORS

The Board Audit Committee monitors and reviews the External Auditor's independence, objectivity and the effectiveness of the audit process taking into account relevant professional and regulatory requirements.

The Committee sets out the policy for the engagement of the External Auditor to provide non-audit services, taking into account:

- » Relevant regulations with regard to the provision of non-audit services and the guidelines issued by the Central Bank of Sri Lanka.
- » The External Auditor's skills and experience for providing the particular non-audit service.
- » The nature of non-audit services, the related fee levels individually and in aggregate relative to the audit firm.

A formal Board approved policy for engagement of the external auditor to provide non audit services is in place. The Board Audit Committee has the primary responsibility for making recommendations on the appointment, re-appointment or removal of the External Auditor in-line with professional standards and regulatory requirements.

### 7 GOING CONCERN

The Board considers and assesses the Bank's status as a going concern in the preparation of the annual and interim financial statements of the Bank. In addition, the Board considers the solvency and liquidity requirements in line with the provisions of the Companies Act No 7 of 2007.

In the unlikely event, the Bank is about to become insolvent, a procedure is in place to inform the Director of Banking Supervision of same.

### 8 COMPLIANCE

The Board and individual Directors are conscious of their duty to comply with the laws, regulations, regulatory guidelines, internal controls and approved policies on all areas of business of the Bank. HNB is compliant with all material legal and statutory requirements. The Bank has implemented controls to provide reasonable assurance of its compliance, including establishment of a compliance function. This function is headed by a dedicated Compliance Officer who reports to the Board Integrated Risk Management Committee.

The Compliance Officer submits a Positive Assurance Certificate on Compliance with Mandatory Banking and Other Statutory Requirements on quarterly basis to the Board Audit Committee and the Board Integrated Risk Management Committee.

# Corporate Governance

## 9 COMPLIANCE WITH BANKING DIRECTION NO.11 OF 2007 ON CORPORATE GOVERNANCE

Section	Principle, Compliance & Implementation
3 [1]	<b>Responsibilities of the Board</b>
3 [1] (i)	<p><b>Strengthening the Safety and Soundness of the Bank</b></p> <p>The Board's responsibilities are set out in the Board Charter. The Board is accountable for the management of the affairs of the Bank and the safety and soundness of the Bank.</p>
	<p><i>a. Setting Strategic Objectives and Corporate Values</i> ✓</p> <p>The Bank's strategic objectives derived from the Vision &amp; Mission statements and its corporate values, have been determined and approved by the Board of Directors and communicated to all levels of staff. The corporate values are included in the Code of Conduct &amp; Business Ethics which is provided in hard copy forms to all new employees, available on the intranet, explained at orientation programmes and also reinforced at meetings.</p>
	<p><i>b. Approving overall Business Strategy including Risk Policy and Management</i> ✓</p> <p>The Board approved five (5) year Corporate Strategic Plan (covering the period 2016-2020), which contains measurable goals was prepared in 2015 and subsequently reviewed in 2017 incorporating internal and external developments. The strategic plan was developed by the Executive Management with the direction and guidance of the Board. The business strategy is reviewed usually on a quarterly basis by the Board with updates at Board meetings on execution of the agreed strategy. The Board approves and monitors the annual budget which is derived from Bank's strategic plan.</p> <p>The Board also approved the overall risk strategy of the Bank, determining the risk appetite, policies and risk management framework &amp; mechanisms. The corporate plan has been aligned to the overall risk strategy of the Bank, where risk appetite was considered in areas such as capital allocation and in the adoption of risk matrix to measure the risk levels. Governance and Compliance which are embedded in the Risk Management Policy Framework have also been included in the strategic plan. Further, the risk management procedures and mechanisms with time bound implementation milestones were approved and monitored by the Board Integrated Risk Management Committee [BIRMC] on a regular basis.</p>
	<p><i>c. Risk Management</i> ✓</p> <p>The Board takes overall responsibility for Risk management of the Bank. The BIRMC, is tasked with assisting the Board in structuring the Bank's Risk Policy, defining the risk appetite, identifying principal risks, setting governance structures and implementing systems to measure, monitor and manage the principal risks. The following reports provide further insights in this regard:</p> <ul style="list-style-type: none"> <li>- Risk Management Report on pages 28 to 52 in CG&amp;RR.</li> <li>- Board Integrated Risk Management Committee Report on pages 94 to 96 in IR.</li> </ul>
	<p><i>d. Communication with all Stakeholders</i> ✓</p> <p>The Board has approved a Corporate Communication Policy to ensure effective and timely communication with all stakeholders. The Corporate Communication Policy, which was reformulated in August 2016 (revised in 2017), is guided by the principles of efficiency, transparency, proactivity, clarity and feedback.</p> <p>The Bank substantially implemented the provisions of Banking Act Directions No 8 of 2011 "Customer Charter of Licensed Banks" which became effective in 2012.</p> <p>The Charter seeks to improve the quality and content in dispensing of customer service by enhancing customer protection and instilling trust and confidence in the bank whilst incorporating a set of customer obligations generated in the interest of bank stability.</p>
	<p><i>e. Internal Control System and Management Information Systems</i> ✓</p> <p>The Board reviews the adequacy and the integrity of the Bank's internal control systems and management information systems and is satisfied with same. It is assisted in this regard by the Board Audit Committee [BAC]. The BAC has reviewed reports from the Internal Audit Department in carrying out this function, together with the Management responses on the same. The findings have been reported to the Board.</p>
	<p><i>f. Key Management Personnel</i> ✓</p> <p>Key Management Personnel comprise the Corporate Management (MD/ CEO, COO, DGMs and AGMs) and the Head of Compliance as per the guideline on "Key Management Personnel in Banking Act Direction for Corporate Governance" issued by the Banking Supervision Department of CBSL. All appointments of Key Management Personnel are recommended by the Nomination Committee and approved by the Board.</p>

Section	Principle, Compliance & Implementation
	<p><i>g. Define areas of Authority and Key Responsibilities for Directors and Key Management Personnel</i> ✓</p> <p>Areas of authority and key responsibilities for the Board of Directors are set out in the Board Charter. Areas of authority and key responsibilities for Key Management Personnel are stated in their Job Descriptions as recommended by the Nomination Committee and approved by the Board. The delegated authority limits for Key Management Personnel have been approved by the Board.</p>
	<p><i>h. Oversight of affairs of the Bank by Key Management Personnel</i> ✓</p> <p>The MD/CEO and other Key Management Personnel are accountable to the Board for carrying out the Bank's activities in a safe and sound manner, in accordance with the policies set by the Board. The Board reviews the performance of the Bank against the strategic plan and receives reports from its sub-committees on matters delegated to them, through which the Board exercises oversight over the affairs of the Bank and the Key Management Personnel. Further, Key Management Personnel make regular presentations to the Board on matters under their purview and are also called in by the Board to explain matters relating to their areas.</p>
	<p><i>i. Assess effectiveness of own Governance practices</i> ✓</p> <p>The effectiveness of the Board's own governance practices, including the process for selection, nomination and election of Directors [which is explained in detail under Rule 3 [2] [ix]] and the process for management of conflict of interest [which is explained in detail under Rule 3 [1] [xii]] are reviewed by Board on a periodic basis. Implementation of changes required are being discussed and determined by the Board at the year-end through the submission of the summary of annual self-evaluations.</p>
	<p><i>j. Succession plan for Key Management Personnel</i> ✓</p> <p>The Bank has an appropriate succession plan for Key Management Personnel aligned to the Bank's strategic objectives and Talent Management Programme. The plan is guided by the policy on Succession Planning for Key Management Personnel and Directors, last reviewed in May 2017. The Nominations Committee is responsible for the formulation, review and rollout of the plan.</p>
	<p><i>k. Regular Meetings with Key Management Personnel</i> ✓</p> <p>The Board maintains a sound relationship with the Corporate/Senior management led by the MD/CEO, who in turn assists the Board to formulate policies, strategies, processes and practices that fit the Bank and its business needs in achieving corporate objectives. The management is open and transparent with the Board, bringing all significant matters to its attention. Key Management Personnel are regularly invited to attend Board and Sub-Committee meetings for discussion on matters concerning their areas of responsibility, or make presentations on key agenda items.</p>
	<p><i>l. Regulatory environment and maintaining an effective relationship with regulator</i> ✓</p> <p>On appointment, Directors are provided with a folder containing all relevant governance information, including regulatory laws, directions and guidelines. Directors are briefed about regulatory developments at Board and Sub-Committee Meetings by Key Management Personnel including the Heads of Internal Audit, Risk and Compliance and by attending Director Forums arranged by the Central Bank of Sri Lanka [CBSL]. Further, Board members regularly meet with CBSL officials to discuss strategic matters specific to the Bank, maintaining an effective relationship with the regulator.</p>
	<p><i>m. Hiring and oversight of external Auditors</i> ✓</p> <p>The External Auditor is appointed following the procedures set out in Article 53 [iv] of the Articles of Association. The Board Audit Committee makes recommendations to the Board for the appointment, re-appointment or removal of the External Auditor in-line with professional &amp; ethical standards and regulatory requirements.</p> <p>A policy for Engagement of the External Auditor to provide Non-Audit Services is in place, as reviewed and recommended by the Board Audit Committee.</p> <p>On the recommendation of the Board, the shareholders approved the reappointment of Messrs Ernest &amp; Young [Chartered Accountants] as the External Auditor of the Bank, at the last AGM.</p> <p>In compliance with Section 163 [3] of the Companies Act No. 07 of 2007, the External Auditors submit a statement annually confirming their independence in relation to the external audit.</p>
3 [1] (ii)	<p><b>Appointment of Chairman and CEO and defining and approving their functions and responsibilities</b> ✓</p> <p>The Board has appointed the Chairman and the MD/CEO. Their roles and responsibilities are separate and set out clearly in the Board Charter, ensuring a balance of power and authority and preventing unfettered power being vested with an individual. These functions and responsibilities are in line with Direction 3(5) of the said Direction.</p>

# Corporate Governance

Section	Principle, Compliance & Implementation
3 [1] (iii)	<p><b>Regular Board Meetings</b> ✓</p> <p>Monthly Board meetings are held regularly and special meetings are scheduled based on need. Seventeen (17) Board meetings were held in 2017. Directors actively participate in the meetings deliberating on matters set before the Board. Attendance at Board meetings is given in CG&amp;RR page 5.</p> <p>Urgent Board papers are approved via circular resolution only on an exceptional basis, where such resolutions are ratified by the Board at the next meeting. 554 credit papers were approved in 2017, via circulation.</p>
3 [1] (iv)	<p><b>Arrangements for Directors to include proposals in the agenda</b> ✓</p> <p>The Board Calendar with tentative dates for Board and subcommittee meetings for the following year is sent to all members approximately 2-3 months before the end of the current year. The Chairman sets the Board agenda assisted by the Company Secretary. Directors may submit proposals for inclusion in the agenda on discussion with the Chairman.</p>
3.1 (v)	<p><b>Notice of Meetings</b> ✓</p> <p>Notice of Meetings, agenda and board papers for the meetings are sent 7 days before the meeting, giving the members sufficient time to attend the meeting and study the documents. Urgent Board papers are included on an exceptional basis, with the consent from the Chairman.</p>
3 [1] (vi)	<p><b>Directors Attendance</b> ✓</p> <p>At appointment, all Directors are apprised of the regulations on attendance. Attendance at Board meetings is given in CG&amp;RR page 5. All Directors have attended at least two thirds (2/3) of Board meetings held during 2017, the lowest attendance being ten (10) Directors at a meeting (including attendance of an alternate Director). No Director has been absent from three consecutive meetings during 2017.</p>
3 [1] (vii)	<p><b>Appointment and setting responsibilities of the Company Secretary</b> ✓</p> <p>The Board has appointed a Company Secretary, an Attorney at Law, who satisfies the provisions of Section 43 of the Banking Act No.30 of 1988. The Company Secretary guides the Board on discharging its duties and responsibilities, facilitates adherence to best practices in Corporate Governance and apprises the Board of relevant legislative and regulatory changes.</p>
3 [1] (viii)	<p><b>Directors access to advice and services of Company Secretary</b> ✓</p> <p>All Board members have full access, to the advice and services of the Company Secretary to ensure that proper Board procedures are followed and all applicable rules and regulations are complied with.</p>
3 [1] (ix)	<p><b>Maintenance of Board Minutes</b> ✓</p> <p>Company Secretary maintains the minutes of the Board meetings. The minutes are circulated to all Board members after being reviewed by the Chairman and are approved at the next Board Meeting upon incorporating any amendments proposed by other Directors. The minute book is maintained by the Company Secretary and opens for inspection by any Director, at any time.</p>
3 [1] (x)	<p><b>Minutes to be of sufficient detail and serve as a reference for regulators and supervisory authorities</b> ✓</p> <p>Minutes of Board meetings are recorded in sufficient detail to reflect that the Board acted with due care and prudence in performing its duties and to serve as a reference for regulatory and supervisory authorities to assess the depth of deliberations at the Board meetings.</p>
3 [1] (xi)	<p><b>Directors ability to seek independent professional advice</b> ✓</p> <p>Procedures are in place to allow Directors to seek independent professional advice, as and when necessary and at the Bank's expense, in discharging their duties and responsibilities. This facility is coordinated through the Company Secretary.</p>
3 [1] (xii)	<p><b>Dealing with Conflicts of Interest</b> ✓</p> <p>Article 40 of Articles of Association addresses the provision with regard to this requirement. The Board is conscious of its obligations to ensure that Directors avoid conflicts of interest (both real and apparent) between their duty to HNB and their other interests. The Board has taken steps to ensure that conflicts and potential conflicts of interest of Directors are disclosed to the Board. Any Director with a material personal interest in a matter being considered by the Board declares his/her interest and unless the Board resolves otherwise, he/she does not participate in discussions or vote on that specific matter. The Directors declare their interests at appointment and thereafter on a quarterly basis.</p>
3 [1] (xiii)	<p><b>Formal schedule of matters</b> ✓</p> <p>The Board reserves for itself a formal schedule of matters on which it takes the ultimate decision.</p>



Section	Principle, Compliance & Implementation
3 (1) [xiv]	<p><b>Inform Central Bank if there are solvency issues</b> ✓</p> <p>The Bank is solvent.</p> <p>In the unlikely event, the Bank is about to become insolvent, a procedure is however in place to inform the Director of Banking Supervision of same, prior to taking any decision or action to suspend payments due to depositors and other creditors.</p>
3 (1) [xv]	<p><b>Capital adequacy</b> ✓</p> <p>The Board monitors capital adequacy and other prudential measures to manage risk and to ensure compliance with regulatory requirements. The Bank is in compliance with the minimum capital requirements of the Monetary Board.</p>
3 (1) [xvi]	<p><b>Publish Corporate Governance Report in Annual Report</b> ✓</p> <p>This report forms part of the Corporate Governance Report of the Bank which is set out on pages 12 to 24 in CG&amp;RR.</p>
3 (1) [xvii]	<p><b>Self-assessment of Directors</b> ✓</p> <p>Each Board member undertakes annually, a self-assessment of his/her own effectiveness as an individual as well as the effectiveness of the Board as a whole. The last appraisal was carried out on 20th February 2018.</p>
<b>3 (2)</b>	<b>The Board's Composition</b>
3 (2) [i]	<p><b>Number of Directors</b> ✓</p> <p>The Board consists of 12 Directors, compliant with CBSL direction which requires the number of Directors to be not less than 07 and not more than 13.</p>
3 (2) [ii]	<p><b>Period of service of a Director</b> ✓</p> <p>The total period of service of all Non-Executive Directors does not exceed nine (9) years as required by the CBSL direction. Tenures of service of Directors are given in CG&amp;RR page 7.</p>
3 (2) [iii]	<p><b>Director Appointment of an employee as a Director</b> ✓</p> <p>The single Executive Director is the MD/CEO. Board balance is compliant with the CBSL direction which limits the number of Executive Directors to 1/3 of the Board.</p>
3 (2) [iv]	<p><b>Independent Non-Executive Directors</b> ✓</p> <p>The Board comprises seven (7) Independent Non-Executive Directors, in excess of the regulatory requirement. The Directors satisfy the criteria for determining independence, which is reviewed annually by the Board based on self-declaration forms submitted by the Directors.</p>
3 (2) [v]	<p><b>Alternate Independent Directors</b> ✓</p> <p>During the year, all alternate Directors appointed to represent Independent Non-Executive Directors were independent.</p>
3 (2) [vi]	<p><b>Criteria for Non-Executive Directors</b> ✓</p> <p>All Non-Executive Directors are eminent professionals in their respective fields, with credible track records and necessary skills and experience. They contribute diverse perspective to matters set before the Board, bringing independent judgment to bear on issues of strategy, performance and resources.</p>
3 (2) [vii]	<p><b>More than half the quorum to comprise Non-Executive Directors</b> ✓</p> <p>Complied with, given the majority of the Board are Non-Executive Directors.</p>
3 (2) [viii]	<p><b>Identify independent Non-Executive Directors in corporate communications and disclose categories of Directors in the Annual Report</b> ✓</p> <p>The independent Non-Executive Directors are expressly identified in all corporate communications that disclose the names of Directors of the Bank. Composition and details of the Board are given in CG&amp;RR page 5.</p>
3 (2) [ix]	<p><b>Formal and transparent procedure for appointments to the Board</b> ✓</p> <p>The Nomination Committee assesses the suitability of the prospective nominees to the Board and recommends persons found to be "fit and proper" for consideration of the entire Board. Upon completion of this process, names are referred to the Director of the Bank Supervision Department of the Central Bank of Sri Lanka for approval as a "fit and proper" person, prior to the appointment. Mr Dinesh Weerakkody was appointed to the Board during 2017.</p>

# Corporate Governance

Section	Principle, Compliance & Implementation
3 (2) (x)	<p><b>Re-election of Directors filling casual vacancies</b> ✓</p> <p>All Directors appointed to the Board are subjected to re-election by shareholders at the first Annual General Meeting after their appointment.</p> <p>Mr Dinesh Weerakkody who was appointed to the Board in July 2017 to fill the casual vacancy created by the resignation of Mr Damien Fernando, will offer himself for re-election at the AGM to be held in March 2018.</p>
3 (2) (xi)	<p><b>Communication of reasons for removal or resignation of Director</b> ✓</p> <p>Resignations of Directors and the reasons are promptly informed to the regulatory authorities and shareholders in compliance with the CSE regulations together with a statement confirming whether or not there are any matters that need to be brought to the attention of shareholders.</p>
3 (2) (xii)	<p><b>Prohibition of Directors or Employees of a Bank becoming a director at another bank</b> ✓</p> <p>None of the Directors are directors or employees of any other Bank. This is a requirement when seeking appointments of Directors.</p>
<b>3 (3)</b>	<b>Criteria to assess fitness and propriety of Directors</b>
3 (3)(i)	<p><b>Age of Director should not exceed 70</b> ✓</p> <p>There are no Directors who are over 70 years of age.</p>
3 (3)(ii)	<p><b>Directors should not be Directors of more than 20 companies and not more than 10 companies classified as Specified Business Entities</b> ✓</p> <p>The Directors do not hold directorships of more than 20 companies/entities/institutions inclusive of Subsidiaries or Associate Companies of the Bank.</p>
<b>3 (4)</b>	<b>Management Functions delegated by the Board</b>
3 (4) (i)	<b>Understand and study delegation arrangements</b> ✓
3 (4) (ii)	<b>Extent of delegation should not hinder Board's ability to discharge its functions</b> ✓
3 (4) (iii)	<b>Review delegation arrangements periodically to ensure relevance to operations of the Bank</b> ✓
	The Board has a clear understanding of the delegation arrangements, studying, reviewing and approving the extent of delegation annually to ensure it meets the business needs of the Bank whilst enabling the Board to effectively discharge their duties.
<b>3 (5)</b>	<b>The Chairman and Chief Executive Officer</b>
3 (5) (i)	<p><b>Separation of roles</b> ✓</p> <p>There is a clear separation of roles of the Chairman and the MD/CEO, ensuring a balance of power for decision-making.</p>
3 (5) (ii)	<p><b>Non-Executive Chairman and appointment of a Senior Independent Director</b> ✓</p> <p>The Chairman is an independent Non-Executive Director; as such there is no requirement to appoint a Senior Independent Director.</p>
3 (5) (iii)	<p><b>Disclosure of identity of Chairman and CEO and any relationships with the Board members</b> ✓</p> <p>The profiles of the Chairman and CEO are disclosed in IR page 22.</p> <p>As declared by the Directors, no relationships including financial, business, family, or any other, prevail between the Chairman, MD/CEO or amongst other Board members.</p>
3 (5) (iv)	<p><b>Role of the Chairman</b> ✓</p> <p>The Chairman leads the Board ensuring that it works effectively, and acts in the best interest of the Bank on a timely basis. The effectiveness of the Chairman in the discharge of the Board functions is assessed annually by Board and in his/her self-assessment.</p>
3 (5) (v)	<p><b>Responsibility for agenda lies with Chairman but may be delegated to Company Secretary</b> ✓</p> <p>The Chairman approves the Board agenda, prepared by the Company Secretary.</p>
3 (5) (vi)	<p><b>Ensure that Directors are properly briefed and provided adequate information</b> ✓</p> <p>The Chairman ensures that the Board is sufficiently briefed and informed regarding the matters arising at Board.</p> <p>Board papers are circulated minimum 7 days prior to meeting, giving the members adequate time to study the documents. Directors have access to Key Management Personnel to clarify matters and to external specialists for independent advice, when required.</p>

Section	Principle, Compliance & Implementation																														
3 (5) (vii)	<p><b>Encourage active participation by all Directors and lead in acting in the interests of the Bank</b> ✓</p> <p>The Chairman has encouraged all Directors to actively contribute towards the best interests of the Bank.</p>																														
3 (5) (viii)	<p><b>Encourage participation of Non-Executive Directors and relationships between Non-Executive and Executive Directors</b> ✓</p> <p>The Chairman has encouraged effective participation of all Directors and has encouraged constructive relations between the MD/CEO and the Non-Executive Directors. This function is assessed annually by the Board and by the Chairman in his self-assessment</p>																														
3 (5) (ix)	<p><b>Refrain from direct supervision of Key Management Personnel and Executive duties</b> ✓</p> <p>The Chairman does not get involved in the supervision of Key Management Personnel or any other executive duties.</p>																														
3 (5) (x)	<p><b>Ensure effective communication with shareholders</b> ✓</p> <p>The Annual General Meeting (AGM) is the main mechanism for shareholders' views to be heard and where the Board interacts with and clarifies matter for the shareholders. The Board formulated a formal policy to handle shareholders complaints.</p>																														
3 (5)(xi)	<p><b>CEO functions as the apex executive in charge of the day to day operations and Business</b> ✓</p> <p>As set out in the Board Charter, the responsibility for the day to day operations and business of the Bank has been delegated to the MD/CEO in his capacity as the apex executive-in-charge.</p>																														
<b>3.6</b>	<b>Board appointed committees</b>																														
3 (6) (i)	<p><b>Establishing Board committees, their functions and reporting</b> ✓</p> <p>The Board has appointed nine (9) Sub-Committees as follows, to ensure its oversight and control over the affairs of the bank.</p> <table border="1"> <thead> <tr> <th>Committee</th> <th>Requirement</th> <th>Report Reference [Page No.]</th> </tr> </thead> <tbody> <tr> <td>Board Audit Committee</td> <td>Mandatory under the CBSL direction</td> <td>IR 97-100</td> </tr> <tr> <td>Human Resources &amp; Remuneration Committee</td> <td>Mandatory under the CBSL direction</td> <td>IR 90-91</td> </tr> <tr> <td>Nomination Committee</td> <td>Mandatory under the CBSL direction</td> <td>IR 92-93</td> </tr> <tr> <td>Board Integrated Risk Management Committee</td> <td>Mandatory under the CBSL direction</td> <td>IR 94-96</td> </tr> <tr> <td>Related Party Transactions Review Committee</td> <td>Prescribed by the Code of Best Practices on Related Party Transactions issued by the SEC</td> <td>IR 101-102</td> </tr> <tr> <td>Strategy &amp; Investment Review Committee</td> <td>To meet the business needs of the Bank</td> <td>-</td> </tr> <tr> <td>Board Procurement Committee</td> <td>To meet the business needs of the Bank</td> <td>-</td> </tr> <tr> <td>Board Credit Committee</td> <td>To meet the business needs of the Bank</td> <td>-</td> </tr> <tr> <td>Committee for Disposal of Assets/Investment Properties</td> <td>To meet the business needs of the Bank</td> <td>-</td> </tr> </tbody> </table> <p>Each Sub-Committee is governed by its own terms of reference and has a Secretary who arranges the meetings and maintains minutes and records under the supervision of the Chairman/Chairperson of the Sub-Committee. The Sub-Committee Chairmen/Chairperson are accountable for the effective functioning of the committees and reports on a periodic basis to the Board on the activities of their respective Sub-Committee, highlighting matters for Board attention. Committee mandates are reviewed regularly.</p>	Committee	Requirement	Report Reference [Page No.]	Board Audit Committee	Mandatory under the CBSL direction	IR 97-100	Human Resources & Remuneration Committee	Mandatory under the CBSL direction	IR 90-91	Nomination Committee	Mandatory under the CBSL direction	IR 92-93	Board Integrated Risk Management Committee	Mandatory under the CBSL direction	IR 94-96	Related Party Transactions Review Committee	Prescribed by the Code of Best Practices on Related Party Transactions issued by the SEC	IR 101-102	Strategy & Investment Review Committee	To meet the business needs of the Bank	-	Board Procurement Committee	To meet the business needs of the Bank	-	Board Credit Committee	To meet the business needs of the Bank	-	Committee for Disposal of Assets/Investment Properties	To meet the business needs of the Bank	-
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<b>3 (6) (ii)</b>	<b>Board Audit Committee</b>																														
	<p><b>a. Chairman to be an Independent Non-Executive Director with qualifications and experience in accountancy and/or audit</b> ✓</p> <p>Mr Sujeewa Mudalige is an Independent Non-Executive Director. A senior practicing Chartered Accountant, he is a Fellow of the Institute of Chartered Accountants of Sri Lanka, Fellow of the Chartered Institute of Management Accountants(UK), Fellow of the Association of Chartered Certified Accountants (UK) and Fellow of the Certified Public Accountants (Australia).</p> <p>He holds over 25 years extensive experience in public accounting practice and has the required skills and experience to function effectively in the capacity of Chairman.</p>																														
	<p><b>b. Committee to comprise solely of Non-Executive Directors</b> ✓</p> <p>All members are Independent Non-Executive Directors.</p>																														

# Corporate Governance

Section	Principle, Compliance & Implementation
	<p><b>c. Board Audit Committee functions</b> ✓</p> <p>In terms of its mandate, the Board Audit Committee is responsible for the following key recommendations:</p> <ol style="list-style-type: none"> <li>i. the appointment of the external auditor for audit services in line with professional and ethical standards and in compliance with regulatory requirements. On the recommendation of the Board Audit Committee/Board, the shareholders have approved the reappointment of Messrs. Ernst &amp; Young (Chartered Accountants) as the External Auditor of the Bank for the year 2017;</li> <li>ii. the service period, audit fee and any resignation or dismissal of the auditor. The Board Audit Committee ensures that the service period of the engagement of the External Audit partner shall not exceed five years, and that the particular audit partner is not re-engaged for the audit before the expiry of three years from the date of the completion of the previous term;</li> <li>iii. the implementation of the Central Bank guidelines issued to auditors from time to time;</li> <li>iv. monitoring and review of the adequacy and effectiveness of accounting policies and the application of relevant accounting standards</li> </ol>
	<p><b>d. Review and monitor external auditor's independence and objectivity and the effectiveness of the audit processes</b> ✓</p> <p>The Board Audit Committee monitors and reviews the External Auditor's independence, objectivity and the effectiveness of the audit process taking into account relevant professional and regulatory requirements.</p>
	<p><b>e. Provision of non-audit services by external auditor</b> ✓</p> <p>The Board is guided by the policy for Engagement of the External Auditor to Provide Non-Audit Services, as reviewed and recommended by the Board Audit Committee.</p> <p>In assignment of non-audit services to External Auditors by the Bank, the Board/Board Audit Committee ensures that the external auditor has the necessary skills and experience for the assignment, and ascertains that independence and/or objectivity of the External Auditor in carrying out his duties and responsibilities will not be impaired. Assigning such non-audit services to External Auditors is discussed at BAC meetings and prior approval obtained.</p> <p>Please refer CG&amp;RR page 11 for further details.</p>
	<p><b>f. Determine the nature and scope of audit</b> ✓</p> <p>The Committee met with the External Auditor three (3) times during the year to discuss their audit approach and procedures including matters relating to the scope of the audit and auditor's independence</p>
	<p><b>g. Review financial information of the Bank</b> ✓</p> <p>The Committee reviews the financial information of the Bank, in order to monitor the integrity of the financial statements of the Bank, its annual report, accounts and quarterly reports prepared for disclosure, and the significant financial reporting judgments contained therein. The review focuses particularly on the following:</p> <ol style="list-style-type: none"> <li>(i) major judgmental areas</li> <li>(ii) any changes in accounting policies and practices</li> <li>(iii) significant adjustments arising from the audit</li> <li>(iv) the going concern assumption</li> <li>(v) Compliance with relevant accounting standards and other legal requirements.</li> </ol>
	<p><b>h. Discussions with External Auditor on interim and final audits</b> ✓</p> <p>The Board Audit Committee discusses issues, problems and reservations arising from the interim and annual audits with the external auditor. The Committee met the External Auditor on two (2) occasions in 2017, in the absence of the MD/CEO and Key Management Personnel.</p>
	<p><b>i. Review of Management Letter and management response</b> ✓</p> <p>The Board Audit Committee reviewed the external auditor's management letter for the 2017 Audit and the management's response thereto.</p>

Section	Principle, Compliance & Implementation
	<p><b>j. Review of Internal Audit function</b> ✓</p> <p>During the year, the Board Audit Committee reviewed the independence, objectivity and performance of the Internal Audit Function. The findings of the internal audits completed during the year and the Internal Audit Department's evaluation of the Bank's internal controls were reviewed by the Board Audit Committee.</p> <p>The Board Audit Committee also reviewed the adequacy of coverage of the internal audit plan and approved the same. It also assessed the Department's resource requirements including succession planning. The Committee reviewed the performance appraisal of the Chief Internal Auditor and other senior staff members of the Internal Audit Department. Committee has also considered major findings of internal investigations and management's responses thereto.</p> <p>The Chief Internal Auditor directly reports to the Board Audit Committee, thus ensuring the independence of the Internal Audit function.</p> <p><b>k. Internal Investigations</b> ✓</p> <p>Major findings of internal investigations and management's responses thereto are reviewed by the Board Audit Committee.</p> <p><b>l. Attendees at Board Audit Committee Meetings</b> ✓</p> <p>MD/CEO, COO, Chief Risk Officer, Chief Financial Officer, Chief Internal Auditor, Head of Compliance and a representative of the External Auditor are typically invited to attend meetings. Other Board members may also attend meetings upon invitation.</p>
	<p><b>m. Explicit authority, resources and access to information</b> ✓</p> <p>The Board Audit Committee is guided by the Committee Charter which sets out authority and responsibility of the said Committee. The Charter was reviewed in January 2018. The Board Audit Committee is authorised to obtain external professional advice and to invite outsiders with relevant experience to attend as and when necessary. The Committee also has full access to information in order to investigate into matters relating its terms of reference.</p> <p><b>n. Regular Meetings</b> ✓</p> <p>The Board Audit Committee met seven (7) times during the year. Conclusions in discharging its duties and responsibilities are recorded in the Minutes of the meetings.</p> <p><b>o. Disclosure in Annual Report</b> ✓</p> <p>Details of the activities of the Board Audit Committee are given in the Report of the Board Audit Committee on pages 97 to 100 in IR. The number of meetings held and attendance at Board Audit Committee meetings held in 2017 are set out in CG&amp;RR page 5.</p> <p><b>p. Maintain Minutes of meetings</b> ✓</p> <p>The Company Secretary serves as the Secretary for the Board Audit Committee and records and maintains minutes of the committee meetings.</p> <p><b>q. Process by which employees raise concerns in confidence</b> ✓</p> <p>A Board approved whistleblowing policy is in place. The whistleblowing policy and the mechanism had been communicated to all staff members.</p> <p>The Board Audit Committee reviews issues relating to breach of ethics if any and the arrangements by which the staff of the Bank may in confidence raise concerns about possible improprieties. The Committee also ensured that the procedures for the independent investigations of such matters are appropriate and are in place.</p> <p>The Board Charter addresses the Board's responsibility to encourage any communication regarding non compliances and unethical behaviour within the Bank.</p>
<b>3 [6] [iii]</b>	<b>Human Resources &amp; Remuneration Committee</b>
	<p><b>a. Remuneration Policy</b> ✓</p> <p>The Committee reviews all significant human resource policies and initiatives, salary structures, promotions and terms and conditions relating to staff at corporate/senior management level with information and recommendations from the MD / CEO and the Chief Human Resource Officer.</p> <p>A Remuneration Policy for the Board of Directors is in place. The HR &amp; Remuneration Committee had also put in place a remuneration policy for all employees of the Bank. In addition a specific remuneration policies for the MD / CEO and Key Management Personnel are currently in place.</p>

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	<p><b>b. Goals and Targets</b> ✓</p> <p>The goals and targets of the Board of Directors have been clearly set out and evaluated at the end of the year. The goals and targets for the MD/CEO and the senior leadership team are documented under the Competency Model Framework.</p> <p><b>c. Performance Evaluation</b> ✓</p> <p>The Directors are evaluated at the end of the year based on the goals and targets set out. The Committee deliberates upon and recommends to the Board of Directors the remuneration packages, annual increments and bonuses of the MD/CEO, COO, members of the Corporate Management and Senior Management, having evaluated their performance against the set goals and targets.</p> <p><b>d. Meetings</b> ✓</p> <p>The Committee met seven (7) times during the year. The MD/CEO attends Human Resources &amp; Remuneration Committee by invitation. The MD/CEO was not present at the time his performance was discussed and evaluated.</p>
<b>3 [6] [iv]</b>	<b>Nomination Committee</b>
	<p><b>a. Appointment of Directors, CEO and Key Management Personnel</b> ✓</p> <p>A formal procedure is in place to appoint new Directors, MD/CEO and Key Management Personnel.</p>
	<p><b>b. Re-election of Directors</b> ✓</p> <p>The Committee considers and recommends the re-election of the Directors to the Board. The Committee also set criteria of the succession of the MD/CEO.</p>
	<p><b>c. Eligibility criteria for appointments to key managerial positions including CEO</b> ✓</p> <p>The Committee sets the eligibility criteria, including qualifications, experience and key attributes, for appointment or promotion to key managerial positions including the position of the MD/CEO.</p> <p>A Board approved procedure to appoint Directors, MD/CEO and Key Management Personnel and is in place.</p> <p>Job descriptions of the newly appointed Key Management Personnel of the Bank were reviewed by Nomination Committee during the year.</p>
	<p><b>d. Fit &amp; Proper persons</b> ✓</p> <p>Each Director including the MD/CEO carries out an assessment of “fitness and propriety” to serve as a Director of the Bank. These declarations reviewed by the Nomination Committee prior to onward transmission to the Director Bank Supervision of the Central Bank of Sri Lanka.</p>
	<p><b>e. Succession Plan and new expertise</b> ✓</p> <p>A Succession Planning Policy for Key Management Personnel and Directors was approved by the Board in 2016.</p> <p>In line with the Strategic plan, each year, the Nomination Committee reviews the additional/new expertise requirements and succession arrangements for Directors and Key Management Personnel of the Bank.</p>
	<p><b>f. Composition of Nomination Committee</b> ✓</p> <p>The following Non-Executive Directors served on the Nomination Committee during 2017</p> <p>Mr Rienzie Arseculeratne - Independent Non-Executive Director</p> <p>Ms Rose Cooray- Non- Executive Director</p> <p>Mr Rusi Captain - Non- Executive Director</p> <p>Mr Palitha Pelpola - Independent Non-Executive Director</p> <p>Mr Rienzie Arseculeratne serves as the Chairperson of the above Committee.</p>

Section	Principle, Compliance & Implementation
3 [6] [v]	Board Integrated Risk Management Committee
	<p><b>a. Composition of Risk Management Committee</b> ✓</p> <p>The following personnel served on the Board Integrated Risk Management Committee during 2017.</p> <p>Ms Rose Cooray - Non Executive Director</p> <p>Mr Jonathan Alles - Managing Director / CEO</p> <p>Mr Damien Fernando - Non Executive Director [resigned w.e.f. 3rd April 2017]</p> <p>Ms Sanjivani Jayawardena - Non Executive Director</p> <p>Mr Duliksha Soosaipillai - Independent Non-Executive Director</p> <p>Mr Damith Pallewatte - Chief Risk Officer /AGM - Risk /CISO</p> <p>Ms Mohini Seneviratne - Head of Compliance</p> <p>The COO, CFO, Chief Digital Officer and Chief Internal Auditor attend meetings on invitation.</p> <p>Ms Rose Cooray serves as the Chairperson of the above Committee.</p>
	<p><b>b. Risk Assessment</b> ✓</p> <p>Policies on Credit Risk Management, Market Risk Management and Operational Risk Management have been approved by the committee, providing a framework for management and assessment of risks. In discharging its responsibilities further as per the mandate, periodic reports on pre-established risk indicators prepared by the Risk Department is submitted to the Committee for review.</p>
	<p><b>c. Review of adequacy and effectiveness management level committees on risk</b> ✓</p> <p>The Committee reviews the reports of the management committees including the Asset and Liability Committee [ALCO] and the Credit Policy Committee to assess their adequacy and effectiveness in addressing specific risks and managing the same within the quantitative and qualitative risk limits set in the Risk Appetite Statement approved by the Board.</p>
	<p><b>d. Corrective action to mitigate risks exceeding prudential levels</b> ✓</p> <p>The Risk Dashboards, prepared on a periodic basis, reflects the actual exposure levels under each risk category against the tolerance levels, decided by the Committee on the basis of the Bank's policies and regulatory and supervisory requirements. The Committee has taken prompt corrective actions to mitigate the effects of risk indicators which have gone beyond the tolerance levels.</p>
	<p><b>e. Frequency of meetings</b> ✓</p> <p>The Committee has met nine [9] times during the year. The agenda covers matters assessing all aspects of risk management including the updated business continuity plans.</p>
	<p><b>f. Actions against officers responsible for failure to identify specific risks or implement corrective action</b> ✓</p> <p>Such matters, if any, are referred to the Human Resources Division for necessary action.</p>
	<p><b>g. Risk assessment report to Board</b> ✓</p> <p>Detailed reports of the BIRMC meetings are submitted to the Board at the subsequent Board meeting.</p>
	<p><b>h. Compliance function</b> ✓</p> <p>The Bank has established a compliance function to assess and ensure the Bank's compliance with laws, regulations, regulatory guidelines, internal controls and approved policies on all areas of business operations, headed by a dedicated Compliance Officer who reports to the BIRMC.</p>

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Section	Principle, Compliance & Implementation
3 [7]	<b>Related Party Transactions</b>
3 [7] (i)	<p><b>Avoid conflict of interest</b> ✓</p> <p>A Board approved policy to enhance the transparency of Related Party Transactions is in place.</p> <p>Steps have been taken by the Board to avoid any conflicts of interest, that may arise, in transacting with related parties as per the definition of this Direction.</p> <p>The Directors provide declarations to the Board of their outside business interests at appointment and quarterly thereafter. The Directors do not participate in, and excuse themselves from, the meeting when the Board considers any matters in which lending to related entities are discussed and where a conflict in interest may arise.</p> <p>Transactions carried out with related parties as defined by LKAS 24 on 'Related Party Disclosures' in the normal course of business are disclosed in Note 17 to the Financial Statements on 'Related Party Disclosures' in IR page 165.</p> <p>Directors' interest in contracts which do not fall into the definition of Related Party Transactions as per LKAS 24 are reported separately in the Annual Report, outside the Financial Statements. The net accommodation granted to each category of related parties as a percentage of the Bank's regulatory capital is given under Rule 3 [8] (ii) [e].</p>
3 [7] (ii)	<p><b>Related Party Transactions covered by direction</b> ✓</p> <p>The Related Party Transactions Policy approved by the Board covers the following transactions:</p> <ol style="list-style-type: none"> <li>The grant of any type of accommodation, as defined in the Monetary Board's Directions on maximum amount of accommodation,</li> <li>The creation of any liabilities of the bank in the form of deposits, borrowings and investments,</li> <li>The provision of any services of a financial or non-financial nature provided to the Bank or received from the Bank,</li> <li>The creation or maintenance of reporting lines and information flows between the bank and any related parties which may lead to the sharing of potentially proprietary, confidential or otherwise sensitive information that may give benefits to such related parties.</li> </ol>
3 [7] (iii)	<p><b>Prohibited transactions</b> ✓</p> <p>The Bank's Related Party Transactions policy prohibits transactions which would grant related parties more favourable treatment than that accorded to other customers. These include the following:</p> <ol style="list-style-type: none"> <li>Granting of "total net accommodation" to related parties, exceeding a prudent percentage of the bank's regulatory capital. Please refer Rule 3 [8] (ii) [e] in CG&amp;RR page 23.</li> <li>Charging of a lower rate of interest than the bank's best lending rate or paying more than the bank's deposit rate for a comparable transaction with an unrelated comparable counterparty;</li> <li>Providing of preferential treatment, such as favourable terms, covering trade losses and/or waiving fees/commissions, that extend beyond the terms granted in the normal course of business undertaken with unrelated parties;</li> <li>Providing services to or receiving services from a related-party without an evaluation procedure;</li> <li>Maintaining reporting lines and information flows that may lead to sharing potentially proprietary, confidential or otherwise sensitive information with related parties, except as required for the performance of legitimate duties and functions.</li> </ol>
3 [7] (iv)	<p><b>Granting accommodation Director or close relation to a Director</b> ✓</p> <p>A formal procedure is in place for granting accommodation to Directors or to close relatives of Directors. Such accommodation must be sanctioned at Board meetings, by not less than 2/3 of the number of Directors excluding Director concerned, voting in favour of such accommodation or through circulation of papers which requires approval by all. The terms and conditions of the facility include a provision that it will be secured by such security as may from time to time be determined by the Monetary Board.</p>
3 [7] (v)	<p><b>Accommodations granted to persons, or concerns of persons, or close relations of persons, who subsequently are appointed as Directors of the Bank</b> ✓</p> <p>As at the Balance Sheet date accommodations granted to the newly appointed Director was within the exemption period of one year allowed by CBSL for providing approved security.</p>
3 [7] (vi)	<p><b>Favourable treatment or accommodation to bank employees or their close relations</b> ✓</p> <p>No favourable treatment or accommodation is provided to Bank employees or their relatives, other than staff benefits.</p>



Section	Principle, Compliance & Implementation																					
3 [7] (vii)	<p><b>Remittance of accommodations subject to Monetary Board approval</b> <input checked="" type="checkbox"/></p> <p>No such situation has arisen during the year.</p>																					
<b>3 [8]</b>	<b>Disclosures</b>																					
3 [8] (i)	<p><b>Publish annual and Quarterly Financial Statements</b> <input checked="" type="checkbox"/></p> <p>Annual Audited Financial Statements and Interim Financial Statements of the Bank were prepared in accordance with the formats prescribed by the Supervisory and Regulatory Authorities and applicable accounting standards and have been published in the newspapers in all 3 languages.</p>																					
3 [8] (ii)	Disclosures in annual Report																					
	<p><b>a. A statement to the effect that the annual audited financial statements have been prepared in line with applicable accounting standards and regulatory requirements, inclusive of specific disclosures.</b> <input checked="" type="checkbox"/></p> <p>Disclosures on the compliance with the applicable accounting standards and regulatory requirements in preparation of the Annual Audited Financial Statements have been made in the 'Statement of Directors' Responsibility for Financial Reporting' in IR page 116, 'Chief Executive Officer's and Chief Financial Officer's Statement of Responsibility' in IR page 115 and note No 2.1.1 [Statement of Compliance] to the Financial Statements in IR page 126.</p>																					
	<p><b>b. Report by the Board on the Bank's internal control mechanism</b> <input checked="" type="checkbox"/></p> <p>A confirmation by the Directors on the effectiveness of the internal control system over financial reporting is given under the Directors' Statement on Internal Control on pages 103 to 104 in IR.</p>																					
	<p><b>c. External auditor's certification on the effectiveness of the internal control mechanism</b> <input checked="" type="checkbox"/></p> <p>The Assurance Report issued by the External Auditor on the Internal Control over Financial Reporting based on "SLSAE 3050 – Assurance Reports for Banks on Directors' Statement on Internal Controls" issued by the Institute of Chartered Accountants of Sri Lanka [CA Sri Lanka] is given in IR page 105. The recommendations made by the Auditors where relevant, will be dealt within 2018.</p>																					
	<p><b>d. Details of Directors, including names, fitness and propriety, transactions with the Bank and the total of fees/remuneration paid by the Bank</b> <input checked="" type="checkbox"/></p> <p>Profiles of Directors are given on pages 22 to 25 in IR.</p> <p>Directors' transactions with the Bank are disclosed in note 60 to the Financial Statements on pages 236 to 241 in IR.</p> <p>Remuneration paid by the Bank to the Board of Directors [Which includes the remuneration of the Executive Director] is disclosed in Note 17 to the Financial statements in IR page 165.</p>																					
	<p><b>e. Total accommodations granted to each category of related parties and as a percentage of the Bank's regulatory capital</b> <input checked="" type="checkbox"/></p> <p>The net accommodation granted to each category of related parties is given below as a percentage of the Bank's regulatory capital.</p> <table border="1"> <thead> <tr> <th>Category of Related Party Transactions</th> <th>Rs Mn</th> <th>%</th> </tr> </thead> <tbody> <tr> <td>Non-Executive Directors and their close family members</td> <td>31.4</td> <td>0.03</td> </tr> <tr> <td>Key Management Personnel* and their close family members</td> <td>196.9</td> <td>0.17</td> </tr> <tr> <td>Subsidiaries</td> <td>1,075.7</td> <td>0.93</td> </tr> <tr> <td>Joint Venture</td> <td>3,770.9</td> <td>3.27</td> </tr> <tr> <td>Entities which Directors and their close family members have a substantial interest</td> <td>4,005.1</td> <td>3.48</td> </tr> <tr> <td>Government of Sri Lanka/Entities Controlled, Jointly Controlled, Significantly Influenced by the Government of Sri Lanka</td> <td>31,874.3</td> <td>27.66</td> </tr> </tbody> </table> <p><i>*Includes the Executive Director</i></p>	Category of Related Party Transactions	Rs Mn	%	Non-Executive Directors and their close family members	31.4	0.03	Key Management Personnel* and their close family members	196.9	0.17	Subsidiaries	1,075.7	0.93	Joint Venture	3,770.9	3.27	Entities which Directors and their close family members have a substantial interest	4,005.1	3.48	Government of Sri Lanka/Entities Controlled, Jointly Controlled, Significantly Influenced by the Government of Sri Lanka	31,874.3	27.66
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# Corporate Governance

Section	Principle, Compliance & Implementation										
	<p><b>f. Aggregate values of remuneration to, and transactions with Key Management Personnel</b> <input checked="" type="checkbox"/></p> <p>The aggregate amount of remuneration paid during 2017 to Key Management Personnel and the transactions with Key Management Personnel are given below</p> <table border="1"> <thead> <tr> <th></th> <th>Rs Mn</th> </tr> </thead> <tbody> <tr> <td>Remuneration Paid</td> <td>377.3</td> </tr> <tr> <td>Loans and Advances</td> <td>288.7</td> </tr> <tr> <td>Deposits</td> <td>292.9</td> </tr> <tr> <td>Investments</td> <td>128.8</td> </tr> </tbody> </table>		Rs Mn	Remuneration Paid	377.3	Loans and Advances	288.7	Deposits	292.9	Investments	128.8
	Rs Mn										
Remuneration Paid	377.3										
Loans and Advances	288.7										
Deposits	292.9										
Investments	128.8										
	<p><b>g. External auditors certification of compliance</b> <input checked="" type="checkbox"/></p> <p>The external auditors have performed procedures set out in Sri Lanka Standards on Related Service 4400 issued by the Institute of Chartered Accountants of Sri Lanka (SLSRS 4400), to meet the compliance requirement of the Corporate Governance Directive. Their findings presented in their report addressed to the Board are consistent with the matters disclosed above and did not identify any inconsistencies to those reported above by the Board. The recommendations made by the Auditors where relevant will be dealt within 2018.</p>										
	<p><b>h. Report confirming compliance with prudential requirements, regulations, laws and internal controls</b> <input checked="" type="checkbox"/></p> <p>There were no material non - compliance to prudential requirements, regulations, laws and internal controls affecting the Bank.</p>										
	<p><b>i. Non-compliance Report</b> <input checked="" type="checkbox"/></p> <p>There were no supervisory concern lapses in the Bank's Risk Management Systems or non-compliance with the said direction that have been pointed out by the Director of the Banks Supervision Department of the CBSL, which has been directed to be disclosed to the public. Hence, there are no disclosures in this regard.</p>										
3 [9]	<p><b>Transitional and other general provisions</b> <input checked="" type="checkbox"/></p> <p>Transitional provisions have been complied with.</p>										

Compliant     Non-Compliant

**10 COMPLIANCE WITH THE CODE OF BEST PRACTICE ON CORPORATE GOVERNANCE JOINTLY ISSUED BY THE SEC & CA SRI LANKA**

Code Ref.	Compliance and Implementation	Adoption status	Reference to corporate Governance Report	Page No
<b>A Directors</b>				
A.1	The Board	☑	Board Composition Diversity and Financial Acumen Board appointment process and re-election of Directors Company Secretary	CG&RR 6 CG&RR 6 CG&RR 6 CG&RR 4
A.1.1	Board Meetings	☑	Board and Sub-committee meeting attendance	CG&RR 5
A.1.2	Role & Responsibilities of the Board	☑	Board Mandate. Summary of Key Responsibilities of the Board	CG&RR 3 CG&RR 3
A.1.3	Compliance with laws and access to independent professional advice	☑	Key areas of the Board focus in 2017 Board access to information and resources Board Mandate	CG&RR 5 CG&RR 8
A.1.4	Access to advise and services of Company Secretary	☑	Company Secretary	CG&RR 4
A.1.5	Independent judgment	☑	Diversity and Financial Acumen	CG&RR 6
A.1.6	Dedicate adequate time and effort to matters of the Board and the Company	☑	Board Calendar and Activities	CG&RR 5
A.1.7	Board induction and Training	☑	Induction and ongoing Director training	CG&RR 8
A.2	Separating the activities of the Board from the executive responsibilities of the Company	☑	Roles of Chairman and MD/ CEO	CG&RR 6
A.3.	Chairman's role in preserving good corporate governance	☑	Chairman's Responsibilities	CG&RR 6
A.4	Availability of financial acumen and knowledge to offer guidance on matters of finance	☑	Diversity and Financial Acumen	CG&RR 6
A.5	Board Balance	☑	Board Composition	CG&RR 6
A.6	Provision of appropriate and timely information	☑	Board Calendar and Activities	CG&RR 5
A.7	Appointments to the Board	☑	Board appointment process and re-election of Directors	CG&RR 6
A.8	Re-election of Directors	☑	Board appointment process and re-election of Directors	CG&RR 6
A.9	Appraisal of the Board & Sub - Committees Performance	☑	Board Evaluation	CG&RR 8
A.10	Disclosure of information in respect of Directors in the Annual Report	☑	Disclosure requirements with regard to Directors as specified in the Code are as follows: Profiles of Directors including experience, expertise and Directorships in other companies Board Composition Remuneration paid to Directors [Note No. 17 to the Financial Statement] Other Business Commitments and Conflicts of Interests Board and Sub-Committee Meeting attendance Board Sub-Committees and areas of oversight	IR 22-25 CG&RR 6 IR 165 CG&RR 7 CG&RR 5 CG&RR 9

# Corporate Governance

Code Ref.	Compliance and Implementation	Adoption status	Reference to corporate Governance Report	Page No
A.11	Appraisal of the CEO	<input checked="" type="checkbox"/>	Appraisal of MD/CEO	CG&RR 8
<b>B Directors' Remuneration</b>				
B.1	Directors' & Executive Remuneration	<input checked="" type="checkbox"/>	Directors' & Executive Remuneration - Policy and procedure	CG&RR 9
B.2	Level & Make Up of Remuneration	<input checked="" type="checkbox"/>	Directors' & Executive Remuneration - Level and Make Up of Remuneration	CG&RR 10
B.3	Disclosures related to remuneration in Annual Report	<input checked="" type="checkbox"/>	Directors' & Executive Remuneration Remuneration paid to Directors (Note No. 17 to the Financial Statement)	CG&RR 9 IR 165
<b>C Relations with Shareholders</b>				
C.1	Constructive use of the AGM & Other General Meetings	<input checked="" type="checkbox"/>	Constructive use of the AGM	CG&RR 10
C.2	Communication with shareholders	<input checked="" type="checkbox"/>	Communication with Shareholders	CG&RR 11
C.3	Disclosure of major and material transactions	<input checked="" type="checkbox"/>	There were no transactions in 2017 which would materially alter the Company's or Group's net asset base, except for the rights issue disclosed in Note 54 to the Financial Statements in IR page 231.	-
<b>D Accountability and Audit</b>				
D.1	Present a balanced and understandable assessment of the Company's financial position, performance and prospects	<input checked="" type="checkbox"/>	<p>The Board has taken every effort to ensure that the Annual Report presents a fair and balanced review of the Bank's financial position, performance and prospects combining narrative and visual elements to facilitate readability and comprehension. All statutory requirements have been complied within the Annual Report and the interim financials have been reviewed and approved by the Board Audit Committee, prior to publication. The following disclosures as required by the Code are included in the Integrated Annual Report:</p> <ul style="list-style-type: none"> <li>» Annual report of the Board of Directors on the affairs of the company</li> <li>» Directors Responsibility for Financial Reporting</li> <li>» Independent Auditors Report</li> <li>» Directors' Statement on Internal Control</li> <li>» Management Discussion &amp; Analysis</li> <li>» Statement of going concern of the Company note 2.2.1,</li> <li>» Related Party Transactions               <ul style="list-style-type: none"> <li>(i) Note 60 in the Financial Statements,</li> <li>(ii) Report of the RPTRC.</li> </ul> </li> </ul> <p>In the unlikely event of the net assets of the company falling below 50% of Shareholders Funds, the Board will summon an Extraordinary General Meeting [EGM] to notify the shareholders of the position and to explain the remedial action being taken.</p>	IR 81-89 IR 116 IR 117 IR 103-104 IR 34-80 IR 127 IR 236-241 IR 101-102
D.2	Process of risk management and a sound system of internal control to safeguard shareholders' investments and the Company's assets	<input checked="" type="checkbox"/>	Risk Management and Internal control	CG&RR 8

Code Ref.	Compliance and Implementation	Adoption status	Reference to corporate Governance Report	Page No
D.3	Board Audit Committee	<input checked="" type="checkbox"/>	<p>The Board Audit Committee of the Board is chaired by Mr Sujeewa Mudalige, an independent Non-Executive Director and eminent Chartered Accountant and comprises 3 other Independent Non-Executive Directors. A summary of its responsibilities and activities are given in the Report of the Board Audit Committee. The Internal Audit function supports the Board Audit Committee in the discharge of duties.</p> <p>The Board also obtains assurance from its external auditors on the effectiveness of internal controls on financial reporting</p> <p>Board Audit Committee Report</p>	IR 97-100
D.4	Code of Ethics	<input checked="" type="checkbox"/>	Code of conduct and ethics	CG&RR 10
D.5	Corporate Governance Disclosures	<input checked="" type="checkbox"/>	This Corporate Governance Report from pages 3 to 27 in CG&RR complies with the requirement to disclose the extent of compliance with the Code of Best Practice on Corporate Governance as specified in Principle D5.	-
E & F	<b>Encourage voting at AGM - institutional and other investors</b>	<input checked="" type="checkbox"/>	<p>The Annual General Meeting is used to have an effective dialogue with the shareholders on matters which are relevant and of concern to the general membership. The Investor Relations team headed by the MD/CEO has regular discussions with key institutional shareholders to share highlights of the Bank's performance and also with the view to obtaining constructive feedback. The feedback obtained from institutional shareholders is communicated to the entire Board by the MD/CEO.</p> <p>Institutional investors are encouraged to give due weight to all relevant factors in Board structure and composition.</p> <p>Individual shareholders are encouraged to carry out adequate analysis or seek independent advice on their investing, holding or divesting decisions.</p> <p>Individual shareholders are encouraged to participate at Annual General Meetings and exercise their voting rights.</p>	-
G	<b>Sustainability Reporting</b>	<input checked="" type="checkbox"/>	<p>Sustainability principles are embedded in the Bank's business strategy and endorsed in the operations. The Sustainability initiatives of the Bank are reported in a holistic manner in the Sustainability Supplement which is hosted on our website <a href="https://www.hnb.net/2017#sustainability-report-2017">https://www.hnb.net/2017#sustainability-report-2017</a>, which cover the following principles;</p> <p>Principle 1 - Reporting of Economic Sustainability (Financial Capital)</p> <p>Principle 2 - Reporting on the Environment (Impact on Environment)</p> <p>Principle 3 - Reporting on Labour Practices (Human Capital)</p> <p>Principle 4 - Reporting on Society (Social Impact)</p> <p>Principle 5 - Reporting on Product Responsibility (Social and Network Capital)</p> <p>Principle 6 - Reporting on Stakeholder identification, engagement and effective communication (Stakeholder Engagement)</p> <p>Principle 7 - Sustainable reporting to be formalised as part of the reporting process and to take place regularly (About this Report)</p>	-

Adopted     Not Adopted

# RISK MANAGEMENT

## MANAGING RISK

### Our Risk Management Framework

Risk management continues to evolve at a rapid pace as regulators strive to maintain pace with technology and other emerging

threats to financial stability. As a domestic systemically important bank (DSIB) in Sri Lanka, our vision is to move beyond mere compliance with regulation by proactively responding to emerging threats to navigate

an increasingly uncertain risk landscape. HNB implemented a risk management framework based on the COSO framework for enterprise risk management and Basel III regulatory framework as summarised below.

STRATEGY		
RISK CULTURE & VALUES [CG&RR Pg 30]		
<b>RISK GOVERNANCE</b>  [CG&RR Pg 30]	<b>Board &amp; Board Committees</b>	Setting the “tone at the top”, governance, internal controls and risk management framework and oversight of their effective function, strategic guidance and resource allocation
	<b>Executive Committees</b>	Implementation of governance, internal control and risk management framework, review, monitoring and reporting,
	<b>Risk Governance Framework</b>	Comprises the structure and policies governing the risk management function
<b>ROLES AND RESPONSIBILITIES</b>  [CG&RR Pg 31]	<b>Three Lines of Defence Model</b>	Clearly defines the roles and responsibilities with regards to risk tolerance, risk management, risk monitoring and assurance on effective functioning of controls
	<b>Risk Management Function</b>	Identify, outlines, implement and overlook the structure and responsibilities of the risk management function which forms the 2nd line of defence
<b>POLICY FRAMEWORK, PROCESSES &amp; CONTROLS</b>  [CG&RR Pg 31]	<b>Capital Planning and ICAAP</b>	Assesses the capital requirement for all identifiable risks on the basis of materiality to ensure completeness in assessing financial risks and non financial risks
	<b>Risk Appetite</b>	Sets out the Bank’s tolerance for risk
	<b>Stress Testing</b>	Analysis conducted to determine adequacy of capital under unfavourable economic scenarios as per guidelines issued by CBSL and according to the model adopted in ICAAP
	<b>Risk Management Policies</b>	Sets out the Bank’s philosophy, processes and controls for managing defined risks
	<b>Risk Reporting and Monitoring</b>	Reports on key performance indicators that enable those charged with governance to determine the banks performance and stability
	<b>Internal Controls</b>	Processes in place to assure operational effectiveness, reliable reporting and compliance with regulations and internal policies

Figure 1: Our Philosophy in Managing Risk

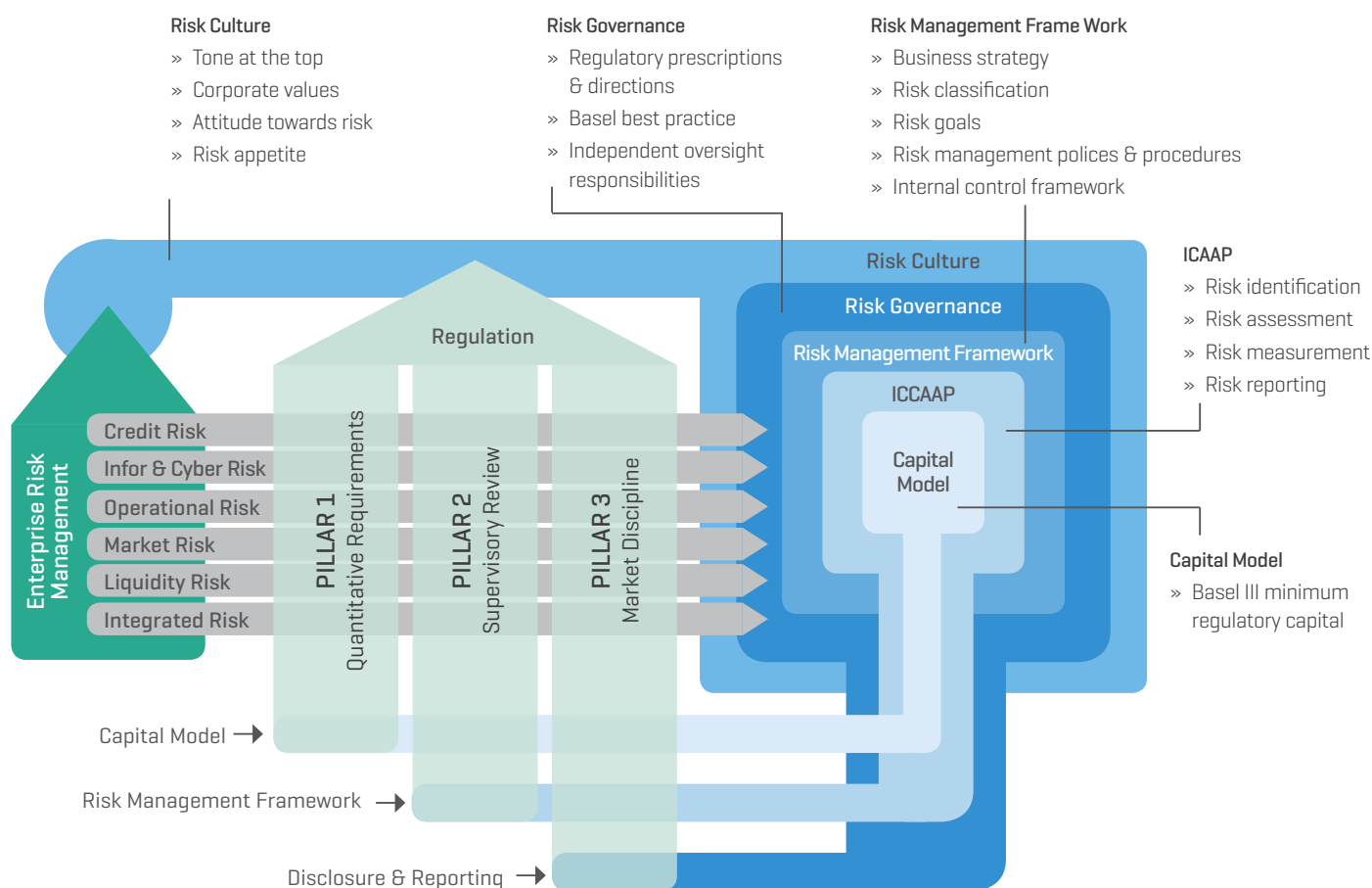


Table 1: Evolution of Risk Management at HNB 2017 & Beyond

Risk	Initiative
<b>Credit Risk</b>	<ul style="list-style-type: none"> <li>» Established a "Centre of Aspiration" to manage overdue/ distressed credits</li> <li>» Implementation of a new Loan Originating System (LOS)</li> <li>» Introduction of non-judgmental scorecards to evaluate personal credit</li> <li>» Extend introduction of non-judgmental scorecards to SME and Micro Finance Segments following implementation of LOS</li> <li>» Validation and re-calibration process of the internal risk rating system to be in line with Basel III and IFRS requirements.</li> <li>» Centralization of credit administration functions covering security documentation, disbursements and recovery.</li> </ul>
<b>Information &amp; Cyber Risk</b>	<ul style="list-style-type: none"> <li>» Established information and cyber security vertical under CRO</li> <li>» Chief Information Security Officer (CISO) responsibilities added to CRO</li> <li>» Developed an information risk management policy framework</li> <li>» Developed &amp; implemented a data governance framework</li> <li>» Obtain ISO27001:2013 for data centre and DR operation initially and progressively covering entire IT operation</li> </ul>
<b>Operational Risk</b>	<ul style="list-style-type: none"> <li>» Roll out of Risk and Control Self-Assessment Process (RCSA)</li> <li>» Created a master list of dynamic "Key Operational Risk Controls" (KORCS).</li> </ul>
<b>Market Risk</b>	<ul style="list-style-type: none"> <li>» Upgraded Finacle Treasury System</li> </ul>
<b>ICAAP</b>	<ul style="list-style-type: none"> <li>» Enhanced ICAAP framework and methodology</li> <li>» Estimation of capital requirements in relation to both financial and non-financial risks</li> </ul>
<b>Reputation Risk</b>	<ul style="list-style-type: none"> <li>» Established a "Reputation Risk Task Force" as a subcommittee of the "Operational Risk Steering Committee" (ORSC)</li> </ul>
<b>Risk Culture</b>	<ul style="list-style-type: none"> <li>» Focus on managing Risk-Reward instead of managing risk</li> <li>» Active engagement with business functions through value additions</li> <li>» Continuous review of policies and procedures to improve efficiency and effectiveness.</li> </ul>

# Risk Management

## Risk Culture

The risk culture of the bank is shaped by a comprehensive risk management policy framework, robust corporate and risk governance, mandatory training, skills and competencies of the risk department and a remuneration framework that rewards a balanced approach to risk. It is reinforced by a code of conduct applicable to all employees, our values and a whistle blowing policy to ensure confidentiality and provisions against retaliation. These key drivers shape our attitudes, norms, and behaviours in relation to risk awareness, acceptance and management which is the key to sustainable growth and profitability.

Care is taken to ensure that policies and guidelines are framed using clear and precise language enabling easy understanding of our risk philosophy, approach and appetite articulated in our policies. Mandatory training reinforces this with case studies and examples drawn from industry and our own experience to educate our team on the correct application of policies. Guidelines are issued to further clarify matters where inconsistencies are observed in the

application of policies. The risk management department works with the HR team in ensuring that the scope and coverage of risk related training is appropriate to ensure compliance with the Bank's strategic objectives.

Risk events of the recent years highlight the need to cultivate appropriate risk behaviour in all employees and align performance management, rewards and remuneration to recognise appropriate risk behaviours and the Board and corporate management of the Bank are keenly aware of this. Accordingly, performance goals and objectives for the Bank, departments and individuals include appropriate risk management objectives which form a key component of the criteria used for performance evaluation.

## Risk Governance

Our risk governance structure ensures that, roles and responsibilities for risk management are clearly defined and give due attention to key aspects of risk management, facilitating high levels of specialisation in these identified areas. The Board has the ultimate responsibility for managing risk

## RISK CULTURE

- Corporate Values
- Corporate Governance
- Risk Governance
- Policy Framework
- Risk Appetite
- Risk Management Function
- Rewards & Remuneration
- Training

and is assisted by the Board Integrated Risk Management Committee [BIRMC] who has oversight responsibility for risk management while the executive functions are responsible for effective implementation of the risk management framework. Executive committees serve to draw on the collective experience and wisdom of corporate and senior management teams and play a key role in the delegation of authority as well. The CRO reports to the BIRMC with an administrative reporting line to MD/CEO and sits on the executive committees to ensure alignment with risk management objectives.

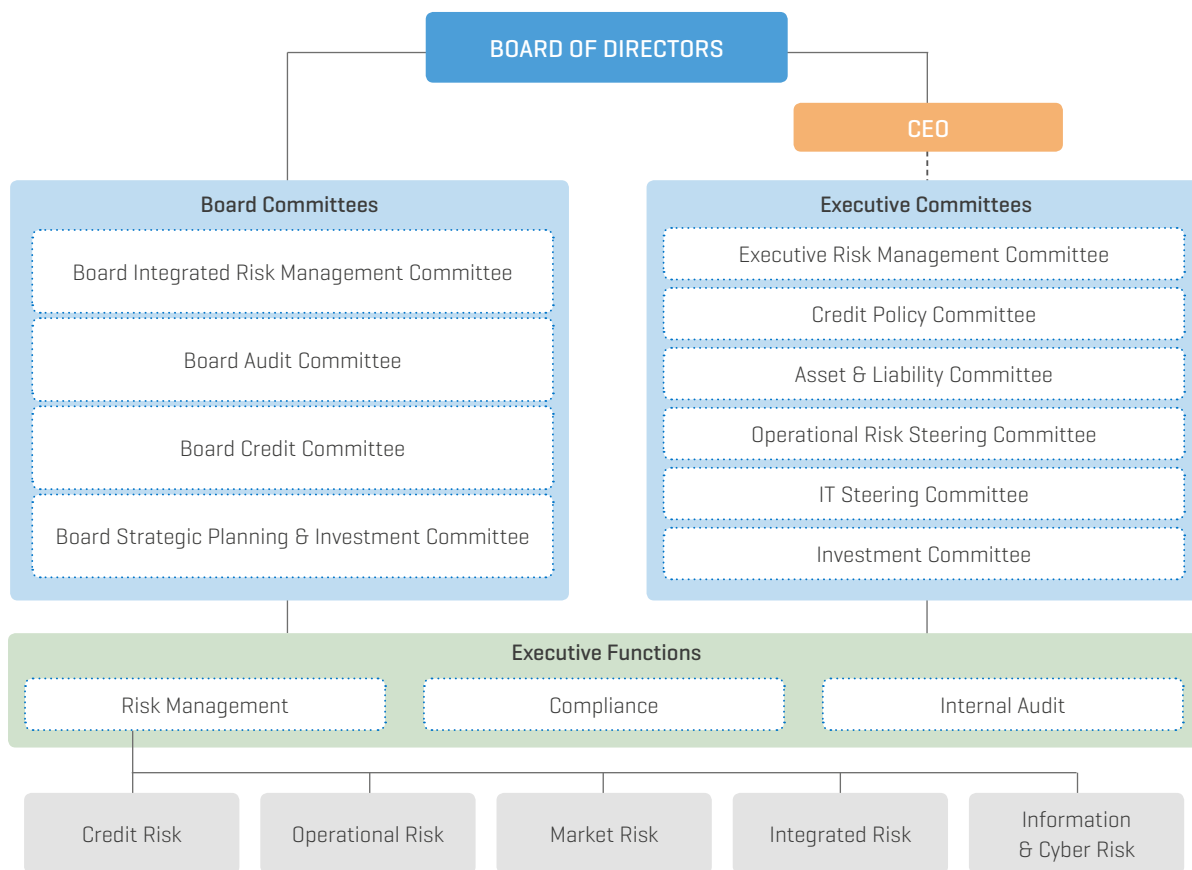


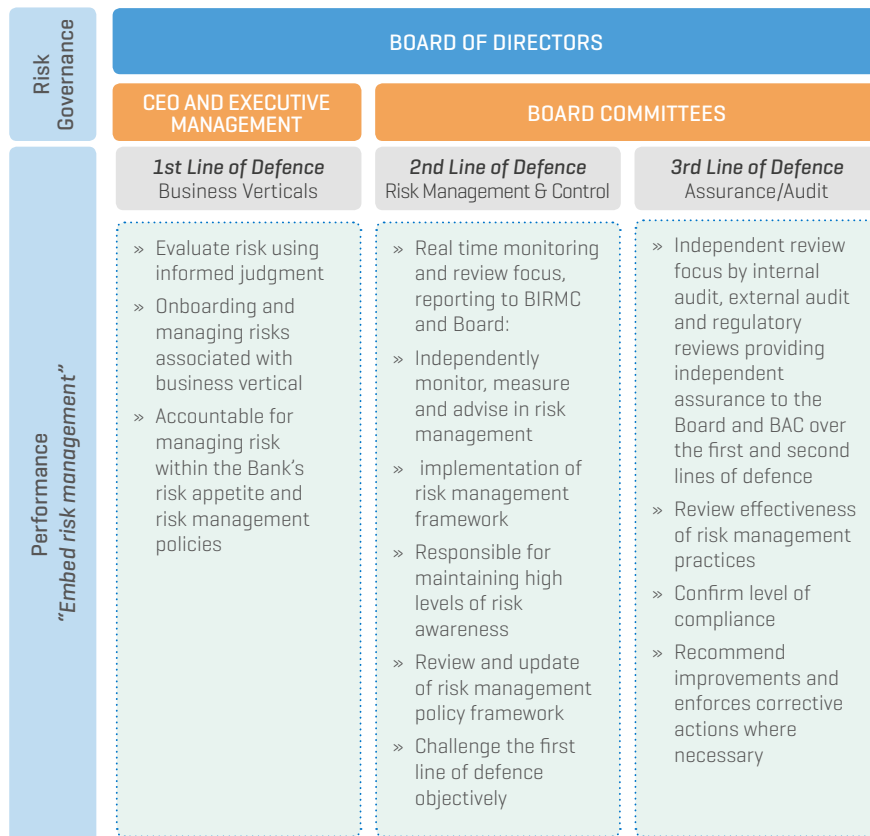
Figure 2: Risk Governance



**Roles & Responsibilities**

HNB's risk management framework is based on the three lines of defence model which provides high levels of risk awareness and shared responsibility for risk management throughout the organization as risk acceptance and management by the front lines are monitored, measured and constructively challenged by an independent and highly specialized risk management function with assurance on the effective functioning of these defense lines.

**Figure 3: Three lines of Defence**



**Policy Framework, Processes & Controls**

A comprehensive risk management policy framework articulates the Bank's philosophy, management approach, processes and controls in managing risk. It is reviewed annually by the risk management department. Overall risks management framework is deliberated at the relevant executive committees prior to presenting to the Board and policy recommendations are submitted to the, Board for formal approval.

Triggers for changes to policies or new policies include changes in regulatory environment, risk events of the Bank, issues raised in internal and external audit reports, changes to IT platform or processes and process reviews. In 2017, our focus has been to ensure that the Bank is ready for challenges under Basel III and IFRS 9 and accordingly changes needed to incorporate in the policy framework. Thus, processes and controls have been amended according to a road map designed to ensure a smooth transition.

**Risk Appetite Statement (RAS)**

The Risk Appetite Statement is a high-level document that defines the Bank's desired risk profile in qualitative and quantitative terms to facilitate alignment of business units expectations to the Bank's overarching strategic objectives and goals. RAS is integrated with other key risk management tools, such as stress testing and emerging risk reports for consistency in risk management practices.

The Bank's RAS is reviewed annually to ensure that risk limits are set considering earnings, capital, risk thresholds, liquidity and other relevant measures which defines the Bank's appetite for risk tolerance. The annual RAS setting process ensures a balance between risk goals set and forecasts of short to medium-term strategy and capital planning. Consequently, the RAS is based on forward looking assumptions that support the Bank's future goals and establishes tolerance levels to key risk parameters. Risk dashboards are presented monthly to the Board and sub committees and deliberate the Bank's compliance with the board approved RAS.

**Stress Testing**

Comprehensive stress testing of our portfolios and impact forecasts supports our risk management and capital planning process which complies with guidelines issued by CBSL.

**Risk Management Process**

The Bank has robust processes in place for identifying, assessing, measuring, monitoring and managing a wide range of known and emerging risks as enumerated in table 2. While the most processes are highly evolved over the years, new threats continue to emerge with rapid changes in our operating environment and business model. Creating a risk awareness supports the evolution of our risk management processes as we are in the process of transforming in to a digital age.

# Risk Management

## Our Material Risks

Measurement, Monitoring and Management of material risks of the Bank are summarized in the table below.

Table 2: Our Material Risks

Risk	Current Assessment & Trend	Measurement, Monitoring and Management
<p><b>Credit Risk</b></p> <p>Is the risk of financial loss to the Bank if a customer or a counterparty to a financial instrument fails to meet its contractual obligations. It arises principally from the Bank's loans and advances to customers, investment in debt and equity securities.</p>	<p>Moderate →</p> <p>Pages 33-37 in CG&amp;RR</p>	<ul style="list-style-type: none"> <li>» <b>Measured</b> based on credit exposure (EAD), Probability of Default (PD), Loss Given Default (LGD) Expected Losses (EL), and Recovery Rates. NPA ratios, stress testing on concentration, large borrower default, increase in provision etc., capital is allocated under CAR as per Basel III</li> <li>» <b>Monitored</b> by a credit risk dashboard reporting to Board, BIRMC, BCC and executive committees on a number of parameters including analysis of arrears, collateral, concentration etc.</li> <li>» <b>Managed</b> through a comprehensive risk management framework which provides clear guidance to those involved in accepting, managing and monitoring risk.</li> </ul>
<p><b>Information and Cyber Risk</b></p> <p>Is any risk of financial loss, disruption or damage to the reputation of the Bank from some sort of compromise of information to unintended parties and unauthorised access to our systems or data/information. It also arises from failure of the Bank's information technology systems.</p>	<p>Moderate ↑</p> <p>Pages 38-39 in CG&amp;RR</p>	<ul style="list-style-type: none"> <li>» <b>Measured</b> with reference to the cyber risk loss limits and cyber risk matrix, hacking attempts for a month,</li> <li>» <b>Monitored</b> by cyber risk monitoring unit through a cyber risk dashboard presented to BIRMC monthly, through Security Incident and Event Management (SIEM) systems logs.</li> <li>» <b>Managed</b> through the Bank's action plan for digital resilience, awareness programs for staff, business continuity plans, use of physical controls, technical and logical access and administrative controls.</li> </ul>
<p><b>Operational Risk</b></p> <p>Is the risk of loss due to inadequate or failed internal processes, people and systems or from external events. It is inherent in all banking products and processes and controlled in a cost effective manner.</p>	<p>High ↑</p> <p>Pages 39-41 in CG&amp;RR</p>	<ul style="list-style-type: none"> <li>» <b>Measured</b> using operational losses, loss events/near misses, key risk indicators, overall risk grid matrix, risk ranking and prioritizing, risk heat map, capital allocation under CAR as per Basel III</li> <li>» <b>Monitored</b> and overseen by Operational risk management vertical under the guidance of ORSC with input from business units through risk and Control Self Assessments (RCSA). Operational risk monthly dashboards are submitted to ERM, BIRMC and the Board</li> <li>» <b>Managed</b> through a sound operational risk management framework through ORM unit and ORSC with the participation of all business/support units</li> </ul>
<p><b>Market Risk</b></p> <p>Is the risk that movements in market factors could reduce our income or value of portfolios. It arises from movement in market factors such as foreign exchange rates, interest rates, credit spreads, equity prices and commodity prices.</p>	<p>Low →</p> <p>Pages 42-46 in CG&amp;RR</p>	<ul style="list-style-type: none"> <li>» <b>Measured</b> using value at risk, sensitivity analysis and stress testing on open positions, mark to market on daily basis to identify the trading book position capital is allocated under CAR as per Basel III</li> <li>» <b>Monitored</b> by ALCO who are supported by an independent Treasury Middle Office (TMO) dedicated to monitoring market risk, reporting directly to CRO, market risk dashboards. Monitors internal and regulatory limits and exceptions are immediately reported to ALCO</li> <li>» <b>Managed</b> by treasury within a robust market risk management framework, market risk limits, through diversification and hedging strategies,</li> </ul>
<p><b>Liquidity Risk</b></p> <p>Is the risk that the Bank is unable to meet its debt obligations associated due to lack of funds or having to meet these obligations at excessive cost. It arises from mismatches in cashflow due to potential short-term cash demands placed upon the Bank, by depositors, borrowers, the Bank's own borrowing activity, trading activities and counterparty interactions.</p>	<p>Low →</p> <p>Pages 46-47 in CG&amp;RR</p>	<ul style="list-style-type: none"> <li>» <b>Measured</b> using a range of metrics including regulatory limits such as the Liquidity Coverage Ratio (LCR), internal model and balance sheet based measures including stress testing, interest rate sensitivity, probabilistic analysis, and NII analysis,</li> <li>» <b>Monitored</b> by ALCO and TMO using a matrix of regulatory and prudential limits and gaps using both stock and flow approaches, dashboards submitted to ALCO and BIRMC and the Board</li> <li>» <b>Managed</b> through a strong liquidity risk management framework which includes contingency plans with both contracted and un-contracted liquidity positions. liquidity buffers , liquidity ladders</li> </ul>

Risk	Current Assessment & Trend	Measurement, Monitoring and Management
<b>Strategic Risk</b> Refers to uncertainties and untapped opportunities embedded in our strategic intent and how well they are executed. As such, they are key matters for the Board and impinge on the whole business, rather than just an isolated unit.	Low ↑ Pages 49-50 in CG&RR	» <b>Measured</b> using a scorecard approach to quantify strategic risk under the Basel III Pillar 2 calculation » <b>Monitored</b> by the risk management function who report to the Board annually via ICAAP submission » <b>Managed</b> at corporate management and the Board level with reference to market developments and potential disruptions to current business model
<b>Reputation Risk</b> Is the loss resulting from damages to the Bank's reputation, in lost revenue; increased operating, capital or regulatory costs; or destruction of shareholder value, consequent to an adverse or potentially criminal event even if the Bank is not found guilty	Low ↑ CG&RR Page 50	» <b>Measured</b> using a scorecard approach by assessing underlying risk drivers of reputational risk due to qualitative nature of the risk » <b>Monitored</b> by the risk management function who report to the Board annually via ICAAP submission » <b>Managed</b> by setting the tone at the top and reinforcing its core values and purpose. A reputation risk task force was established as a sub-committee of ORSC to discuss/identify any reputation risk trigger events and guide where necessary.

## CREDIT RISK

Credit risk is the most significant risk for HNB due to our main focus on traditional lending products and accounts for over 68% of the assets book. Consequently, significant resources are allocated to manage credit risk in a comprehensive and effective manner with responsibility shared across several departments.

### Credit Risk Review

The Bank's maximum exposures to credit risk increased by 10.78% during the year as lending portfolios for both retail and corporate banking grew by 5.15% and 5.36% respectively. The Bank has taken a view of consolidation loan portfolio hence, strategically was not driving aggressive asset growth during 2017.

The allowance for individual impairment increased by 60% due to a single large exposure related to state owned enterprise (SOE) being fully impaired while the allowance for collective impairment decreased by 34.66% in line with the movements in lending portfolios. Impairment allowance coverage is maintained above regulatory requirements due to adoption of prudent provisioning policies.

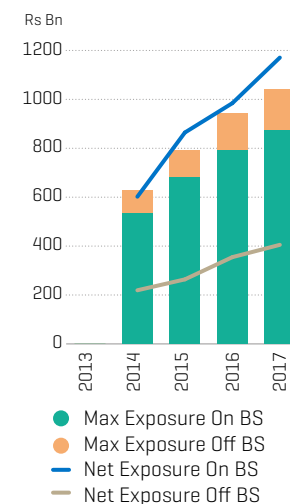
Table 3: Credit Risk Parameters

Audited	2017		2016	
	Maximum Exposure			
	Rs 000		Rs 000	
Maximum Credit Exposures	1,043,787,910	942,248,011		
» Total Assets subject to Credit Risk	873,193,102	792,889,705		
» Off Balance Sheet Commitment subject to Credit Risk	170,594,808	149,358,306		
» Gross Loans & Receivables to customers	649,547,067	595,513,919		
Net Carrying amount of Loans & Receivables to Customers	264,132,296	216,949,035		
Impaired Loans	15,048,382	15,949,298		
Provisions for impairment	10,445,006	11,101,192		
» Individual Impairment	5,390,947	3,366,278		
» Collective Impairment	5,054,059	7,734,914		
Impaired Loans as a % of gross Loans and Receivables	2.35%	2.73%		
NPA (Gross)	2.28%	1.80%		

## COMPONENTS OF CREDIT RISK

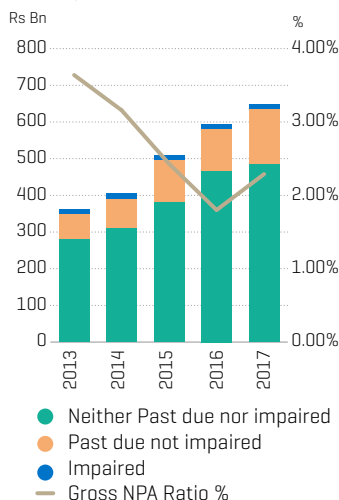
- Default Risk
- Counterparty Risk
- Concentration Risk
- Residual Credit Risk
- Recovery Risk
- Portfolio Risk

## CREDIT EXPOSURES



# Risk Management

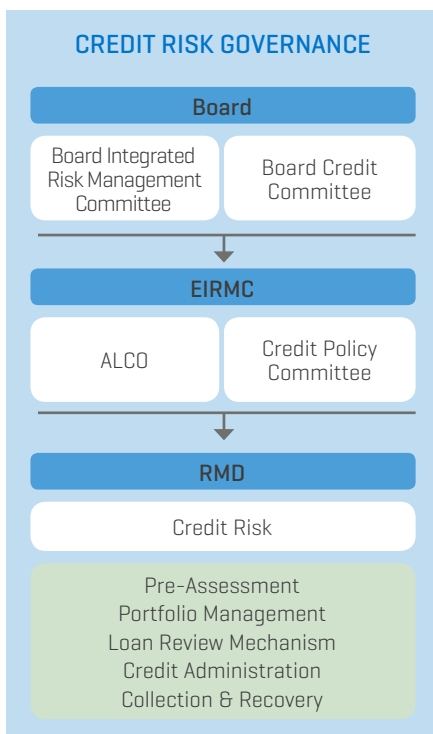
## CREDIT QUALITY



### Credit Risk Governance

With credit risk being the most significant risk in the Bank and responsibility for oversight is shared by both BIRMC and the BCC. BIRMC responsibilities are given in the committee report from page 94 to 96 in IR. ERMIC monitors credit risk on a monthly basis while CPC reviews credit policy related matters.

The risk management department reviews and constructively challenges or support business units assessment of credit risk for loans prior to sanction although it does not approve credit. Applications where the risk management department has a difference in opinion are referred to a higher level of authority than the relevant authority for approval as per the Board approved delegated authority structure of the Bank. All retail credit facilities are reviewed by dedicated staff members at the Centre of Excellence (CoE) who are highly skilled banking professionals trained in assessing personal financial products. Business units manage client relationships and play a supporting role in recoveries which are driven and monitored by the credit & recovery department which is the newly established centralized collections unit. The centralization of credit administration function initiated in 2017 plays a key supporting role in ensuring that credit security documentations are completed and accurate, prior to disbursement of facilities and liaise closely with the business units and branch network to ensure a seamless service to the client.



### Credit Risk Management Processes

During 2017, the risk management division floated three transformational initiatives to strengthen credit risk management processes.

**Centralized Security Repository (SRU)** – SRU handles all pre-disbursement processes including preparation, execution and checking of security documents minimising legal risk. The department will also retain custody of security documents and set up limits, interest rates and other details in the system. This process relieves the front line staff a significant volume of administrative functions which time can now be devoted to provide better customer service and offer enhanced level of customer experience. Further, this initiative allows greater control for risk management, enhances the level of accuracy in system records and management information while relieving the front line staff from administrative duties.

**Centre of Aspiration (COA)** – A centralized collection unit was established to standardize the management of delinquencies early facilitating swift remedial action. Specially trained staff in COA are supported by a sophisticated IT platform facilitating collections and recoveries in a structured manner. COA will be one of the first units to benefit from predictive analytics to prioritize

high risk customers in its dunning strategy based on past repayment behaviour.

**Loan Origination System (LOS)** – The next generation LOS will completely digitize the credit underwriting and review processes complementing the electronic work-flow driven credit evaluation and approval system in place. Roll out of this initiative in 2018 will enhance efficiencies and data/information security features within the Bank.

Additionally, an initiative for validation and recalibration of internal risk rating models was kicked off to ensure that estimated probability of defaults of the customers reflects real probabilities and are in line with the current environmental factors. This initiative would provide a reasonable risk assessment of the default probability of the obligor when evaluating and thereby reducing the possible levels of false comfort.

Credit risk is managed through the overarching overall risk framework policy and a specific credit policy approved by the Board. The framework comprises the risk appetite statement, risk goals /tolerance limits, delegation of authority which are reviewed at least annually and amended as deemed necessary by the Board based on the recommendations of the CPC and the BCC.

## KEY DEVELOPMENTS IN 2017

- Established a new Security Repository System
- Centralisation of Credit Disbursement
- Established a Centre of Aspiration for Centralized Collections
- Project kicked-off for next generation LOS
- Validation and recalibration of Internal Risk Rating models

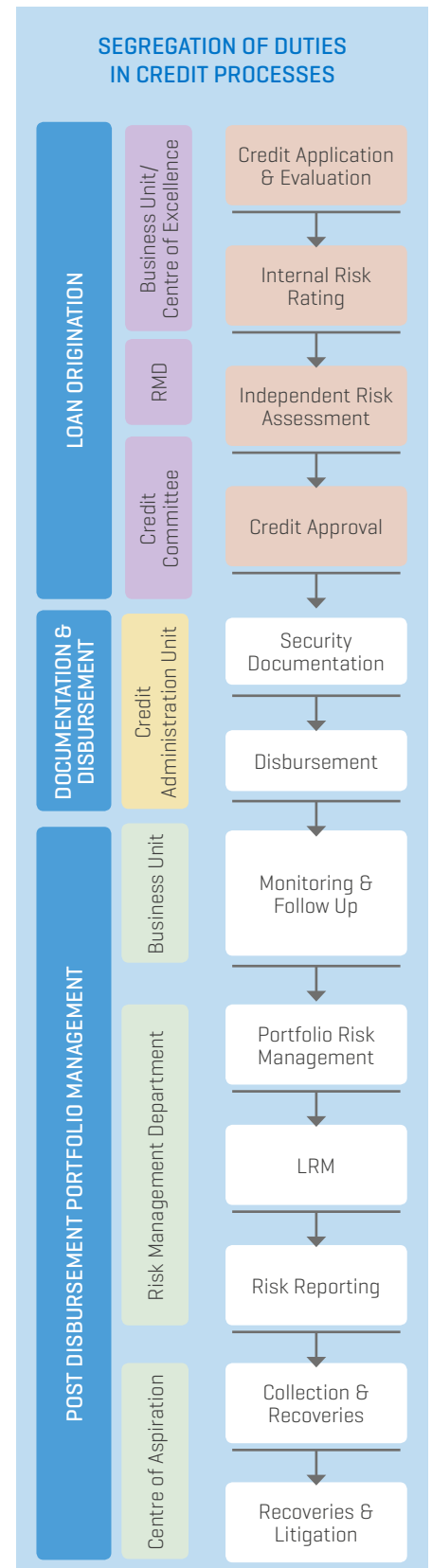
These policies facilitate the following processes and controls ensuring that, assessment, monitoring, and reporting are carried out in an effective manner:

**Segregation of credit risk management tasks** – Segregation of duties along the life cycle of a credit facility is given in the adjacent digram. The credit risk function is organised in to 5 specialised focus areas to enable review throughout the lifecycle and offer strong support to business units who own the relationships and products. Business units are responsible for review of the credit application and its evaluation including assignment of an internal risk rating to determine the probability of default of applicants.

- » **Internal Risk Ratings** - Obligor risk rating is assessed based on a specialized statistical rating model customized for HNB for both corporate as well as retail clients.
- » **Independent Risk Assessment** - The COE carries our pre-evaluation of credit for retail loans building high levels of specialisation and faster response times. Corporate, Mid-Market and SME facilities are independently reviewed by the pre-assessment division of the credit risk management function.
- » **Credit Approval** - Approval of credit facilities above a specified threshold have been assigned to committees based on delegated authority approved by the Board. Prior to final approver/approving committee risk management division provides its assessment to facilitate a well-informed credit decision.
- » **Security Documentation and Disbursement**- A specialised documentation centre under the purview of RMD is charged with checking completeness and authenticity of security documents and fulfilment of approval

conditions prior to disbursement. This supports regulatory compliance and recovery processes with required documentation. The centralised credit operations function ensures that a correct limit is marked in the system at an accurate interest rate for draw down by the customer.

- » **Loan Review Mechanism** – A LRM function has been established within the credit risk function to carry out post approval reviews of credit facilities in order to identify qualitative improvements in credit evaluation and administration processes and also providing valuable insights on the effective functioning of processes and controls set in place. Reports from LRM are submitted to BIRMC and the Board. The Bank currently carries out LRM on corporate and SME portfolios and intend to extend cover other business lines in time to come.
- » **Management of Large Exposures** - Large borrower exposures are maintained within internal risk limits of 20 largest exposures including limits on lending to government and limits on single industry concentration etc., They are monitored closely with corrective action initiated in a proactive manner on identification of concerns impacting the credit quality.
- » **Early Warning Signs (EWS)** - The portfolio risk management unit and collections and recovery divisions together with business units identify deteriorating credits early facilitating rehabilitation or minimal loss exits. EWS and watch lists are used to initiate remedial action and alert the Board and committees.
- » **Specialised Recovery Function** - A specialised COA with state of the art systems was established in view of the need to strengthen collections and recoveries.

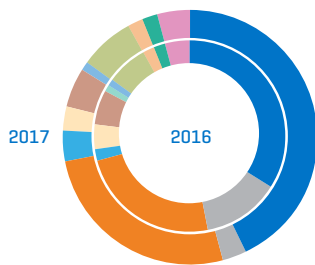


# Risk Management

## Concentration Risk

Concentration risk is managed by diversification of risk across industry sectors, products, counterparties and geographies. Exposure limits for identified segments are clearly given in the Bank's RAS/risk goals limits which are monitored by the credit committee, ERM, BIRMC and Board. These exposures are graphically depicted below.

### EXPOSURE BY COUNTER PARTIES

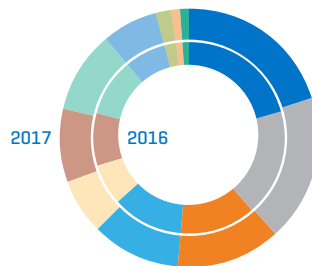


	2017	2016
Large Corporates	43%	34%
Mid Market	3%	13%
SME	26%	24%
Micro Finance	4%	2%
Personal Loans	3%	4%
Housing Loans	5%	6%
Dream Drive	0%	1%
Credit Cards	1%	1%
Leasing	7%	7%
Pawning	2%	2%
Staff Loans	2%	2%
Others	4%	4%

## Off Shore Exposure

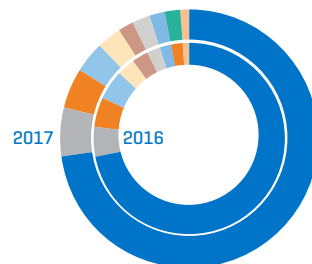
The Bank's off shore exposures to outside Sri Lanka is around 2.5% of the loan book and 17.2% of core capital. Exposures granted are for countries rated B and above by international rating agencies and governed by internally set country risk limits reviewed annually by risk management department maintained within the RAS of the Bank. Country limits are set as a percentage of core capital taking in to account various indicators including but not limited to political, economic, legal, sovereign, banking sector and currency risks etc., of a particular territory in addition to the rating justification by international rating agencies. Further, the Bank closely monitors any trigger events in these countries which may hamper performance of counterparties. Majority of off shore exposures are linked with local promoters or well reputed conglomerates established in respective countries to finance

### EXPOSURE BY INDUSTRY SECTOR



	2017	2016
Traders	20%	20%
Infrastructure/ Construction including condominiums	19%	18%
Manufacturing	13%	13%
Financial & Business		
Services	11%	12%
Retail	7%	7%
Other Services	9%	9%
Agriculture & Fishing	10%	10%
Tourism	7%	7%
Transport	2%	2%
New economy	1%	1%
Unclassified	2%	1%

### EXPOSURES BY GEOGRAPHICAL DISTRIBUTION

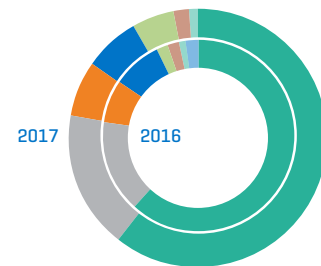


	2017	2016
Western Province	73%	72%
Central Province	6%	5%
North Western Province	5%	5%
Southern Province	4%	5%
Northern Province	3%	3%
Eastern Province	2%	3%
North Central Province	2%	2%
Sabaragamuwa Province	2%	2%
Overseas Exposures	2%	2%
Uva Province	1%	1%

projects of national importance to those countries.

In an eventuality, the Bank will take a prudent risk mitigating approach by reducing counter party limits and recalling facilities which constitute part of the loan agreement covenant signed between the Bank and the borrower.

### PORTFOLIO BY PRODUCT



	2017	2016
Term Loan	60%	60%
Overdraft	17%	15%
Leasing	7%	7%
Trade Finance	7%	6%
Shanthi Housing	5%	6%
Pawning	2%	2%
Credit Card	1%	1%
Others	1%	3%

The risk department keep abreast of developing any political or economic vulnerabilities in relevant countries and keep business units informed of any uncertainties and eventualities. Further, BIRMC is kept informed with regards to such incidents

## Government Exposures

HNB has been playing a supportive role in government infrastructure development projects and several other projects of national importance. Consequently, total lending exposure of the Bank to government sector projects constitutes 11.4% of the loan book. The Bank's risk appetite is set at a limit of 150% of core capital to accommodate government exposures. Our exposures stand within such limit i.e. 80% of core capital. Except for one state owned enterprise, all other government exposures are backed by either sovereign guarantee or borrowing is directly by the Ministry of Finance.

As of the reporting date lending to one SOE has been classified as NPA and fully impaired which had a significant impact on the Bank's NPA ratio and impairment for 2017. Negotiations are underway with the government to arrive at a settlement

All other government exposures are serviced satisfactorily according to the original repayment schedule. Project finance unit of the Bank closely monitors progress of the each of those government projects and reports the status to BCC as a part of regular review and for follow-ups.

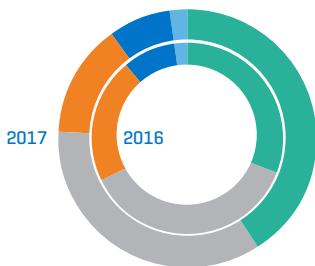
**Default Risk**

Default risk is the risk of potential loss arising from the inability or unwillingness of a counterparty to make the required payments on their debt obligations. The Bank monitors default risk using tools such as ageing, early warning signals, watch lists, management review lists and internal risk ratings which indicates the quality of the asset portfolio. The Bank's IRR model is depicted in table 4. Default risk is managed through rigorous processes for credit approval, documentation, monitoring and a loan review mechanism, recoveries and collections which facilitates continuous improvement of policies and processes.

**Table 4: Internal Risk Rating Model**

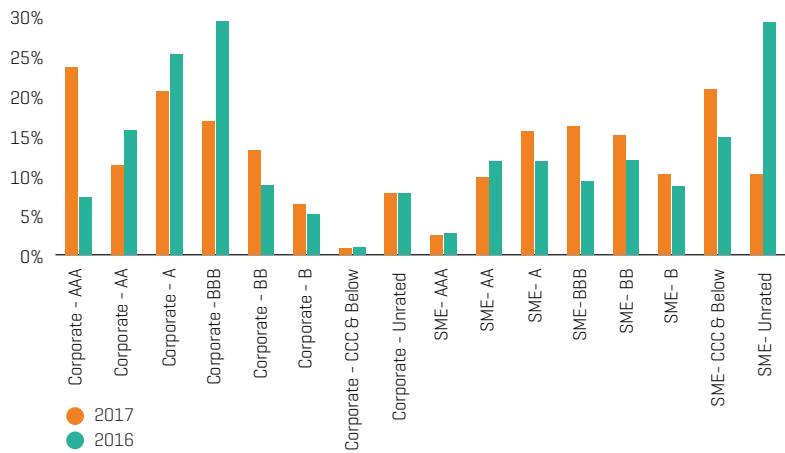
Internal Risk Rating	Grading	Credit Quality
AAA	Investment Grade	Normal Monitoring
AA		
A		
BBB	Sub Investment Grade	Close Monitoring
BB		
B		
CCC and Below	Default	Default

**PORTFOLIO BY COLLATERAL**

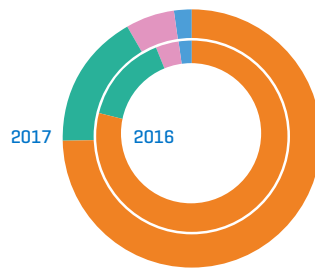


	2017	2016
Other Securities	41%	31%
Immovable Assets	35%	37%
Cash, quoted shares & other readily realizable assets	14%	21%
Movable Assets	8%	9%
Gold	2%	2%

**EXPOSURE BY RATING MODELS**



**PORTFOLIO BY DAYS PAST-DUE**



	2017	2016
Current	75%	79%
1-30 DPD	17%	15%
31-60 DPD	6%	4%
61-90 DPD	0%	0%
91-120 DPD	0%	0%
121-150 DPD	0%	0%
151-180 DPD	0%	0%
>180 DPD	2%	2%

**IFRS 9 Readiness**

The Bank is aware that, IFRS 9 will have a significant implications on loan book and investment book of the Bank.

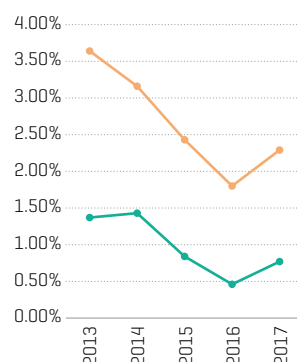
Historical PDs derived based on delinquency has to be calibrated with forward looking macro-economic factors to determine the PD term structure. The forward looking expectations will reflect the Bank's current view of the future and needs to be unbiased estimates without any conservatism or optimism.

The Expected Credit Loss [ECL] approach represents a paradigm shift in the banking industry both globally and in Sri Lanka as approach is significantly different to current practice.

Following are factors that the Bank is working on to ensure implementation is smooth and efficient.

- » **Portfolio Segmentation** – Granular segmentation of loan portfolio based on homogeneous risk characteristics. Impairment attributes [PD, LGD, EAD] differ among segments based on level of risk involved resulting in varying loss ratios.
- » **Data Collection** – Collating data required for modelling of ECL component based on historical delinquency of the loan portfolio.
- » **Data Cleansing and Validation** – Building processes to identify and cleanse data required for ECL modelling while establishing mechanisms to validate by the owners of such data.

**NON PERFORMING ADVANCES**



●	NPA Gross as a % of Loans & Advances
●	NPA Net as a % of Loans & Advances

# Risk Management

## INFORMATION & CYBER RISK MANAGEMENT

Information is considered a vital, strategic asset to HNB as it is the basis for corporate decision-making and therefore information needs to be of high quality, be easily retrievable, complete, relevant and accurate. Just as any other asset, information must be managed systematically throughout its lifecycle efficiently, according to a predetermined and predictable set of rules, in order to sustain the Bank's operational needs, in achieving its corporate vision and in compliance with obligations which are regulatory or otherwise. As a part of the HNB's commitment towards information risk management, it has developed and implemented an information management policy suite, governing various aspects of information management. The policy suite was developed under the custody of CISO and formulated in compliance with the applicable laws, best practices and other policies and procedures practiced at HNB. It aims at providing the Bank with means to enhance the quality and security of its information and overall structure, standardization and efficiency in the management of information.

Cyber risk continues to gain prominence as the dependence on technology, the number of cyber-attack incidents and their impact

increases. As witnessed in 2017, cyber risk events cross bordered with ease as the sophistication, frequency and magnitude of events increased where even the world's largest corporates became victims to hackers. Cyber risk is a key component of operational risk which encompasses events that could have a wide-ranging impact on the business as a whole such as system interruptions, errors, system manipulations, obsolescence in applications, lagging competitor technology, compromise of data, hacking etc.,. Consequently, with the increased focus on digitalisation of banking activities, managing cyber risk assumes a top priority for the Bank as new threats and solutions continue to emerge at a rapid pace requiring high levels of vigilance and investment.

In response to mounting threat levels in cyber landscape, the Bank has established an information & cyber risk management vertical under the purview of CRO. The scope of the CRO's responsibilities has also been expanded by amalgamating the responsibilities of the CISO during the year. Thus, the new risk vertical manages information & cyber risks in accordance with the laid down information & cyber risk policies to enhance the digital resilience of the Bank. The Bank has initiated a robust information & cyber risk management framework as depicted in figure 7.

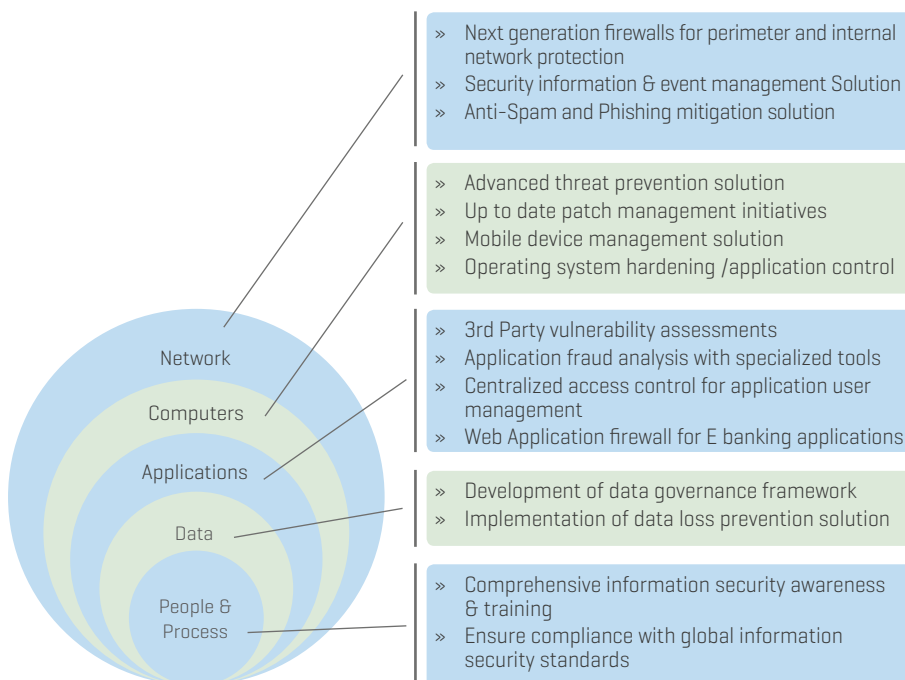
## Information & Cyber Risk Learnings and HNB's Resilience

Similar to other key players in the market, the Bank also had risk trigger events which were managed well within defined response mechanisms and with minimal damages. Key part of the Bank's resilience strategy was the implementation of duly crafted holistic damage control plan through centralized management of dissemination of wrongful and misleading information via a "Situation Management Centre" which allow all stake holders an access to accurate information with high level of transparency. It is noteworthy to mention that despite such incidents the Bank was able to retain customer confidence with no loss in deposits and business volumes within affected segments providing a great testimony to the effectiveness of the strategy adapted.

Following activities broadly outline the key steps taken to ensure continuous vigilance and structured approach to safeguard the Bank from emerging threats.

- » Independent expert vulnerability assessments
- » Independent expert security & compliance reviews
- » Periodic review of the effectiveness of the Bank's internal IT/IS management by IT security team, internal audit and CISO.
- » A comprehensive review of cyber security "current state" of the Bank on an on-going basis
- » Rolling out a well-defined data classification methodology supported by industry leading IT tools
- » Implementing appropriate but optimal controls over data in transit, at rest and in use. Email flow and USB/CD ROM restrictions were implemented together with organization wide training and awareness campaigns to enhance levels of information security.
- » Implementation of a Security Information & Event Management (SIEM) solution and strong application controls where all critical systems and databases are integrated for log analysis enhancing capabilities of identifying IT & cyber risks.
- » Continuous upgrade of antivirus/malware/ ransomware protection.

Figure 4 : Layered Defense Model for Cyber Security Management





HNB continues to strengthen its resilience against cyber risks by adopting industry best practice and evaluates its vulnerabilities by conducting comprehensive due diligence tests. The IT disaster recovery plan is a key component of the Bank's Business Continuity Plan. Accordingly, it is tested regularly and amended as appropriate. BAC and the Board monitor the Bank's capabilities to manage cyber risks and progress of on-going initiatives through a "cyber risk dashboard" which is presented to BIRMC and Board on a monthly basis.

A number of projects commenced during 2017 to assure customer privacy and information security and are scheduled for completion in 2018 which include the following:

- » Obtain the ISO 27001:2013 Certification for the primary and disaster recovery IT data centre
- » Enhance the existing incident response plan to establish a Cyber Crisis Management Plan (CCMP) addressing the entire life cycle of incident detection, response, containment and recovery.
- » Implement a data loss prevention solution
- » Introduce an identity access management solution for user access control and authentication
- » Continuous upgrade of the existing firewall infrastructure with next generation firewall capabilities
- » Implementation of two (02) factor authentication capability for internet banking applications
- » Mandate the EMV chip based cards for all credit and debit card holders

With a clear vision and aggressive focus on digital banking, HNB is committed to safeguarding interests of all stakeholders including our customers, and investors. The Bank continues its efforts to strengthen the protection and resilience against cyber risks by adopting latest protection mechanisms and educating our staff and customers on same. BAC, BIRMC along with the Board, closely monitor and have an oversight of the Bank's cyber risk management activities which are supported with routine assessment of reports regarding the cyber risk posture

### Challenges in Managing Information & Cyber Risks

Information and cyber risks continue to evolve rapidly necessitating continuous monitoring for emerging threats and resources to execute new classes of activities to navigate and combat embryonic threats. The Bank has addressed a number of challenges in a short time frame to enhance awareness of issues related to information and cyber risk and set in place the identification, measurement, monitoring and mitigating mechanisms in alignment with other conventional risks management activities. These initiatives included enhancing awareness of issues within corporate management and Board through regular presentations by internal and external experts on the subject. A deep understanding of the business is necessary to align information & cyber risk management strategy with business needs of the Bank and this was done through continuous impact assessment of ease of doing business securely.

Moving forward, we need to set benchmarks for the information & cyber risk vertical to determine whether our capabilities, staffing levels, competencies budgets and results compare favourably with those of our peers and competitors. We are strengthening our processes to evaluate third party ecosystems to identify and mitigate vulnerabilities that may arise from supply chain partners given recent data breaches that have served to underline that companies are only as secure as their weakest partner. Introducing risk metrics to this evolving area of risk also poses a challenge as CISO needs sound metrics and measurement capabilities to make smart decisions about how to allocate resources. This is being addressed on a continuous basis as our information & cyber risk vertical increase the scope and depth of the duties undertaken.

Adoption of novel technology in business smartphones, tablets and mobile devices are changing the ways employees and customers access corporate systems. The Internet of Things (IoT), digital disruption, and other global business trends will require the CISO to implement new risk control processes and technology with guidance from experts to strengthen information and cyber risks without hampering business growth.

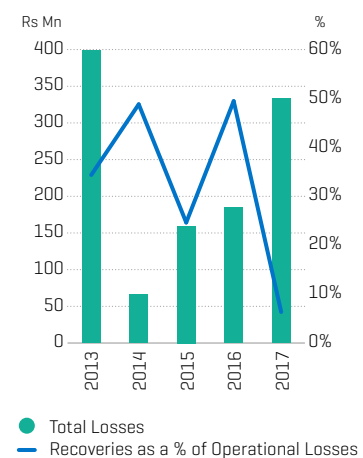
### OPERATIONAL RISK

Operational risk is inherent in all banking products and processes and is a rapidly evolving area as the Bank seeks to move to advanced approaches which can reduce the capital required and enhance the customer experience. Responsibility for managing operational risk is shared across the organization with every employee required to manage the operational risk relevant to their activities.

#### Operational Risk Review

Operational losses in 2017 remained well below the internal alert level of 2% of the Bank's gross revenue reflecting the rigour of operational risk management processes and the tone at the top. The below graph depict the operational risk losses of the Bank reflecting an increase over the past five years as although we continue to strengthen this vital risk through focused efforts.

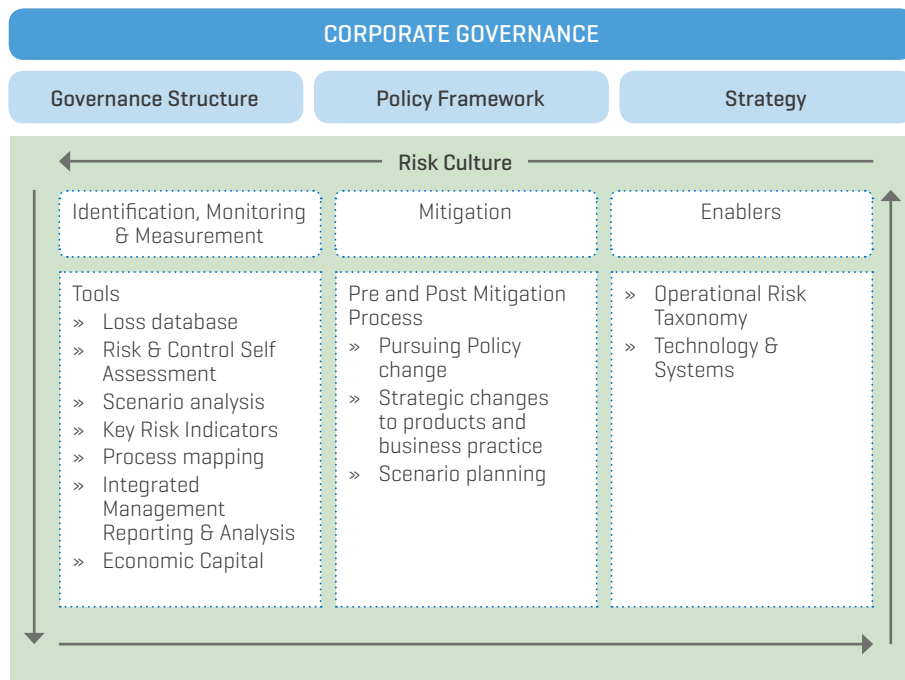
#### TRENDS IN OPERATIONAL LOSSES REPORTED



Losses in retail banking business lines remain the most significant due to the large volumes of transactions processed by them. External frauds was the key area of concern in 2017 according to Basel event type classification.

# Risk Management

Figure 5: Excellence in ORM



## Operational Risk Framework & Governance

Operational risk is managed in accordance with the Bank's overarching overall risk framework policy and specific operational risk management policy which articulates procedures for measurement, monitoring, reporting and strategies for management of operational risk together with tolerance and alert levels. Figure 5 summarises the Bank's quest for excellence in ORM.

The Board of Directors is assisted by BIRMC in ensuring that a robust framework for managing operational risks and roles and responsibilities are clearly communicated and understood as set out in operational risk policy. DRSC is responsible for overseeing the day to day management of operational risk and is supported by the operational risk management unit who are mandated to review operational risk reports in detail, highlight potential risks and recommend improvements to policy, processes and controls. This division has two areas of focus. Predominantly it focusses on key operational risk controls both preventive and detective with specific attention on preventive controls. In addition to above RCSA process, KRIs and loss data collection process enable the operational risk unit to gauge the level of implementation severity. Engagement with business units is key to identifying potential risks, areas of concern and for improvement. Effective implementation of business unit

wise risk grid as well as overall risk grid of the bank where two way communication with business units would help in improving the policy level decision making.

## Operational Risk Management Processes & Tools

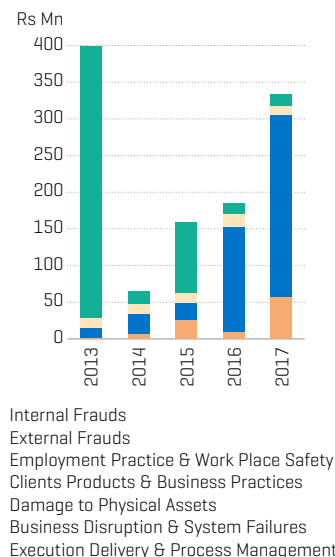
The ORM framework sets out the following specific tools for managing operational risk:

### Risk & Control Self-Assessment (RCSA)

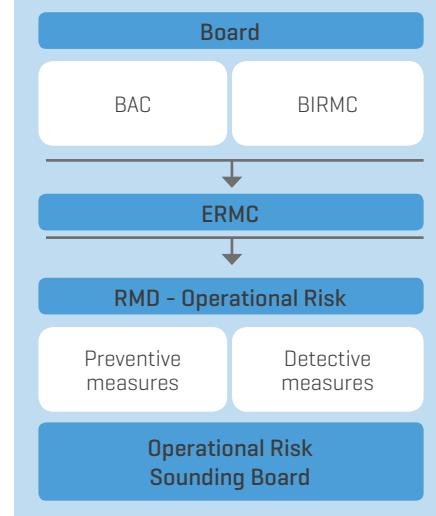
Key to effective implementation of the 1st line of defence, is the RCSA process which facilitates business units taking ownership for assessing their own processes and controls on an annual/semi-annual/quarterly basis. This is carried out at business unit / segment level and overall for the Bank which is vetted and assessed by operational risk function which enables:

- » Identification of potential operational risks
- » Formulation of action plans to address identified control gaps
- » Evaluation of the operational risk profile of the entire Bank
- » Ensures that behaviours and trends of key operational risks are monitored

## OPERATIONAL LOSSES BASED ON EVENT TYPE



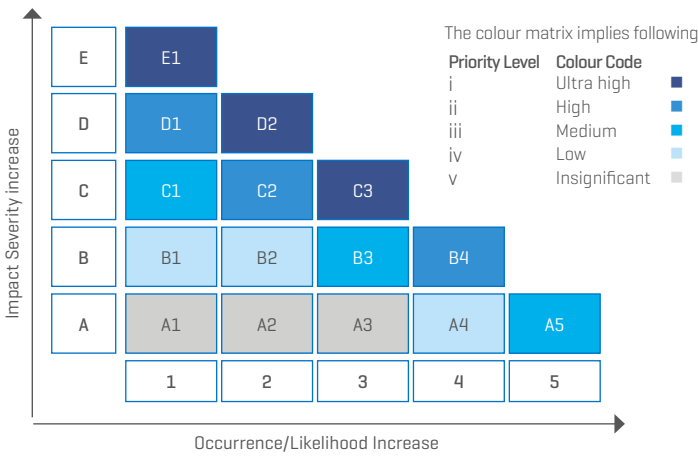
## OPERATIONAL RISK GOVERNANCE



## Risk Matrices

Risk grids capturing internal and external risks which have the potential to materially impact the Bank's operations is reviewed and updated annually. Inherent risks identified in segments or banking activities are compared with mitigating factors to identify residual risk. These are set in a matrix according to the impact - severity and likelihood of occurrence as given in figure 6 facilitating an understanding of inherent risks, underlying causes and mitigating controls/actions.

**Figure 6: Risk Matrix**



**Key Risk Indicators (KRI)**

Key risk indicators provide early warning of increased risk exposures developed/identified by the Bank. The ORM team added new indicators widening the scope and has also set trigger thresholds for some indicators. KRIs are monitored continuously and updated to reflect regulatory requirements and trends observed externally and internally. New and refreshed KRIs with thresholds will be introduced in 2018 based on risk drivers and causal factors identified via RCSA and root cause analysis (RCA).

**Internal Loss Data Capturing & Reporting**

Loss data indicating internal losses and “near misses” for material exposures from all business units, support functions and geographic locations are captured and categorised according to Basel guidelines on loss classification. Review mechanisms and processes are in place to analyse the on-going relevance of loss data against key business lines or other related trends using judgment to support assessment of operational risk and control improvements.

**Mitigating Operational Risk**

Operational risk is mitigated through both prior and post operational risk event analysis. Preventive risk tools of the Bank include establishing risk management frameworks, policies and guidelines, training and development of our team to strengthen our first line of defence, making strategic changes in products and business practices and implementing a sound system of internal controls. Post event mitigation mechanisms rely on our ability to respond to operational

risk events in a timely and effective manner, containing losses to lives and assets of the Bank. The following tools are key to mitigating operational risk:

- » **Insurance** – Insurance is used judiciously to mitigate the financial impact of risk events that could result in or trigger a potential loss to the Bank. A comprehensive insurance cover is in place securing the Bank from low frequency-high severity and high frequency- low severity loss events. Adequacy and effectiveness of risk transfer via insurance covers are reviewed annually and monitored through a ratio of uninsured loss events against the gross income which is measured compared to an industry benchmark. The Bank has also completed a data cleansing exercise in insurance claim process and data base and automation of the claim process will be launched in 2018.
- » **Business Continuity Planning (BCP) & Disaster Recovery (DR)** – A comprehensive BCP policy is in place to ensure that business can continue in the event an emergency or disaster occurs. It identifies Mission Critical Units (MCUs) and procedures which are tested according to specified frequencies and includes a comprehensive IT disaster recovery for critical processes. The Bank ensures regular testing through drills which are subject to independent validation by internal audit department. Their observations are submitted to BAC while learning and improvements to disaster recovery activities are ratified by the BIRMC.

- » **Scenario planning** – A key tool assisting with the development of appropriate responses to few potential loss events that can or likely to take place together such as fire, security breach etc..
- » **Outsourcing** – A comprehensive and detailed policy and guideline on outsourcing functions is in place and the compliance division of the Bank is responsible for implementation of the same. Archival of documents, ATM cash management and cash transport and selected recovery functions are some of the outsourcing activities of the Bank which are managed within this policy and specific service level agreements. Detailed KYC and due diligence tests are conducted prior to engagement of new service providers or renewal of existing contracts to assess the AML/CFT risks that may arise with regard to the outsourcing arrangements. A complete report on outsourced activities is submitted to CBSL periodically as required for review. Moving forward, the operational risk unit will emphasise on risk based review of outsourcing activities covering BCP, contingency plans, documentation risk, performance review, contractual obligations of outsourced parties.

ORSC implemented wide ranging initiatives to further strengthen management of evolving & emerging operational risks by way of proactive measures and preventive controls while ensuring that disciplinary action is taken against violators serving as deterrents.

# Risk Management

## MARKET RISK

Market risk is a key determinant of the Bank's profitability as all operations are subject to at least one element of market risk. Rising interest rates and exchange rate fluctuations during the year posed challenges and opportunities which were managed within the Bank's risk appetite and strict implementation of tolerance limits to optimize returns while maintaining prudent risk profile.

### Market Risk Review

HNB's market risk stems largely from the Bank's Non-Trading Portfolio (Banking book). The Bank's trading portfolio is not material

compared to the total assets subject to market risk as set out Table 6. The main components of market risk are Interest Rate Risk (IRR) and Foreign Exchange (FX) Risk as the Bank has minimal exposure to commodity price risk and equity risk.

Exposure to market risk stems from the Bank's trading portfolio or (Assets Held for Trading - AFS) and the Bank's Non-Trading Portfolio (Financial Assets Held to Maturity - HTM). The trading portfolio is managed by Treasury and the Non-Trading Portfolio is impacted by the Bank's key business verticals. The Balance Sheet and Income Statement implications of market risk are summarised in Table 6.

Table 5: Internal Risk Rating Model

	Audited (Rs.Mn)	
	Carrying Amount	
	2017	2016
<b>Assets Subject to Market Risk</b>		
Cash and Cash equivalents	21,740	17,511
Balances with Central Bank of Sri Lanka	38,611	33,778
Placements with banks	3,182	753
Reverse repurchase agreements	-	4,303
Derivative financial instruments	615	290
Other financial instruments - Fair value through P&L	120	545
Loans and receivables to Customers	639,102	584,412
Financial Investments - Loans & Receivables	122,199	99,261
Financial Investments - AFS	95,404	89,915
<b>Total Assets Subject to Market Risk</b>	<b>920,973</b>	<b>830,768</b>
<b>Liabilities subject to Market Risk</b>		
Due to banks	62,463	69,219
Derivative financial instruments	1,306	666
Securities sold under repurchase agreements	5,064	13,458
Due to customers	701,519	623,495
Other borrowings	27,258	27,840
Debt Securities Issued	4,540	4,653
Subordinated term debt	25,809	26,153
<b>Total Liabilities subject to Market Risk</b>	<b>827,959</b>	<b>765,484</b>

Table 6: Market Risk Impact on Financial Statements

Portfolio	Line Items	Balance Sheet Value	Income Statement
<b>Banking Book</b> "Hold Until Maturity" and "Available for Sale" (AFS)	» Deposits » Loans » Bonds (Investment Portfolio)	Historical Cost	Net Interest Margins (NIM)
<b>Trading Book</b> "Intend to Actively Trade"	» Bonds (Treasury Portfolio) » Derivatives (Forward, Options,)		

## 2017 HIGHLIGHTS

- Risk appetite on the foreign exchange risk was redefined with improved limits on foreign currency borrowings.
- Improvements made in information on Liquidity Risk management enabled better management of liquidity mismatched arising from cross currency exposures.

The trading portfolio is exposed to all components of market risk while the non-trading portfolio is exposed mainly to re-pricing risk, basis risk and forex risk.

### Market Risk Framework & Governance

Market risk management is a critical aspect in implementing Asset and Liability Management (ALM) framework of the Bank as summarized in Figure 7.

The governance structure for market risk management in accordance with the Bank's overall risk framework policy. Responsibility for approval of policy and the RAS rests with the Board and BIRMC while ERMC is responsible for policy formulation and recommending parameters relating to the RAS. ALCO is responsible for monitoring market risk exposure and initiating necessary action to manage market risk exposures within the risk appetite.

The market risk management unit which is part of the integrated risk management division measures, monitors and reports on market risk exposures and assists in review of the Bank's market risk related policies and

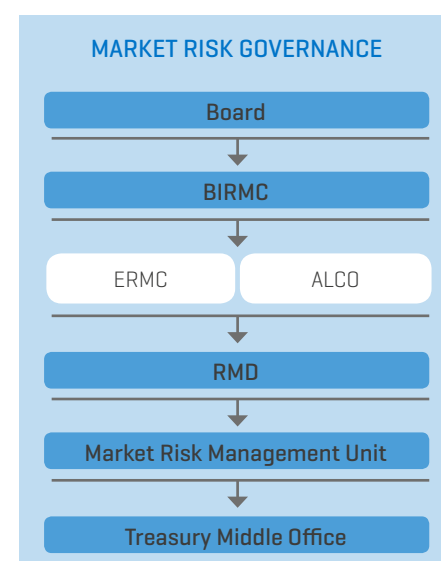


Figure 7: Elements of Asset & Liability Management

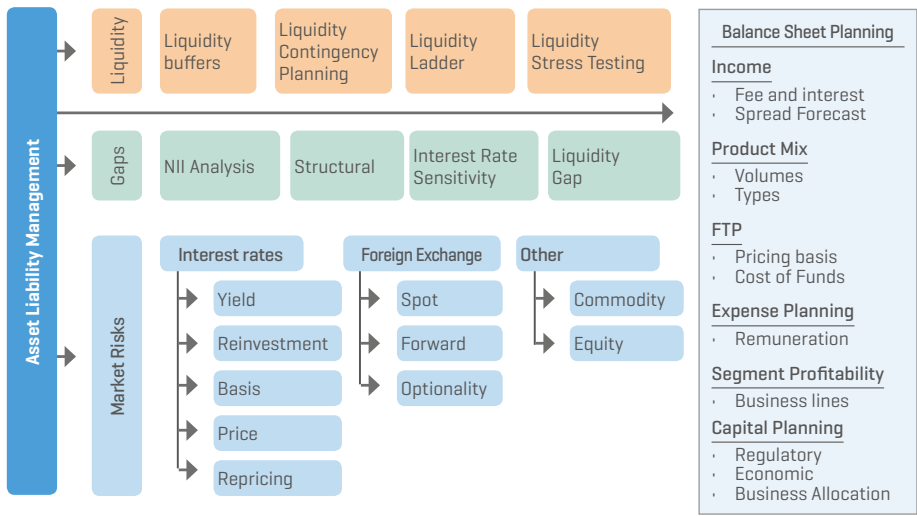


Table 7: Market Risk Limits

Limit Description	Target Risk Area	Effectiveness
<b>Treasury Activity Limits</b>		
FCY Borrowings	Governs the maximum percentage foreign currency borrowings limiting undue exposures that could arise from liquidity mismatches and exchange rate risk	governed by statutory limit of 15% of capital base for DBU. New CBSL direction in effect from January 2018
SWAP Ratio	Governs the maximum percentage of foreign currency deposits convertible to LKR.	Monitored daily, any breach escalated for appropriate covering approval and informed to treasury department for corrective action
Cap on inter-bank "Call" borrowing	Limits the Bank's exposure to adverse fluctuations in inter-bank call money rates	
<b>Transaction/dealer Limits</b>		
Stop-Loss Limit (Single deal/daily/ monthly)	Restricts the extent of loss per single trading transaction/ loss on a particular day/ loss on a monthly basis	Monitored on daily basis

exposure limits at least annually, providing an independent view on market risk. Treasury plays an important role in managing both banking/trading book and asset and liability position of the Bank and is segregated in line with best practices in to front office, middle office and back office. TMO ensures that treasury front office deals within limits set out in the Bank's risk appetite and also reviews the activities of the back office to ensure that all exposures are reconciled and key issues are escalated promptly.

**Market Risk Management**

The Bank manages market risk in accordance with the standardized approach set out in Basel III and is moving in line with the road map directed by CBSL for implementation of the more advanced Internal Model

Approach. Significant investment has been made in improving market risk management framework by ongoing treasury system upgrade project. On implementation, the Bank will have advance limit monitoring system and statistical tools for better MI and analysis.

**Key elements of the Bank's Market Risk Management Framework include:**

**Market Risk Limits** – These are limits reviewed and approved by the Board and are regularly reviewed by ALCO and ERM. These are typically contained within narrower bands than specified in the RAS if market dynamics indicate elevated risk levels

**Interest Rate Risk in Banking Book**

IRRBB arises due to the differences in re-pricing of Rate Sensitive Assets [RSA] and Rate Sensitive Liabilities [RSL], which will have an impact on the future interest income and expenses and its economic value. Consequently, the Bank's interest rate sensitive assets and interest rate sensitive liabilities are analysed by different maturity buckets to determine suitable strategies to optimize earnings based on identified gaps and future interest rate forecasts. The Bank uses modified duration gap approach for analysing the changes in economic value of equity, which requires the mapping of assets and liabilities into different time buckets based on their residual maturity as set out below depicting an increased/decreased sensitivity.

# Risk Management

Table 8: Interest Rate Sensitivity Analysis for local and foreign currency denominated assets and liabilities as at 31 December 2017 (in Rs. Mn)

	Upto 1 Month	1-3 Months	3-6 Months	6-12 Months	1-3 Years	3-5 Years	Over 5 Years	Non-Sensitive	Total (Rs.Mn)
Assets and Off Balance Sheet Exposures									
Balances due from Head Office, Affiliates and Own Branches	-	-	-	-	-	-	-	3,772	3,772
Bills of Exchange	2,117	968	73	-	-	-	-	-	3,158
Cash on hand	-	-	-	-	-	-	-	20,813	20,813
Deposits with Central Bank	-	-	-	-	-	-	-	38,611	38,611
Investments (Net of provisions)	14,645	33,823	90,637	7,374	33,322	22,793	7,436	-	210,030
Loans and Advances	289,410	48,110	22,192	35,363	71,237	25,728	13,386	-	505,426
Non-Performing Loans	-	-	-	-	3,504	4,530	9,604	-	17,638
Net Inter-Branch Transactions	-	-	-	-	-	-	-	2	2
Other Assets	-	-	-	-	-	-	-	22,144	22,144
Overdrafts	62,797	7,566	4,758	29,612	-	-	-	-	104,733
Accrued Interest	-	-	-	-	-	-	-	3,852	3,852
Balances due from Other Banks	3,183	-	-	-	-	-	(124)	-	3,059
Fixed Assets	-	-	-	-	-	-	-	15,988	15,988
Reverse Repo	-	-	-	-	-	-	-	-	-
<b>Total</b>	<b>372,152</b>	<b>90,467</b>	<b>117,660</b>	<b>72,349</b>	<b>108,063</b>	<b>53,051</b>	<b>30,302</b>	<b>105,182</b>	<b>949,226</b>
Liabilities and Off Balance Sheet Exposures									
Balances due to Other Banks	20,171	47,108	12,153	6,226	-	-	-	-	85,658
Bills Payable	1,523	-	-	-	-	-	-	-	1,523
Demand Deposits	-	-	-	-	-	-	-	36,905	36,905
Interest Payable	-	-	-	-	-	-	-	18,914	18,914
Other Liabilities	-	-	-	-	-	-	-	30,652	30,652
Savings Deposits	209,636	-	-	-	-	-	-	-	209,636
Time Deposits	69,412	145,778	92,313	112,956	6,992	6,786	6	-	434,243
Bonds Issued	-	-	-	-	2,757	16,067	2,318	-	21,142
Borrowings	200	216	473	865	1,907	1,101	513	-	5,275
Capital	-	-	-	-	-	-	-	31,086	31,086
Certificates of Deposits	91	60	100	-	-	-	-	-	251
Repo	4,021	653	316	47	-	-	-	-	5,037
Reserves	-	-	-	-	-	-	-	68,904	68,904
<b>Total</b>	<b>305,054</b>	<b>193,815</b>	<b>105,355</b>	<b>120,094</b>	<b>11,657</b>	<b>23,954</b>	<b>2,837</b>	<b>186,461</b>	<b>949,226</b>
Period Gap	67,098	(103,349)	12,305	(47,746)	96,406	29,098	27,465		
Cumulative Gap	67,098	(36,251)	(23,946)	(71,692)	24,714	53,812	81,277		
RSA/RSL	1.22	0.47	1.12	0.60	9.27	2.21	10.68		

**Notes:**

- 1] The above figures have been prepared as per SLAS and may differ from SLFRS figures given in the Statement of Financial Position
- 2] Prepared as per requirement given in the Banking Act Direction No 7 of 2011 on "Integrated Risk Management Framework".

### Stress Testing On Projected NII

The Bank carries out stress tests on IRR for its loans and advances portfolio and the fixed income securities portfolio as given below.

**Table 9: Stress Testing on Loans & Advances Portfolio**

	2017		2016	
	100 bp Parallel Up Rs. '000	100 bp Parallel Down Rs. '000	100 bp Parallel Up Rs. '000	100 bp Parallel Down Rs. '000
As at December 31st	2,466,833	(2,515,086)	755,946	(794,842)
Average for the Year	1,412,789	(1,433,197)	411,682	(429,522)
Maximum for the Year	2,466,833	(613,903)	755,946	(217,086)
Minimum for the Year	583,369	(2,515,086)	208,809	(794,842)

**Table 10: Stress testing on Fixed Income Securities Portfolio**

Magnitude of shock		1%	2%	5%
<b>Fixed Income Risk</b>	<b>Original CAR</b>	<b>CAR after Change</b>		
Fixed Income Total Portfolio	17.04%	16.80%	16.56%	15.82%
Fixed Income Trading Portfolio		17.04%	17.04%	17.04%

### Foreign Exchange (FX) Risk

Foreign exchange risk of the Bank arises from its foreign currency inflows and outflows and is managed using currency swaps while overnight positions are curtailed by the regulator through the NOP limit. The Bank also calculates VaR, to measure market risk exposure of the Bank's overnight foreign exchange positions by using 10 day VaR, at 99% confidence level. TMO monitors limits online and at specified frequencies in accordance with a comprehensive market risk management limit structure ensuring that they are maintained within the Bank's risk appetite. Trigger points are escalated to CRO, MD/ CEO or Board of Directors depending on the potential loss that may arise. The Bank's exposure to FX risk as at the end of the reporting period is given in table 11 and it is noteworthy that over 95% of the Bank's foreign currency exposure is in US dollars.

**Table 11: Foreign Currency Exposures**

	Net Open Position [NOP] 000	Overall Exposure in Respective Foreign Currency 000	Overall Exposure in Rs 000
United States Dollar	-6,530	2,037,207	312,202,009
Great Britain Pound	5	81,690	16,896,297
Euro	35	195,199	35,841,762
Japanese Yen	-829	4,354,742	5,927,240
Singapore Dollar	10	6,564	753,023
Other currencies in USD	305	75,616	11,588,213
Total Exposure	-6,176	2,500,545	383,208,544
Total Capital Funds as at December 31, 2017 Rs 000		115,340,970	
Total exposure as a % of Capital Funds as at December 31, 2017		0.82%	
VaR [99%, 1 day] 31st December 2017		0.29%	
VaR [99%, 1 day] 31st December 2016		0.63%	

The Bank applies rate shocks between 5% to 15% to estimate the impact on profitability and capital adequacy of the Bank. Accordingly, a 15% change in exchange rate has a minimal impact on CAR as given in the table 12.

**Table 12: Stress Testing on Foreign Currency Exposures**

Magnitude of shock	Original CAR	5%	10%	15%
<b>Foreign Currency Risk</b>		<b>CAR after Change</b>		
All foreign currencies	17.04%	17.03%	17.03%	17.02%
USD/LKR		17.03%	17.03%	17.02%

# Risk Management

## Equity Price Risk

The Bank's equity portfolio is more strategic in nature. Stress testing conducted at 10% to 40% change in equity prices indicate no change in CAR. The bank conducts mark-to-market calculations for held-for-trading and available-for sale portfolios and VaR calculations 99% on a 10 day basis. Year end positions on the trading portfolio are summarised in table 13 and stress testing results are depicted in table 14.

**Table 13: Equity Price Exposures**

	Dec 2017		Dec 2016	
	Exposure Rs.mn	VaR [99%, 10 day]	Exposure Rs.mn	VaR [99%, 10 day]
Equity (MV)	120 Mn	4.26 Mn.	648 Mn.	32.28 Mn.

**Table 14: Equity Risk Stress testing**

Magnitude of shock	Original CAR	10%	20%	40%
Equity Risk		CAR after Change		
Equity Prices	17.04%	17.04%	17.04%	17.03%

## LIQUIDITY RISK

HNB continues to maintain a stable liquidity and funding profile as reflected by its liquid assets ratio, credit ratings and maturity gap analysis.

### Liquidity Risk Review

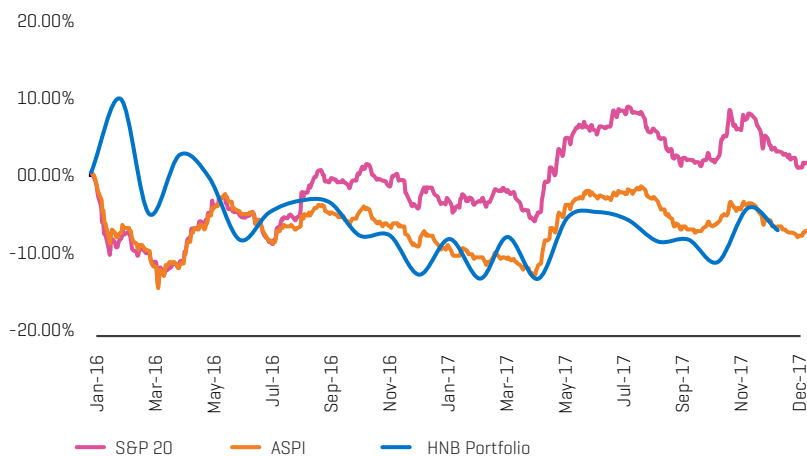
Growth in deposits exceeded advances growth around 3%, cash flows from additional equity and subordinated debt improved the liquidity position reducing the reliance of interbank borrowings and currency swaps.

Bank is conscious of a sustainable growth in the deposit base and especially in CASA and will continue to focus in the area.

### Liquidity Risk Management Framework & Governance

Potential short term cash demands by depositors and borrowers, the Bank's own borrowing, trading and counterparty interactions combine with variability in asset and liability maturity profiles, giving rise to liquidity risk. A comprehensive liquidity risk management framework is in place which includes contingency plan encompassing both contracted and un-contracted liquidity positions as depicted in figure 8. The governance structures identifying roles of those with responsibility for managing liquidity risk. The Board, BIRMC, ERMC and ALCO regularly review reports on the Bank's liquidity indicators to ensure that they are managed within agreed parameters.

## PERFORMANCE OF EQUITY PORTFOLIO



## Commodity Risk

Commodity risk is limited to the extent of the Pawning portfolio which is impacted by movements in the price of gold. The Bank's exposure is indirect by nature and is managed by cautious approach to managing risks associated with the Pawning portfolio. The Bank also uses conservative loan to value ratios to manage its exposures to commodity price risk.

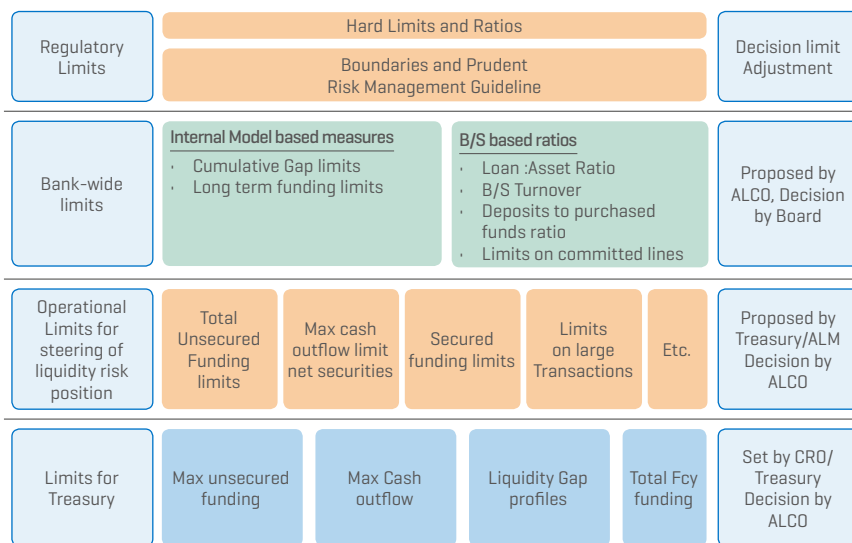
### 2017 HIGHLIGHTS

124.3%

Liquidity coverage Ratio  
Regulatory requirement 100%



**Figure 8: Liquidity Risk Management Framework**



**Managing Liquidity Risk**

Key liquidity risk indicators used by the Bank to assess its liquidity position include Statutory Liquid Asset Ratio (SLAR), Liquidity Coverage Ratio (LCR), Net Advances to Deposit Ratio, Dynamic and Static (Structural) Liquidity Gap Summary, Core Funding Ratio, Funding Concentration and Commitments Vs Funding Sources. Managing liquidity

risk entails shifting of assets and liabilities, obtaining interbank loans and drawing down credit lines. Liquidity ladders, probabilistic analysis and stress tests are undertaken to evaluate liquidity requirements of the Bank using both stock and flow approaches. Internal limits in place are more stringent than the statutory requirements in line with the Bank's overall approach to risk management.

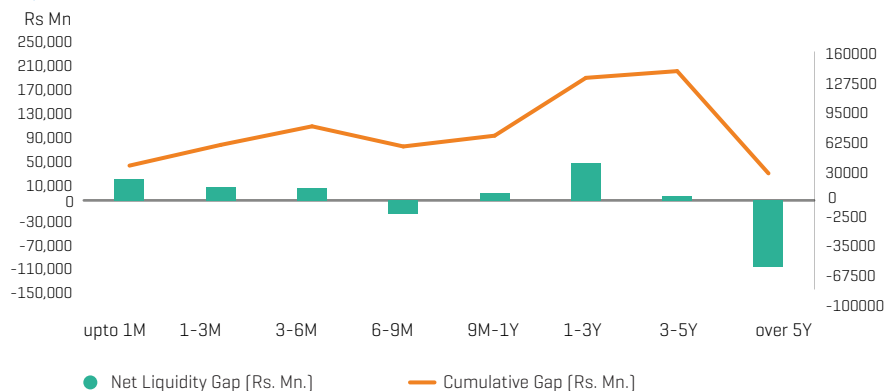
Liquidity gaps are monitored based on the behavioural analysis of the Bank's assets and liabilities, historical rollover patterns, drawdown of unutilised overdrafts and disbursement of approved but undisbursed loans. The liquidity gaps behaviour analysis as at 31st December 2017 is given below.

The Bank also measures its liquidity position in all major currencies at both individual and aggregate levels to maintain potential risks within specified limits. Potential liquidity commitments resulting from loan disbursements and undrawn overdrafts are also monitored to assess adequacy of funding sources. Liquidity risk is mitigated by maintaining an adequate margin in high quality liquid assets and diverse funding sources. Contingency funding agreements with peer banks are in place ensuring availability of sufficient liquidity buffers in accordance with the Bank's contingency funding plan.

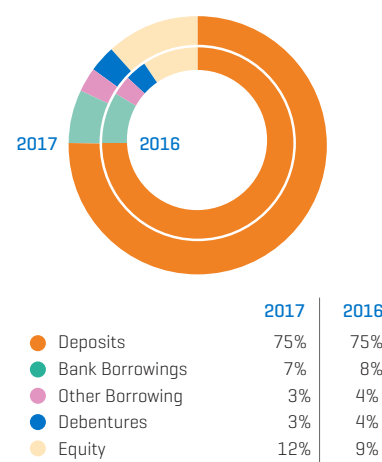
**Funding Diversification by Product**

The Bank's primary source of funding is deposits from customers which accounts for 75% of funds. The graph below provides an analysis by products of the Bank's funding diversification as at year end.

**LIQUIDITY GAP - BASED ON BEHAVIOURAL ANALYSIS**



**FUNDING DIVERSIFICATION**



**Table 15: Managing Liquidity Risk**

Funding Plan	Managing Liquidity Risk	Managing intra day liquidity risk	Identify Contingent Funding Requirement	Managing Regulator
Identify concentration risk in banking book	Establish liquidity policy and appetite	Maintain liquidity buffers	Early warning indicators	Maintaining LCR
Pricing liquidity risk via transfer pricing mechanism within the bank	Monitor intra day limits and carry out stress testing	Daily clearing and settlement	Conduct liquidity simulations	Reporting on liquidity assets and reserves

# Risk Management

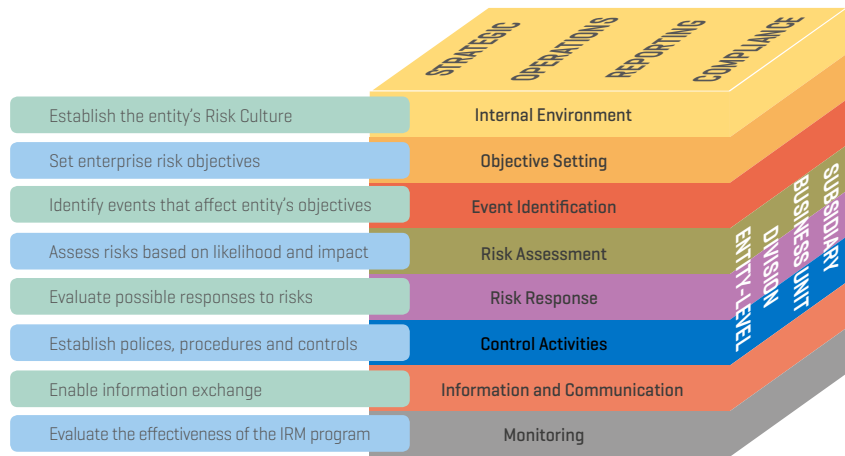
## INTEGRATED RISK MANAGEMENT

Integrated risk management vertical consolidates all identified risks in HNB providing a holistic view of its vulnerabilities and strengths. The dedicated IRM function within the purview of the CRO ensure that a disciplined approach is followed in aligning business strategy, processes, people, technology and knowledge within respective risk verticals for balanced decision making. Scenario driven stress tests are performed across risk verticals to estimate shock absorption capacity of the Bank. The unit also prepare a comprehensive ICAAP document for the Bank and supports development of the Bank's risk appetite framework and high-level risk goals to monitor compliance. HNB uses the COSO framework depicted in figure 9 to ensure that appropriate internal controls are in place to facilitate achievement of the strategic goals of the Bank.

## CAPITAL MANAGEMENT

The objective of capital management is to ensure that the HNB has sufficient capital to support its regulatory, business and stress testing requirements at all times in line with its risk appetite. The Bank's Internal Capital Adequacy Assessment Process (ICAAP) Framework is in line with Basel III requirements which sets out the process for assessing total overall capital adequacy in relation to the Bank's risk profile as summarized in table 16. Prudent internal limits which are more stringent than the regulatory requirements provide early warning signals with regard to capital adequacy.

Figure 9: COSO Framework for Internal Control



While the standardized approach is used for credit and market risk computation, the operational risk related capital is computed based on basic indicator approach. The Bank has also migrated to compute capital in line with the road maps set by CBSL under Implementation of Basel III directive.

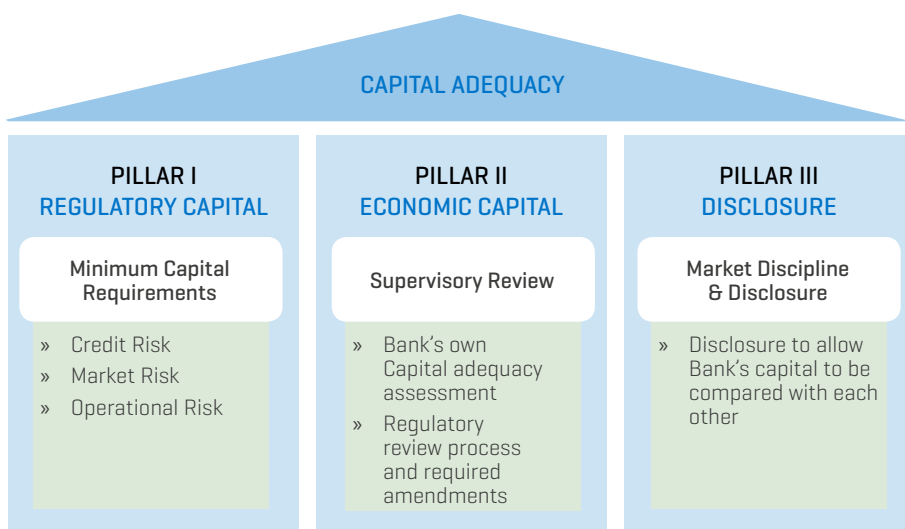
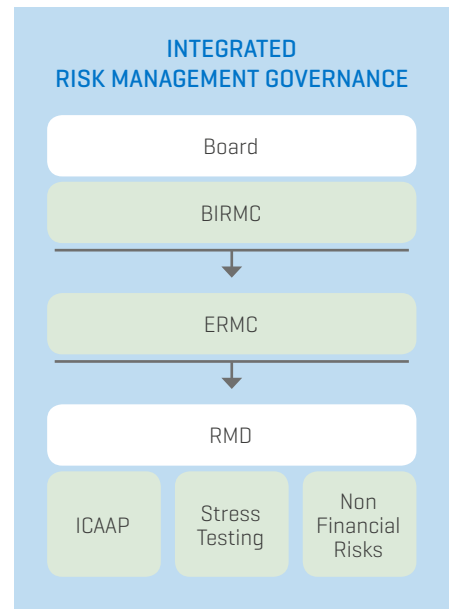
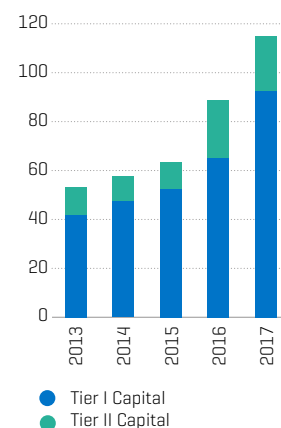


Figure 10: Capital Adequacy Framework

## CAPITAL



**Table 16: Pillar I – Current Approach Adopted by the Bank**

Capital Ratios	Basel III	Basel II
	2017	2016
Tier I (Regulatory minimum 5%) (Basel III - 6%)	13.72%	11.22%
Total CAR (Regulatory minimum 10%) (Basel III - 11.75%)	17.04%	15.27%

**Table 17: Capital at Bank’s Level**

Capital	Basel III	Basel II
	2017 Rs 000	2016 Rs 000
Tier I: Core Capital	92,876,653	65,082,084
Tier II: Supplementary Capital	22,464,317	23,486,696
Total Capital Base	115,340,970	88,568,780
Total Risk Weighted Assets	676,946,963	579,879,091

HNB ensures strict compliance with both regulatory capital requirements and our own prudential capital requirements. Consequently, we are well positioned to meet future expected requirements as we continue to attract sufficient capital to support our growth aspirations and business needs.

**Internal Capital Adequacy Assessment Process (ICAAP) at HNB**

The ICAAP document of the Bank assesses capital requirement in terms of both regulatory and economic capital perspective. ICAAP provides an assurance to the Bank and the regulator of the availability of high quality capital to cover actual risks, which are considered material. Accordingly, the Bank computes economic capital under Pillar 2 of Basel III by using both quantitative and qualitative approaches. The Bank’s strategic objectives for next three years are taken in to account when preparing the forward looking ICAAP assessment commensurate with the Bank’s risk appetite, size of the risk weighted assets, market and regulatory expectations etc.,

Building blocks of the ICAAP framework are risk governance, risk appetite statement, risk measurement methodologies, risk based pricing, performance measurement, capital planning, and stress testing.

ICAAP of the Bank supports consideration of strategic, risk management and capital plans in a meaningful manner and along with key risk assumptions made in arriving forecasts. The process involves high level inputs from senior management, management committees, board committees and the Board. The Bank also adopted new

methodologies in capital planning and stress testing.

The Bank is currently in the process of adopting IFRS 9 for the ICAAP and accordingly underlying assumptions will be changed to accommodate an expected loss model migrated from current incurred loss model. As a result of IFRS 9 implementation PD and LGD computation methodologies will have a significant impact which in turn affect the economic capital.

The ICAAP process also supports profit optimization as it involves evaluation of potential impacts through measurement of vulnerabilities by carrying out stress testing and scenario-based analysis, enhancing the information available to the leadership of the Bank in making critical decisions. It also facilitates identification of gaps in managing qualitative and quantitative aspects of reputational risk and strategic risk which are not covered under Pillar 1 of Basel III.

**Internal Liquidity Adequacy Assessment Process (ILAAP)**

Apart from regular supervisory review and evaluation process applicable for ICAAP, the Bank is now moving towards Internal Liquidity Adequacy Assessment Process (ILAAP) where it identifies and assesses all relevant liquidity and funding risks to ensure adequate measures and monitoring mechanisms are put in place to take timely action to avoid liquidity shortages. ILAAP requires a robust liquidity stress testing management, which would quantify the Bank’s position in a stressed scenario and assess the ability to endure severe stress today and for a foreseeable future.

**NON FINANCIAL RISKS (NFR)**

**Strategic Risk**

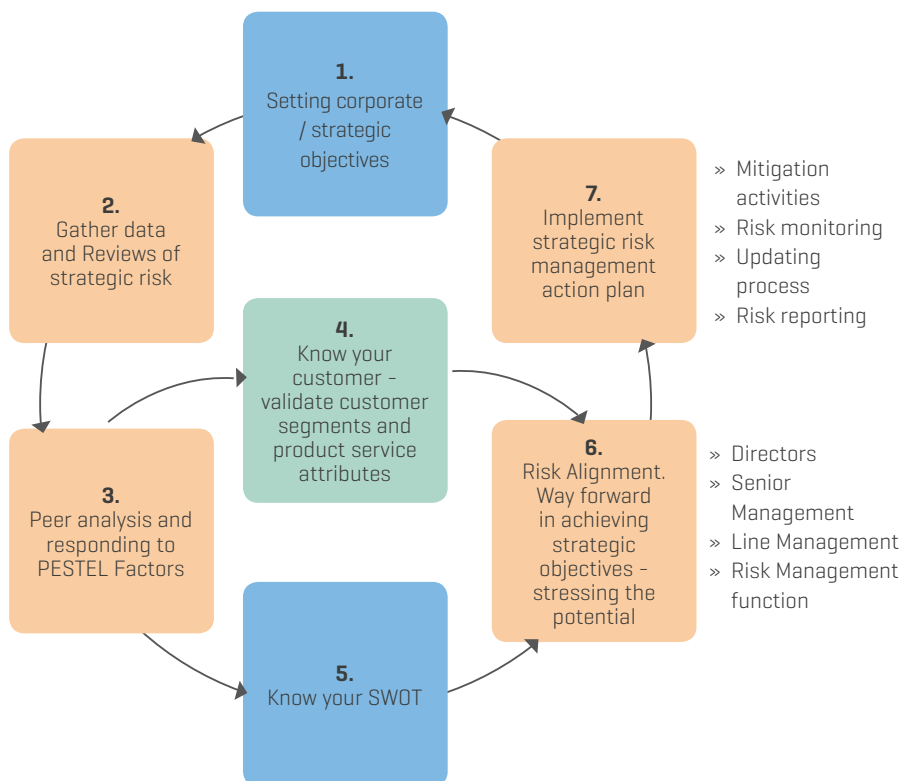
Strategic risk is the risk that the Bank’s future business plans and strategies may sound inadequate to prevent financial loss or protect the Bank’s competitive position and shareholder returns. Strategic and business risks are arising as a result of adverse business decision and deficient execution, noncompliance with regulatory requirements, laidback approach in responding to emerging PESTEL factors, industry developments etc... Thus, the Bank conducts periodic review of its strategic objectives to ensure that the Bank comprehend the prevailing market conditions in which we have material operations. The bank carries out strategic risk assessment in both quantitative and qualitative dimensions. Scorecard approach is used to compute capital allocation for strategic risk as a part of Pillar 2 risk assessment under ICAAP.

As a D-SIB, HNB is subject to a high level of regulatory oversight and is compliant with all regulations including the capital requirement under proposed Basel III new Direction No 01 of 2016. Leadership of the Bank is collectively responsible for providing strategic direction and undertake evaluation of alternative strategies which are deliberated in depth to charter its course. Optimizing risk and return with a thorough understanding of risks and opportunities is key to managing strategic risk coupled with a robust strategic planning process which ensures that, key assumptions are tested using models and analysed to identify and assess potential areas of concern.

Given the impact and importance associated with strategic risk, the Board and the CEO along with senior management withstand reasonability in overseeing and managing strategic risk of the Bank.

# Risk Management

Figure 11: Strategic Risk Management Framework



Strategic risk is quantified in accordance with Basel III Pillar 2 requirements using a scorecard approach to assess a variety of parameters which may impact the Bank's short, medium or long term strategy. It focuses on strengthening processes for setting business strategy with reference to product and customer segments, business impact from macroeconomic environment and number of other aspects. Each aspect is assigned a score considering the severity impact on the Bank's strategic decision and mapped with capital allocation scale developed internally. This process enhances the Bank's approach in managing strategic risk facilitating a thorough analysis of its competitiveness and prospects in relation to a number of aspects such as sustained profitability, market share, customer satisfaction etc.,

## Reputational Risk

Management of reputational risk continues to increase in prominence due to its wide spread nature and difficulty to quantify. A code of ethics applicable to all employees, strict regulatory compliance, a comprehensive system of internal controls, effective leadership and tone at the top play a key role safeguarding the reputation risk of the

Bank. Careful balancing of stakeholders in a transparent manner while maintaining its core values has supported the standing of the Bank within the industry and the continued trust of its customers providing testimony to careful stewardship of its reputation.

A scorecard approach is used to ascertain the additional capital requirement under Basel III, Pillar 2 computation for reputation risk. Key factors evaluated to assess reputation risk include management integrity, severity of loss events, business process and practices, corporate culture of the HNB, transparency and accountability. Similar to the strategic risk scorecard assessment, reputation risk scores are also based on severity impact with additional capital requirements determined according to the score achieved. Apart from the quantified approach to reputation risk, HNB also seeks to manage its reputation risk by reinforcing a culture of accountability, transparency and awareness of possible consequences.

Giving due consideration to its impact, a reputational risk task force has been established under the supervision of ORSC to review reputational risk trigger events and to manage the attributes that impact the reputation of the Bank, reducing the capital

requirement. Reputational risk task force comprises representatives from different business verticals whose recommendations are escalated to ORSC, ERMC and other respective management committee for their necessary action. These preemptive measures would support improving the assessment using score cards and thereby reducing the capital allocation under reputational risk.

## Group Risk

The group structure is given on page 8 in IR while the performance of the subsidiaries is given on pages 75 to 80 in IR. Operations of the subsidiaries are closely monitored with the presence of the HNB corporate management on the Boards of the same. The Risk management divisions of each subsidiary forward their risk management review reports to the Banks IRM function which include key risks identified, mitigant measures, and financial highlights of the preceding month.. Diversity in the operating models of group companies pose challenges to aggregating of risks which are being addressed as we continue to improve the risk monitoring mechanisms. Group risk mitigants include the following:

- » Performance of group companies
- » HNB's capital at risk is limited to amount invested in these companies in the form of equities at the time of companies were incorporated or acquired
- » Key Management Personnel/Director representation on boards of group companies ensuring adherence to core values, alignment of business strategy and a sufficient information flow
- » Regulation of HNB Assurance, the largest subsidiary by the Insurance Regulatory Commission of Sri Lanka and the CSE
- » Well developed regulatory compliance monitoring systems in place.

## HNB Assurance

HNB Assurance PLC (HNBA) and its fully owned subsidiary HNB General Insurance Limited (HNBGI) face a wide range of risks which are often interlinked and managed in accordance with a regulatory framework and the company's vision. In view of the fiduciary obligations to its customers, the company adopts a holistic approach to adequately identify, measure, control, monitor and mitigate these risks.

The company's risk management framework is guided by the risk management policy

of the company and integrates with the risk management framework of the parent company HNB. The company reports the details of the risk management activities carried out by HNBA and HNBGI to the BIRMC of HNB on a quarterly basis. Further, in order to manage the compliance risk, reports of status of compliance are submitted to the compliance division of HNB on a quarterly basis.

HNBA's and HNBGI's risk management activities are monitored through the board risk management committee of HNBA. The chairperson of BIRMC, COO and CRO of HNB have been made members of the board risk management committee of HNBA to ensure the risk management activities of HNBA and HNBGI integrates with the risk management framework of HNB.

#### HNB Grameen (HNBGI)

The integrated risk management framework of the hnbgi is under the supervision of BIRMC where CRO of HNB is a member of the risk management committee of HNBGI. BIRMC Chairperson of HNB is the Chairperson of board risk management committee of HNBGI.

The risk division, comprehensively assess the quality of the loan book, NPA ratio, portfolio quality indicators, risk coverage ratios etc.,. As a part of continuous improvements to risk management processes, HNBGI has progressively developed tools and techniques to assess the operational risk, strategic risk, market risk and monitoring and reporting of its material risks.

**Table 18: Board Representation on Subsidiaries**

Group Co.	Board Representation	Chairman	Board Risk Committee Representation
HNB Assurance PLC	✓	✓	✓
Acuity Partners (Pvt) Ltd	✓	✓	✓
Sithma Developments Ltd	✓	✓	✓
HNB Grameen (Pvt) Ltd	✓	✓	✓

#### Acuity Partners (Pvt) Ltd

APL group risk exposure is monitored and followed by the group's audit committee with an oversight of HNB BIRMC. APL group submits a quarterly report on risk management activities to the BIRMC of HNB.

Material risks identified by the APL are market risk, compliance risk and liquidity risk. Those risks are assessed and mitigated through laid down procedures based on regulatory and internally set limits.

#### STRESS TESTING

The Board is responsible for putting in place an appropriate stress testing framework and monitoring and implementation of fully embedded stress testing methodologies with the risk management framework and strategic planning process of the Bank. Accordingly, stress testing is performed on key risk areas such as the loan book, the trading and investment portfolios, pawning portfolio and at an aggregate bank level. Further, ICAAP of the Bank has introduced additional stress

tests to factor in the Pillar 2 requirements of CBSL directive on ICAAP

Stress tests are conducted under hypothetical, but plausible unfavourable economic scenarios and designed to determine adequacy of capital to withstand impacts of potentially adverse developments is a key component of ICAAP under Pillar 2. It reinforces the process for assessment of the Bank's vulnerability to defined shocks relative to the Bank's risk appetite. Stress testing also provides valuable inputs in to a number of processes including strategic planning, capital and liquidity management, determining risk appetite, exposures and development of risk mitigation plans facilitating strengthening of the Bank's risk profile.

A range of scenarios stressing different risk aspects which are subject to varying stress levels are applied to diverse risk areas at appropriate frequencies for significant individual exposures, portfolios, business lines and for the Bank as a whole. These aspects include increased Non-Performing Advances (NPAs) default of large borrowers,

**Table 19: Stress Testing Scenarios**

Type of Risk	Scenarios	Results
Credit Risk	<ul style="list-style-type: none"> <li>» Increase in the Non-Performing Advances (NPAs) and provisions</li> <li>» Negative shift in NPA categories and resultant increase in provisioning</li> <li>» Large borrower default</li> <li>» Increase in NPA due to fall in FSV of mortgaged collateral</li> </ul>	Stressed CAR derived from different scenarios is well above regulatory capital of 11.75% in all scenarios.
Market Risk	<ul style="list-style-type: none"> <li>» Volatility in foreign exchange covering USD, LKR and other currencies</li> <li>» Shocks in the local stock/equity market and impact on the Bank's equity portfolio</li> <li>» Impact of Interest rate changes on the Bank's fixed income portfolios</li> <li>» Impact of interest rate changes on the banking book</li> </ul>	Stressed CAR is maintained well above the regulatory CAR of 11.75% at all times under different stress scenarios.
Operational Risk	Increase in operational losses at different thresholds based on loss database of the Bank	Stressed operational losses are well within the board approved alert level of 2% of gross income of the Bank.
Liquidity Risk	<ul style="list-style-type: none"> <li>» Loss of short term liquidity in the local market</li> <li>» Global banking crisis which could affect interbank liquidity</li> <li>» Possible run on deposits</li> </ul>	LAR is maintained above 20% at "Low" and "Moderate" level of shock scenarios and drops below 20% at the "worse-case" shock level, which would be managed by internally defined funding strategies of the Bank and liquidity contingency plan.

# Risk Management

impact of increased concentration, foreign exchange risk, liquidity risk, Interest rate risk in banking book. Outcomes of stress testing are reported to the ERM and BIRMC on a periodic basis supporting quality of decision making and is now established as an effective communication tool for the leadership of the Bank, risk owners, risk managers and regulators. Key aspects of the bank's stress testing results for the year are summarised in table 19.

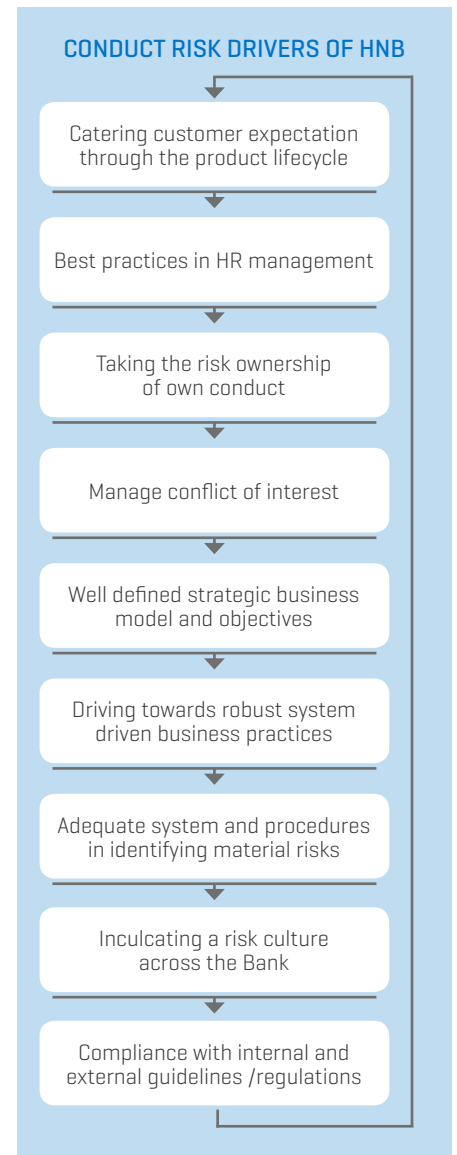
## Conduct Risk

Managing conduct risk as a NFR has become increasingly critical in the banking industry with the growing number of events as a result of lack of controls, noncompliance, negligence etc., Consequently banking and financial sector have been penalized by regulators globally with hefty penalties and resulting loss of customer confidence and trust in both global and local context during last two decades.

HNB understands that there is an ethical obligation to conduct itself as a responsible corporate citizen. In order to sustainably achieve and promote right conduct, the Bank has significantly invested in operational risk,

A dynamic business environment, specifically the shift towards digital space made challenges in risk management front more elastic. The strong foundation on which the HNB's risk management framework is built on helps the Bank to navigate such challenges with confidence optimizing risk return formula. The envisaged use of predictive analytics, robotic process automation and artificial intelligence tools will open up risk management capabilities beyond conventional possibilities which our risk management team is poised to exploit.

IT risk, compliance processes and systems commensurate with increasing expectations of all stakeholders. The Bank believes that holistic first- and second-line control framework would facilitate an end-to-end accountability in the Bank's daily operations whilst improving the risk ownership and promoting right conduct. HNB has initiated many mitigating tactics, which explicitly deal with NFR by fine tuning relevant risk management functions such as appointment of CISO and establishment Information and cyber risk vertical formulating new executive level focused group in the name of "Reputation Risk Task Force" etc., Such actions will strengthen and broaden the scope of overall coverage of risk department involvement. Further, the Bank has formulated a best practice of code of conduct to promote ethical practices and good behaviour. Improve awareness of such practices with a focussed approach in managing potential risk complement the principal of right conduct. The Bank is of the view that an integrated approach across possible foreseeable risks is necessary to manage complex NFRs in a more efficient and effective manner. HNB will continue to invest in strengthening the management of conduct risks in future.



## MARKET DISCIPLINE – DISCLOSURE REQUIREMENTS UNDER PILLAR III

With the implementation of Basel III directives w.e.f 1st July 2017, all licensed banks are required to disclose pillar III disclosure requirements in order to complement the minimum capital requirements and supervisory review process by developing a set of disclosure requirements which will allow the market participants to gauge the capital adequacy and risk exposures of licensed banks.

These requirements will improve the comparability and consistency of disclosures among licensed banks and facilitate assessment of the banks by others, including investors, analysts, customers, other banks and rating agencies which leads to good corporate governance.

### Key Regulatory Ratios - Capital and Liquidity

Item	Bank		Group	
	2017 - Basel III	2016 - Basel II	2017 - Basel III	2016 - Basel II
<b>Regulatory Capital [LKR '000]</b>				
Common Equity Tier 1	92,876,653	N/A	100,246,115	N/A
Tier 1 Capital	92,876,653	65,082,084	100,246,115	71,295,392
Total Capital	115,340,970	88,568,780	122,560,440	95,198,840
<b>Regulatory Capital Ratios [%]</b>				
<b>Common Equity Tier 1 Capital Ratio [Minimum Requirement - 4.5% ]</b>	13.72%	N/A	13.74%	N/A
Tier 1 Capital Ratio [Minimum Requirement - 2017 - 6%, 2016-5%]	13.72%	11.22%	13.74%	11.51%
Total Capital Ratio [Minimum Requirement - 2017 - 11.75%, 2016 - 10%]	17.04%	15.27%	16.80%	15.37%
Leverage Ratio [Minimum Requirement - 4%]	8.64%	N/A	8.92%	N/A

Item	Bank	
	2017	2016
<b>Regulatory Liquidity</b>		
Statutory Liquid Assets [LKR'000]	217,431,828	176,366,293
<b>Statutory Liquid Assets Ratio [Minimum Requirement - 20%]</b>		
Domestic Banking Unit [%]	24.06%	23.49%
Off-Shore Banking Unit [%]	46.15%	26.46%
Liquidity Coverage Ratio [%] – Rupee [Minimum Requirement - 2017 - 80%, 2016 - 70%]	182.39%	176.48%
Liquidity Coverage Ratio [%] – All Currency [Minimum Requirement - 2017 - 80%, 2016 - 70%]	124.32%	118.45%

## Market Discipline – Disclosure Requirements Under Pillar III

### Basel III Computation of Capital Ratios - 2017

Item	Bank (LKR '000)	Group (LKR '000)
<b>Common Equity Tier 1 (CET1) Capital after Adjustments</b>	92,876,653	100,246,115
<b>Common Equity Tier 1 (CET1) Capital</b>	97,545,738	104,187,351
Equity Capital (Stated Capital)/Assigned Capital	31,409,119	31,409,121
Reserve Fund	5,460,000	5,460,000
Published Retained Earnings/(Accumulated Retained Losses)	15,193,585	17,964,806
Published Accumulated Other Comprehensive Income (OCI)	2,289,847	2,320,997
General and other Disclosed Reserves	43,193,187	43,416,458
Unpublished Current Year's Profit/Loss and Gains reflected in OCI	-	-
Ordinary Shares issued by Consolidated Banking and Financial Subsidiaries of the Bank and held by Third Parties	-	3,615,969
<b>Total Adjustments to CET1 Capital</b>	4,669,084	3,941,236
Goodwill (net)	-	122,942
Intangible Assets (net)	695,072	915,380
Defined benefit pension fund assets	1,719,510	1,719,510
Investments in the capital of banking and financial institutions where the bank does not own more than 10 per cent of the issued ordinary share capital of the entity	459,285	495,097
Significant investments in the capital of financial institutions where the bank owns more than 10 per cent of the issued ordinary share capital of the entity	1,795,218	688,307
Additional Tier 1 (AT1) Capital after Adjustments	-	-
Additional Tier 1 (AT1) Capital	-	-
Qualifying Additional Tier 1 Capital Instruments	-	-
Instruments issued by Consolidated Banking and Financial Subsidiaries of the Bank and held by Third Parties	-	-
Total Adjustments to AT1 Capital	-	-
Investment in Own Shares	-	-
<b>Tier 2 Capital after Adjustments</b>	22,464,317	22,314,325
<b>Tier 2 Capital</b>	22,650,694	22,498,854
Qualifying Tier 2 Capital Instruments	17,644,096	17,492,256
Revaluation Gains	2,090,479	2,090,479
General Provisions	2,916,119	2,916,119
Instruments issued by Consolidated Banking and Financial Subsidiaries of the Bank and held by Third Parties	-	-
Total Adjustments to Tier 2	186,376	184,528
Investment in Own Shares	-	-
Investments in the capital of financial institutions and where the bank does not own more than 10 per cent of the issued capital carrying voting rights of the issuing entity	186,376	184,528
CET1 Capital	-	-
Total Tier 1 Capital	92,876,653	100,246,115
<b>Total Capital</b>	115,340,970	122,560,440
<b>Total Risk Weighted Assets (RWA)</b>	676,946,964	729,522,672
RWAs for Credit Risk	599,411,330	634,182,841
RWAs for Market Risk	2,478,510	2,700,030
RWAs for Operational Risk	75,057,124	92,639,801
CET1 Capital Ratio (including Capital Conservation Buffer, Countercyclical Capital Buffer & Surcharge on D-SIBs) (%)	13.72%	13.74%
of which: Capital Conservation Buffer (%)	1.25%	1.25%
of which: Countercyclical Buffer (%)	N/A	N/A
of which: Capital Surcharge on D-SIBs (%)	0.50%	0.50%
Total Tier 1 Capital Ratio (%)	13.72%	13.74%
Total Capital Ratio (including Capital Conservation Buffer, Countercyclical Capital Buffer & Surcharge on D-SIBs) (%)	17.04%	16.80%
of which: Capital Conservation Buffer (%)	1.25%	1.25%
of which: Countercyclical Buffer (%)	N/A	N/A
of which: Capital Surcharge on D-SIBs (%)	0.50%	0.50%



## Computation of Leverage Ratio

Item	Amount [LKR '000]	
	Bank	Group
	2017 [LKR '000] Basel III	2017 [LKR '000] Basel III
Tier 1 Capital	92,876,653	100,246,115
Total Exposures	1,074,726,780	1,124,326,843
On-Balance Sheet Items (excluding Derivatives and Securities Financing Transactions, but including Collateral)	944,292,662	993,120,723
Derivative Exposures	3,135,706	3,135,706
Securities Financing Transaction Exposures	5,472,978	6,244,980
Other Off-Balance Sheet Exposures	121,825,434	121,825,434
Basel III Leverage Ratio [%] (Tier 1/Total Exposure)	8.64%	8.92%

## Basel III Computation of Liquidity Coverage Ratio All Currency

Item	Amount [LKR'000]			
	2017		2016	
	Total		Total	
	Un-weighted Value	Total Weighted Value	Un-weighted Value	Total Weighted Value
<b>Total Stock of High-Quality Liquid Assets (HQLA)</b>	114,870,080	111,415,311	89,391,522	86,517,716
<b>Total Adjusted Level 1A Assets</b>	102,603,924	102,603,924	84,348,965	84,348,965
<b>Level 1 Assets</b>	102,085,442	102,085,442	83,643,909	83,643,909
<b>Total Adjusted Level 2A Assets</b>	8,393,000	7,134,050	-	-
<b>Level 2A Assets</b>	8,393,000	7,134,050	-	-
<b>Total Adjusted Level 2B Assets</b>	4,391,638	2,195,819	5,747,613	2,873,807
Level 2B Assets	4,391,638	2,195,819	5,747,613	2,873,807
Total Cash Outflows	821,254,637	135,594,004	744,842,723	117,488,542
Deposits	549,003,929	54,900,393	504,198,077	50,419,808
Unsecured Wholesale Funding	145,289,624	55,172,692	113,439,571	43,226,791
Secured Funding Transactions	4,020,888	-	8,402,826	-
Undrawn Portion of Committed (Irrevocable) Facilities and Other Contingent Funding Obligations	122,940,196	14,651,873	118,802,249	14,082,831
Additional Requirements	-	10,869,046	-	9,759,112
Total Cash Inflows	92,294,506	45,972,734	92,588,214	44,446,193
Maturing Secured Lending Transactions Backed by Collateral	-	-	-	-
Committed Facilities	3,000,000	-	3,000,000	-
Other Inflows by Counterparty which are Maturing within 30 Days	80,997,232	42,086,367	82,870,410	41,435,205
Operational Deposits	936,154	-	695,829	-
Other Cash Inflows	7,361,120	3,886,367	6,021,975	3,010,988
<b>Liquidity Coverage Ratio [%] (Stock of High Quality Liquid Assets/Total Net Cash Outflows over the Next 30 Calendar Days) * 100</b>		124.32%		118.45%

# Market Discipline – Disclosure Requirements Under Pillar III

## Main Features of Regulatory Capital Instruments

Description of the Capital Instrument	Stated Capital	Debtures - 2007	Debtures - 2006 Type E	Debtures - 2006 Type F	Debtures - 2011	Debtures - 2013	Debtures - 2016	Debtures - 2016	Debtures - 2016	Debtures - 2013	Debtures - 2014 Type B	Debtures - 2014 Type C	Foreign Borrowing
Issuer	HNB PLC	HNB PLC	HNB PLC	HNB PLC	HNB PLC	HNB PLC	HNB PLC	HNB PLC	HNB PLC	HNB PLC	HNB PLC	HNB PLC	German Development Financial Institution
Unique Identifier													
Governing Law of the Instrument	Sri Lanka	Sri Lanka	Sri Lanka	Sri Lanka	Sri Lanka	Sri Lanka	Sri Lanka	Sri Lanka	Sri Lanka	Sri Lanka	Sri Lanka	Sri Lanka	German
Original Date of Issuance	N/A	August 1, 2007	April 1, 2006	April 1, 2006	September 5, 2011	June 13, 2013	March 28, 2016	November 1, 2016	November 1, 2016	September 5, 2011	December 15, 2014	December 15, 2014	June 12, 2012
Par Value of Instrument	N/A	LKR 100/-	LKR 100/-	LKR 100/-	LKR 100/-	LKR 100/-	LKR 100/-	LKR 100/-	LKR 100/-	LKR 100/-	LKR 100/-	LKR 100/-	N/A
Perpetual or Dated	Perpetual	Dated	Dated	Dated	Dated	Dated	Dated	Dated	Dated	Dated	Dated	Dated	Dated
Amount Recognised in Regulatory Capital (in LKR '000 as at the Reporting Date)	31,409,119	700,000	366,598	700,268	2,000,000	4,000,000	7,000,000	2,000,000	4,000,000	1,533,373	2,757,240	84,040	3,831,250
Accounting Classification (Equity/Liability)	Equity	Liability	Liability	Liability	Liability	Liability	Liability	Liability	Liability	Liability	Liability	Liability	Liability
Issuer Call subject to Prior Supervisory Approval	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Optional Call Date, Contingent Call Dates and Redemption Amount (LKR '000)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Subsequent Call Dates, if Applicable	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Coupons/Dividends	Dividends	Coupons	Coupons	Coupons	Coupons	Coupons	Coupons	Coupons	Coupons	Coupons	Coupons	Coupons	Coupons
Fixed or Floating Dividend/Coupon	N/A	Fixed	Fixed	Fixed	Fixed	Fixed	Fixed	Fixed	Fixed	Fixed	Fixed	Fixed	Floating
Coupon Rate and any Related Index	N/A	16.75%	11.00%	11.25%	11.50%	14.00%	11.25%	11.75%	13.00%	8.00%	7.75%	8.33%	6 Month LIBOR + 425% p.a.
Non-Cumulative or Cumulative													
Convertible or Non-Convertible	N/A	Non-Convertible	Non-Convertible	Non-Convertible	Non-Convertible	Non-Convertible	Non-Convertible	Non-Convertible	Non-Convertible	Non-Convertible	Non-Convertible	Non-Convertible	Non-Convertible
If Convertible, Conversion Trigger (s)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
If Convertible, Fully or Partially	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
If Convertible, Mandatory or Optional	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
If Convertible, Conversion Rate	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

Credit Risk under Standardised Approach – Credit Risk Exposures and Credit Risk Mitigation (CRM) Effects

Item	Amount (LKR'000) as at December 31, 2017					
	Exposures before Credit Conversion Factor (CCF) and CRM		Exposures post CCF and CRM		RWA and RWA Density [%]	
	On-Balance Sheet Amount	Off-Balance Sheet Amount	On-Balance Sheet Amount	Off-Balance Sheet Amount	RWA	RWA Density
Claims on Central Government and CBSL	282,235,307	-	282,235,307	-	-	-
Claims on Foreign Sovereigns and their Central Banks	-	-	-	-	-	-
Claims on Public Sector Entities	-	-	-	-	-	-
Claims on Official Entities and Multilateral Development Banks	-	-	-	-	-	-
Claims on Banks Exposures	6,838,851	-	6,838,851	-	5,490,889	0.80
Claims on Financial Institutions	23,350,237	-	23,350,237	-	14,017,953	0.60
Claims on Corporates	241,422,105	313,929,704	233,732,990	110,431,645	328,188,046	0.95
Retail Claims	296,665,542	66,053,606	258,587,537	13,447,121	187,647,359	0.69
Claims Secured by Residential Property	38,144,780	-	38,144,780	-	24,480,400	0.64
Claims Secured by Commercial Real Estate	-	-	-	-	-	-
Non-Performing Assets (NPAs)	7,937,085	-	7,937,085	-	9,330,201	1.18
Higher-risk Categories	946,719	-	946,719	-	2,366,797	2.50
Cash Items and Other Assets	47,614,478	-	47,614,478	-	27,889,685	0.59
<b>Total</b>	<b>945,155,104</b>	<b>379,983,310</b>	<b>899,387,984</b>	<b>123,878,766</b>	<b>599,411,330</b>	<b>-</b>

Credit Risk under Standardised Approach: Exposures by Asset Classes and Risk Weights

Description	Risk Weight	Amount (LKR'000) as at December 31, 2017 (Post CCF & CRM)								Total Credit Exposures Amount
		0%	20%	50%	60%	75%	100%	150%	>150%	
Claims on Central Government and Central Bank of Sri Lanka		282,235,307	-	-	-	-	-	-	-	282,235,307
Claims on Foreign Sovereigns and their Central Banks		-	-	-	-	-	-	-	-	-
Claims on Public Sector Entities		-	-	-	-	-	-	-	-	-
Claims on Official Entities and Multilateral Development Banks		-	-	-	-	-	-	-	-	-
Claims on Banks Exposures		-	1,678,125	12,550	-	-	5,146,551	1,625	-	6,838,851
Claims on Financial Institutions		-	541,802	17,797,685	-	-	5,010,750	-	-	23,350,237
Claims on Corporates		-	13,883,845	9,739,025	-	-	320,541,764	-	-	344,164,634
Retail Claims		-	-	-	118,437,363	96,933,177	41,389,782	-	-	256,760,322
Claims Secured by Gold		2,797,951	12,476,386	-	-	-	-	-	-	15,274,337
Claims Secured by Residential Property		-	-	27,328,760	-	-	10,816,020	-	-	38,144,780
Claims Secured by Commercial Real Estate		-	-	-	-	-	-	-	-	-
Non-Performing Assets (NPAs)		-	-	361,768	-	-	4,427,317	3,148,000	-	7,937,085
Higher-risk Categories		-	-	-	-	-	-	-	946,719	946,719
Cash Items and Other Assets		19,724,794	-	-	-	-	27,889,685	-	-	47,614,479
<b>Total</b>		-	-	-	-	-	-	-	-	1,023,266,751

## Market Discipline – Disclosure Requirements Under Pillar III

### Market Risk under Standardised Measurement Method

Item	Amount (LKR '000)
	As at December 31, 2017
<b>[a] RWA for Interest Rate Risk</b>	-
General Interest Rate Risk	
(i) Net Long or Short Position	-
(ii) Horizontal Disallowance	-
(iii) Vertical Disallowance	-
(iv) Options	-
Specific Interest Rate Risk	-
<b>[b] RWA for Equity</b>	141,677
(i) General Equity Risk	74,077
(ii) Specific Equity Risk	67,600
<b>[c] RWA for Foreign Exchange &amp; Gold</b>	1,653,532
Capital Charge for Market Risk [(a) + (b) + (c)] * CAR	210,937

### Operational Risk under Basic Indicator Approach

Business Lines	Capital Charge Factor	Fixed Factor	Gross Income (LKR'000) as at December 31, 2017		
			1st Year	2nd Year	3rd Year
The Basic Indicator Approach	15%	-	34,873,532	43,114,218	49,769,056
Capital Charges for Operational Risk (LKR'000)	-	-	-	-	6,387,840
Risk Weighted Amount for Operational Risk (LKR'000)	-	-	-	-	75,057,124

Mapping of Financial Statement Categories with Regulatory Risk Categories – Bank Only

Item	Amount (LKR '000) as at December 31, 2017				
	a	b	c	d	e
	Carrying Values as Reported in Published Financial Statements	Carrying Values under Scope of Regulatory Reporting	Subject to Credit Risk Framework	Subject to Market Risk Framework	Not subject to Capital Requirements or Subject to Deduction from Capital
<b>Assets</b>	<b>954,877,581</b>	<b>947,796,924</b>	<b>897,249,308</b>	<b>120,486</b>	<b>50,427,130</b>
Cash and Cash Equivalents	21,739,800	21,739,800	21,739,800	-	-
Balances with Central Banks	38,610,940	38,610,940	38,610,940	-	-
Placements with Banks	3,182,377	3,175,500	3,175,500	-	-
Derivative Financial Instruments	615,357	-	-	-	-
Financial investments - Loans and receivables	122,199,048	120,036,816	120,036,816	-	-
Financial investments - Fair value through profit or loss	120,486	120,486	-	120,486	-
Loans and Receivables to Banks	-	-	-	-	-
Loans and Receivables to Customers	639,102,061	642,021,628	596,254,508	-	45,767,120
Financial Investments - Available-For-Sale	95,403,820	89,288,612	87,243,268	-	2,045,344
Financial Investments - Held-To-Maturity	-	-	-	-	-
Investments in Subsidiaries	3,017,285	3,017,285	1,973,000	-	1,044,285
Investments in Joint Ventures	755,000	755,000	-	-	755,000
Property, Plant and Equipment	17,905,320	17,905,320	17,905,320	-	-
Investment Properties	327,464	327,464	327,464	-	-
Goodwill and Intangible Assets	815,381	815,381	-	-	815,381
Deferred Tax Assets	-	-	-	-	-
Other Assets	11,083,242	9,982,692	9,982,692	-	-
<b>Liabilities</b>	<b>846,729,982</b>	<b>847,764,594</b>	<b>-</b>	<b>-</b>	<b>-</b>
Due to Banks	62,463,497	60,809,685	-	-	-
Derivative Financial Instruments	1,305,900	-	-	-	-
Securities sold under repurchase agreements	5,064,360	5,037,090	-	-	-
Financial Liabilities Designated at Fair Value Through Profit or Loss	-	-	-	-	-
Due to Other Customers	701,519,297	686,412,415	-	-	-
Dividends payable	975,371	975,371	-	-	-
Other Borrowings	27,258,006	27,093,696	-	-	-
Debt Securities Issued	4,540,259	4,374,653	-	-	-
Current Tax Liabilities	3,974,624	4,211,246	-	-	-
Deferred Tax Liabilities	5,082,636	6,447,032	-	-	-
Other Provisions	3,015,875	22,893,589	-	-	-
Other Liabilities	5,720,896	4,911,702	-	-	-
Due to Subsidiaries	-	-	-	-	-
Subordinated Term Debts	25,809,261	24,598,116	-	-	-
<b>Off-Balance Sheet Liabilities</b>	<b>598,364,726</b>	<b>598,364,726</b>	<b>-</b>	<b>-</b>	<b>-</b>
Guarantees	124,389,833	124,389,833	124,389,833	-	-
Performance Bonds	-	-	-	-	-
Letters of Credit	28,291,149	28,291,149	28,291,149	-	-
Other Contingent Items	136,891,225	136,891,225	136,891,225	-	-
Undrawn Loan Commitments	308,792,519	308,792,519	308,792,519	-	-
Other Commitments	-	-	-	-	-
<b>Shareholders' Equity</b>					
Equity Capital [Stated Capital]/Assigned Capital	31,409,119	31,409,119	-	-	-
of which Amount Eligible for CET1	-	-	-	-	-
of which Amount Eligible for AT1	-	-	-	-	-
Retained Earnings	15,193,585	11,660,698	-	-	-
Accumulated Other Comprehensive Income	4,166,167	-	-	-	-
Other Reserves	57,378,728	57,285,541	-	-	-
<b>Total Shareholders' Equity</b>	<b>108,147,599</b>	<b>100,032,330</b>	<b>-</b>	<b>-</b>	<b>-</b>

# Market Discipline – Disclosure Requirements Under Pillar III

## EXPLANATION OF SIGNIFICANT DIFFERENCES BETWEEN ACCOUNTING AND REGULATORY EXPOSURE AMOUNTS

### **[a] Derivative financial instruments**

Derivatives are financial instruments which derive values in response to changes in interest rates, financial instrument prices, commodity prices, foreign exchange rates, credit risk and indices.

The fair value of these derivative financial instruments are determined using forward pricing models. The positive fair value changes of these financial instruments as at the balance sheet date are reported as assets while the negative fair value changes are reported as liabilities. The details of derivative financial instruments have been disclosed in Note 28 to the financial statements.

### **[b] Loans and receivables to other customers**

The loans and receivables to customers considered in regulatory reporting differs with the published financial statements since CBSL time based provisions were netted off when arriving at loans and receivables for regulatory reporting purposes, while impairment allowances based on incurred losses have been netted off in loans and receivables for publication purposes. The impairment allowance has been computed using established processes with judgments being exercised when determining the presence of objective evidences of impairment. The process used in determining the impairment provision has been described in detail in Note 31 (b) to the financial statements.

### **[c] Financial investments - Available for sale**

Financial investments - Available for sale have been measured at fair value in published financial statements while these investments have been measured at cost for regulatory reporting purpose. The details of financial investments - available for sale have been disclosed in Note 33 to the financial statements.

## COMPUTATION OF CAPITAL ADEQUACY RATIO UNDER BASEL II - 2016

### CAPITAL BASE

	Bank Rs Mn	Group Rs Mn
<b>TIER 1</b>		
Voting ordinary shares	12,339	12,339
Non-voting ordinary shares	3,001	3,001
Statutory reserve fund	4,560	4,560
Published retained earnings [Note1]	10,628	13,871
General & other reserves	37,247	37,056
Non - controlling Interest	-	2,939
Less: Deductions from Tier 1 capital [Note 2]	(2,693)	(2,471)
Eligible Tier 1 Capital	65,082	71,295
<b>TIER II</b>		
50% of approved asset revaluation reserves [ Note 3]	2,091	2,091
General provision for loan losses	2,756	2,756
Approved subordinated term debt	21,333	21,305
Tier II Capital	26,180	26,152
Less: Deductions from Tier II capital[ Note 2]	(2,693)	(2,248)
Eligible Tier II capital	23,487	23,904
Capital Base	88,569	95,199
<b>Risk Adjusted capital ratios</b>		
Tier 1 [ Eligible Tier 1 capital / Total risk adjusted balance] *	11.22	11.51
Total [ Capital base / Total risk adjusted balance] **	15.27	15.37

\* Statutory minimum 5%

\*\* Statutory minimum 10%

## Computation of Capital Adequacy Ratio Under Basel II - 2016

### Risk adjusted On-Balance sheet exposure

	Balance		Risk Weights %	Risk Adjusted Balance	
	Bank Rs Mn	Group Rs Mn		Bank Rs Mn	Group Rs Mn
Exposures					
- To Central Government and CBSL	253,721	260,900	0	-	-
- To banks/foreign sovereigns	3,857	6,430	20 - 150	3,257	4,021
- To financial institutions	33,690	35,177	20 - 150	18,664	19,297
- To corporates	209,744	208,015	20 - 150	167,845	165,879
- To retail sector (excluding claims secured by residential properties)	216,037	229,308	75 - 100	169,566	179,517
- Secured on residential property mortgages	37,276	37,276	50 - 100	23,781	23,781
- Non performing advances	5,501	5,501	50 - 150	5,902	5,902
- Cash and cash items in the process of collection	20,873	22,030	0 - 20	1,003	1,003
- Other assets	20,559	38,856	100	20,559	38,856
Asset base for risk weight	801,258	843,494		410,577	438,256

### Risk adjusted Off-Balance sheet exposure

	Amount of Off-Balance Sheet Items Bank/Group Rs Mn	Credit Conversion Factor %	Credit Equivalent Amount Bank/Group Rs Mn	Risk Weights %	Risk Adjusted Balance Bank/Group Rs Mn
Financial guarantees, bank acceptances and other guarantees	57,082	100	57,082	0 - 100	55,806
Performance related guarantees and warranties and stand by LCs related to particular transactions	46,338	50	23,169	0 - 100	21,965
Shipping guarantees, documentary letter of credit and trade related acceptances	45,939	20	9,188	0 - 100	8,842
Other commitments with an original maturity of < 1year	69,309	0 - 20	-	0 - 100	-
> 1year	44,936	50	22,469	0 - 100	22,469
Foreign exchange contracts	121,423	2	2,428	0 - 100	2,428
Total off- balance sheet exposures	385,027		114,336		111,510



### Capital charge for Market Risk

	Capital Charge		Risk Adjusted	
	Bank Rs Mn	Group Rs Mn	Balance Bank Rs Mn	Group Rs Mn
Interest rate	-	-	-	-
Equity	65	95	650	950
Foreign exchange & gold	267	267	2,670	2,670
Total risk adjusted balance for market risk	332	363	3,320	3,620

### Capital charge for Operational risk

	Capital Charge	
	Bank Rs Mn	Group Rs Mn
Average gross income	36,319	43,996
15% of average gross income	5,448	6,599
Total capital charge for operational risk	5,448	6,599

	Bank Rs Mn	Group Rs Mn
Risk weighted assets considered for operational risk	54,480	65,994
Total risk weighted Assets (credit risk,market risk,operational risk)	579,887	619,380

Notes:

1. In computing the CAR profits for the year was computed based on SLFRS/LKAS
2. Deductions

As at 31st December	Tier I		Tier II	
	Bank Rs Mn	Group Rs Mn	Bank Rs Mn	Group Rs Mn
Additional investment in Sithma Development (Pvt) Ltd.	450	450	450	450
HNB Grameen Finance Ltd	330	-	330	-
Equity and Debenture investments	1,913	1,798	1,913	1,798
GoodWill	-	123	-	-
Intangible Assets arising on Acquisition	-	-	-	-
Total deductions	2,693	2,693	2,248	2,248

3. Revaluation reserves approved by CBSL is Rs 4,181 Mn.







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