SEPTEMBER 2009

CREDIT RATING RATIONALE

FINANCIAL INSTITUTIONS – SRI LANKA

A wholly owned subsidiary of RAM Holdings Berhad

RAM RATINGS

STATE MORTGAGE & INVESTMENT BANK – Initial Rating

Financial Institution Ratings:
Long-term: A [Assigned]
Short-term: P1 [Assigned]

Rating Outlook:
Stable

Strength:
- State ownership

Weakness:
- Widening negative gap in ALMM

Principal Activities:
Deposit mobilisation, providing housing and agricultural loans

Analysts:
Prakash Jerome ACMA
(9411) 2553089
prakash@ram.com.lk

Khailash Weeralingam BSc
(9411) 2503551
khailash@ram.com.lk

Company Contact:
Adrian Perera
MBA, FCMA, FCCA, FSCMA, AIB
Chief Executive Officer
(9411) 2596099
adrian@ram.com.lk

Website: www.ram.com.lk

Summary

RAM Ratings Lanka has assigned respective long- and short-term financial institutions rating of A and P1 to State Mortgage and Investment Bank ("SMIB" or "the Bank"). The ratings are primarily based on the state ownership of the Bank, tempered by the wide asset-liability maturity mismatch ("ALMM") inherent in its business model.

SMIB is a licensed specialised bank ("LSB") created by the Government of Sri Lanka ("GOSL") under the State Mortgage and Investment Bank Act No. 13 of 1975, following the amalgamation of 2 state-owned banks. SMIB comes under the purview of the Ministry of Finance and Planning ("MOF"). The Bank is only permitted to disburse loans for housing, agriculture or for industry. It is a medium-sized bank that accounted for 3.34% of the industry's assets as at end-December 2008, and has limited geographic reach; of its 13 branches, 6 are in the western province. Whereas the market's largest player took up 67.49%, with a branch network of over 130.

SMIB has been aggressively expanding its loan portfolio in the past 2 years, despite the weakening macroeconomic environment. The Bank's loan portfolio consists of housing loans collateralised either by property or by the Employees' Provident Fund ("EPF"). EPF-backed loans took up 42.77% of SMIB's total loans as at the end of FYE 31 December 2008 ("FY Dec 2008"); loans backed by property accounted for another 55.24%. Although SMIB's gross non-performing-loan ("NPL") ratio (classified on a 3-months-past-due basis) stood at 27.58% as at end-FY Dec 2008, we note that NPLs from its EPF-backed loan portfolio accounted for 80.31% of the Bank's total NPLs. Excluding these NPLs (since they are reimbursed by the Central Bank), SMIB's NPL ratio would stand at a much lower 11.45% (end-June 2009: 14.54%) – albeit weaker than the industry average of 7.6%. RAM Ratings Lanka notes that the high level of NPLs reflects the Bank's social objective vis-a-vis providing housing for the masses. As the arrears (capital and interest) on loans collateralised by the EPF are only settled by the Central Bank once every year, rendering its cash inflow volatile.

Nonetheless, SMIB's funding and liquidity position is deemed adequate, underpinned by its deposit franchise (derived from state ownership). Amid waning public confidence in private financial institutions, SMIB's deposit base augmented by LKR 2.01 billion as at end-June 2009, reflecting its deposit franchise. Concurrently, customer deposits accounted for 92.69% of total interest bearing funding as at the same date. However, the Bank has an inherent negative gap in its ALMM, as it provides long term housing financing funded by short tenure deposits. Majority (end-FY Dec 2008: 84.91%) of its deposits were within the 1 year bucket while bulk (end-FY Dec 2008: 67.15%) of loans were in the greater than 5 year bucket. Exposing the Bank to both interest rate and liquidity risks.

Being a state linked entity, SMIB had been a beneficiary of concessionary funding through the MOF. The Bank received funding from the Asian Development Bank ("ADB") and the United States Agency for International Development ("USAID").

The interest rate mismatch in the Bank's ALMM pressured its financial performance. Short term deposits re-priced upwards in the rising interest rate environment, while rates on long term loans inched-up at a slower pace. Accordingly SMIB's net interest margin ("NIM") narrowed from 7.96% as at end-FY Dec 2006 to 3.47% as at end-FY Dec 2008. However, this was still better than the industry averages of 4.2% and 2.8%, respectively. Concurrently, SMIB's return on assets ("ROA") and return on equity ("ROE") also weakened to 0.40% (end-FY Dec 2006: 3.28%) and 2.18% (end-FY Dec 2006: 13.02%), respectively.

Despite the Bank's moderate financial performance, which had suppressed its internal rate of capital generation ("IRCG"), SMIB's capital adequacy is deemed healthy as its risk-weighted capital-adequacy ratios ("RWCARs") are well above the regulatory minimums. The Bank's tier-1 and overall RWCARs clocked in at 27.81% and 28.47%, respectively, as at end-FY Dec 2008 - well above the corresponding regulatory floors of 5% and 10%. At the same time, the Banks regular payments to the State has also hampered its capital growth. Over the past 5 years, the Bank has contributed LKR 326.00 million of its total post-tax profits (LKR 980.62 million).

Outlook

The stable outlook on the long-term rating reflects the state ownership and therein the implicit support available to SMIB in times of distress. As such, the ratings will be subject to downward pressure if such support is not extended. Although upward revision of the ratings are unlikely in the medium term, it may materialise if the Bank is able to materially narrow the gap in its ALMM on a sustained basis.

Corporate Profile

Created by GOSL for disbursement of housing and agricultural loans

SMIB is a government-backed LSB, created under the State Mortgage and Investment Bank Act No. 13 of 1975; it became fully operational in 1979. The Bank is also registered under the Banking Act No. 30 of 1988, and is supervised by the Central Bank. SMIB had been formed through the amalgamation of Ceylon State Mortgage Bank and the Agricultural and Industrial Credit Corporation. The Bank had been created with the goal of providing affordable housing solutions to the masses, and it is one of 2 LSBs designated for this objective (with the other being Housing Development and Finance Bank).

Restricted to housing and agricultural lending

We note that SMIB is restricted to only providing loans for housing, agricultural or industrial purposes. Although the Bank can extend agricultural loans, it has instead focused on the housing sector. It disburses mortgage- and EPF-backed loans for housing purposes.

Medium-sized player, limited geographic reach

In an industry dominated by a single large player that accounted for 67.49% of the market's total assets as at end-December 2008, SMIB is a medium-sized player, taking up 3.34% as at the same date. The Bank has limited geographic reach, with 9 of its 6 branches located in the western province.

Ownership

State-owned entity

SMIB's ratings are anchored by its state ownership; the Bank is wholly owned by the GOSL and comes under the purview of the MOF. It is the fourth-largest bank within the MOF's portfolio. RAM Ratings Lanka opines that State support should be readily extended if needed, as evinced by its solid track record; the GOSL has supported the Bank through LKR 250 million of long-term loans to date. SMIB is also a participant in the MOF's special funding schemes. Moreover, concessionary funding lines from Asian Development Bank and United States Agency for International Development ("USAID") have come via the MOF as rupee loans (thus the exchange-rate risk is borne by the MOF). Meanwhile, the Bank has been making regular contributions to the GOSL.

Management & Strategies

Vastly experienced senior personnel

The Bank's management team is led by its general manager, Mr Ajith Weerasinghe, who took office in 2006. The other senior management personnel comprise vastly experienced individuals, most of whom have been with the Bank for more then 2 decades. Given its state ownership, SMIB's strategies are influenced by the GOSL.

Strategies influenced by GOSL

As a state-linked bank formed to further the GOSL's objective of providing shelter to the masses, SMIB is encouraged to lend to the lower-income segment. In consonance with this, the Bank had previously resisted lifting its lending rates for existing borrowers. Hence the Bank has traditionally absorbed the interest-rate risk from such loans (discussed further in *Financial Performance* section). However, the escalating interest rates in 2008 were significant enough for the management to revise the rates of SMIB's existing borrowers. These efforts have borne fruit, as the Bank's margins had widened by end-June 2009.

To upgrade inadequate IT system

The Bank's present information-technology ("IT") system is considered inadequate as it only provides limited management information. In addition, the system's rigidity hampers operational effectiveness and efficiency. In this regard, the management has taken steps to implement a new system by end-March 2010. To assist in this process, the Bank recruited an assistant general manager of IT last year.

Focusing on recovery and monitoring

Meanwhile, the management is focusing on curtailing defaults amid rising NPLs. Monitoring and recovery efforts have been beefed up, with the formation of a special recoveries unit. A dedicated call centre has also been created to follow up on loans that have been in arrears for 1-3 months; along with telephone calls, customers are also sent notices. On the other hand, loans that have been in arrears for more than 3 months are followed up by the respective credit officers in charge. The special recovery unit, meanwhile, handles loans that have been in arrears for over 6 months; the unit employs methods such as visiting the customer as well as negotiations. In a bid to manage new NPLs, the Bank's loan growth has been curtailed during the first half of FY Dec 2009.

Branch expansion in pipeline

Going forward, the Bank intends to extend its branch network; 3 branches are being planned in the northern, eastern and central provinces. The management also plans to venture into industrial loans. However, we opine that such diversification will not be easy as the Bank has been focusing solely on housing loans and lacks credit expertise in the proposed segment.

Corporate Governance

Board members appointed by MOF

SMIB's 10-member board consists of independent non-executive directors appointed by the Minister of Finance for 3-year tenures. Board members are selected from various ministries to ensure independence and to bring in experience from various spheres. The board convened 22 times in 2008; however, since end-July 2009 Board meetings were held on a monthly basis.

Board sub-committees

The apex body is assisted by the audit, credit, asset-liability, and management committees. The Bank has an internal audit department while external audits are carried out by the Auditor General; a representative from the Auditor General's office is permanently based at the Bank. SMIB's internal audit department, reports directly to the board audit committee.

Risk Management

SMIB's risk-management framework is still evolving. Nonetheless, we note that the Bank is in the process of improving its operational procedures, spearheaded by its chief risk officer.

Risks on loan portfolio mitigated by EPF loans

Arrears on EPF loans paid by Central Bank

The Bank's credit risk is somewhat mitigated as most of its loans (42.77%) are backed by the EPF. Before granting a loan, the customer's repayment capacity is checked and the purpose of the loan verified, as SMIB can only lend money for construction or agricultural purposes. Customers are granted a maximum of 75% of their EPF balances; this is be confirmed by the labour department. RAM Ratings Lanka notes that most of these loans are in default because the borrowers feel that these are advances against their EPF contributions, which they can only have access to when they reach 55 years of age. Once the loan is in default, the Central Bank will reimburse SMIB the arrears (including interest). However, this exposes the Bank to cashflow volatility, as the Central Bank only makes such payments once a year.

More stringent approval process for mortgage loans

Meanwhile, SMIB's assessment of mortgage loans has become more stringent. The Bank will make disbursements based on the repayment capacity of the client and the value of the pledged security. Salaried customers are required to provide salary slips for the preceding 3 months while self-employed borrowers are required to provide the business' financial statements for the preceding 3 years. Furthermore, the property is valued internally by the valuation department, staffed by qualified personnel. The borrower will be given a maximum of 60% of the forced-sale value of the land. As such, market risk on repossessed land is moderated by the Bank's conservative lending policy.

Weak IT system heightens operational risks

In terms of operational risk, SMIB's inadequate IT system has led to several inconsistencies, which have also been highlighted by the Auditor General. Moreover, the IT system exposes the Bank to information risk. In this regard, RAM Ratings Lanka notes that the Bank is in the process of introducing more operational controls with the help of its chief risk officer. A new IT system is expected to be introduced by end-March 2010.

Asset Quality

Weak asset quality

RAM Ratings Lanka opines SMIB's asset quality is weak because of the Bank's high delinquency rates. While we acknowledge it has good recovery prospects, we also note that recovery efforts are crimped by legal procedures. Nonetheless, we are cognisant of the Bank's efforts to enhance its asset quality.

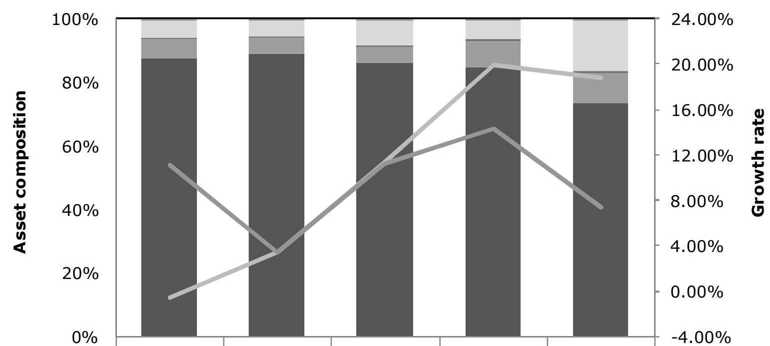
Higher-than-industry growth rate

SMIB has been enjoying better-than-industry growth in the last 2 years, spurred by its aggressive loan expansion. The Bank's asset base augmented 18.82% and 19.99% in FY Dec 2007 and FY Dec 2008, respectively (refer to Chart 1) - better than the industry's 14.26% and 7.44%. SMIB's growth has been driven by its expanding loan base, which accounted for the bulk (84.93%) of its asset base as at end-FY Dec 2008. The Bank's credit portfolio expanded 17.01% in FY Dec 2008, despite the harsh economic climate; the industry posted a more modest pace of 5.10%.

Loan growth curtailed; investment in securities augmented

However, as asset quality began to weaken the Bank curtailed loan growth during the first half of FY Dec 2009. By end-June 2009 loans and advances made up 73.45% of its total assets. Concurrently, investment securities' share had increased to 16.26%; these are mainly commercial papers of other government-owned financial institutions which we deem low credit risk.

Chart 1: SMIB's asset composition and growth rates



	FY Dec 2005	FY Dec 2006	FY Dec 2007	FY Dec 2008	end-June 2009
Cash and bank balances	0.18%	0.26%	0.19%	0.28%	0.22%
Investment securities	5.83%	5.19%	7.82%	6.15%	16.26%
Property, plant & equipment	0.34%	0.30%	0.30%	0.25%	0.25%
Other assets	5.95%	5.19%	5.43%	8.38%	9.82%
Loans and Advances	87.70%	89.06%	86.25%	84.93%	73.45%
SMIB growth	-0.58%	3.38%	11.34%	19.99%	18.82%
Industry growth	11.03%	3.44%	11.21%	14.26%	7.44%

Collateralised loans

Most of SMIB's loans were backed by either mortgages (55.24%) or the EPF (42.77%) as at end-FY Dec 2008; loans against deposits and other loans accounted for the remainder. Although EPF-backed loans have been contributing to the Bank's loan growth, its mortgage portfolio has also driven the expansion of its loan base in the last 2 years.

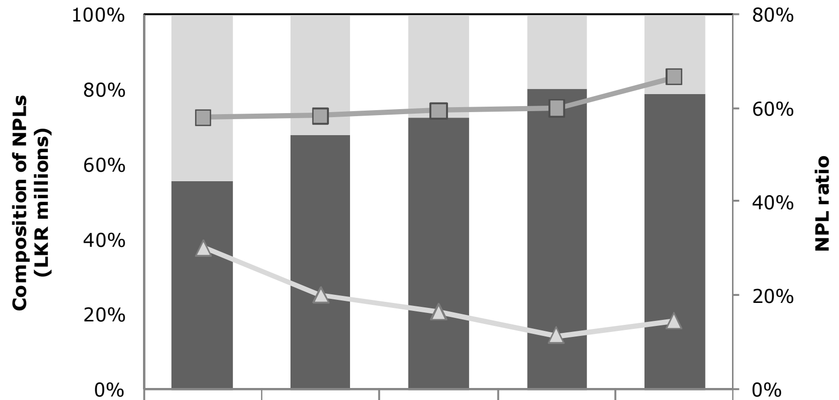
Bulk of NPLs from EPF-backed loans

Given the non-conducive economic climate and aggressive loan expansion, the Bank's NPLs increased from LKR 4.21 billion as at end-FY Dec 2008 to LKR 5.04 billion as at end-June 2009. We note that NPLs from EPF loans accounted for bulk (end-FY Dec 2008: 80.31%) of this (refer to Chart 2); these loans are backed by the EPF contributions of the borrower and are reimbursable by the Central Bank. Although the NPL ratio stood at a high 27.58% as at end-FY Dec 2008, the NPL ratio excluding EPF-backed loans (as these are reimbursable) clocked in at 11.45% - higher than the industry average of 7.6%.

High NPL ratios reflect target market

RAM Ratings Lanka notes that the Bank's weaker NPL ratio is also reflective of SMIB's target market, i.e. low- and middle-income consumers. The deterioration in the Bank's gross NPL ratio (excluding EPF backed loans) (end-June 2009: 14.54%) was heightened, by the upward revision in loan interest rates (as discussed further under *Performance*).

Chart 2: Composition of SMIB's NPLs and NPL ratios



	FY Dec 2005	FY Dec 2006	FY Dec 2007	FY Dec 2008	end-June 2009
Mortgage	1,554.15	1,096.06	1,029.26	828.71	1,052.40
EPF	1,937.79	2,335.10	2,744.60	3,380.14	3,983.53
Mortgage NPL ratio	30.28%	20.13%	16.47%	11.45%	14.54%
EPF NPL ratio	57.97%	58.20%	59.32%	59.94%	66.63%

Low provisioning due to collateralisation

Meanwhile, SMIB's provisioning levels remained low as all of its NPLs are backed by residential properties. Furthermore, the Bank is not required to provide for non-performing EPF loans as these are backed by the Central Bank. The Bank's provisions declined from LKR 79.14 million as at end-FY Dec 2007 to LKR 78.00 million as at end-FY Dec 2008. SMIB had previously followed its own haircut rule for provisioning, by providing a certain percentage of the outstanding amount. However, it now follows the Central Bank's Direction 4 of 2008 with regard to provisioning, which allows the value of collateral to be offset when arriving at the provisioning value. Meanwhile, the Bank's mortgage NPL coverage stood at 9.41% as at end-FY Dec 2008 (end-June 2009: 7.77%).

Lengthy repossession process

In the context of recoveries, we note that the Bank has *parate* rights that allow it to seize land without recourse to the courts of law. That said, the Bank follows due processes vis-a-vis legally securing properties, which are time-consuming.

Going forward, RAM Ratings Lanka expects SMIB's asset quality to improve, underpinned by the Bank's concerted recovery efforts (as discussed under *Management & Strategies*) and decelerated loan growth, together with the improving macroeconomic climate.

Performance

Moderate financial performance

RAM Ratings Lanka deems SMIB's financial performance to be moderate due to its better-than-industry NIM. However, as the Bank has not passed on the heightened deposit interest rates to its loan portfolio, its financial performance has deteriorated significantly over the past 2 years amid the environment of rising interest rates.

Narrowing NIM

SMIB's NIM has been trending downwards in line with the industry's as a result of elevated interest rates. The Bank's NIM thinned from 7.96% in FY Dec 2006 to 3.47% in FY Dec 2008 (refer to Chart 3), due to its reluctance to make upward revisions to its loan rates to match the rise in deposit rates. As a state-owned entity, SMIB has to keep in line with the GOSL's political agenda. Nonetheless, the Bank's NIM has remained above the tumbling industry average. The Bank's ratio of interest expenses over interest-bearing funds deteriorated from 9.26% as at end-FY Dec 2006 to 16.49% as at end-FY Dec 2008 (refer to Table 1). On the other hand, its ratio on interest income against interest-earning assets only improved from 15.12% to 16.92% over the same period. Under the circumstances, its net interest income contracted from LKR 770.98 million to LKR 465.68 million. However, the Bank began revising the interest rates upwards on its loans towards the end of FY Dec 2008, leading to a slightly better NIM of 3.83% by end-June 2009.

Chart 3: SMIB's NIM vs the industry

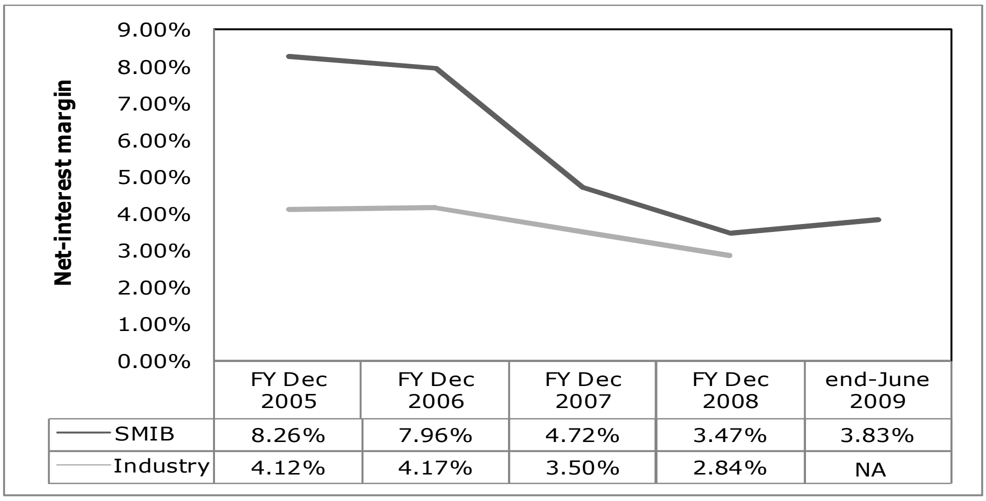


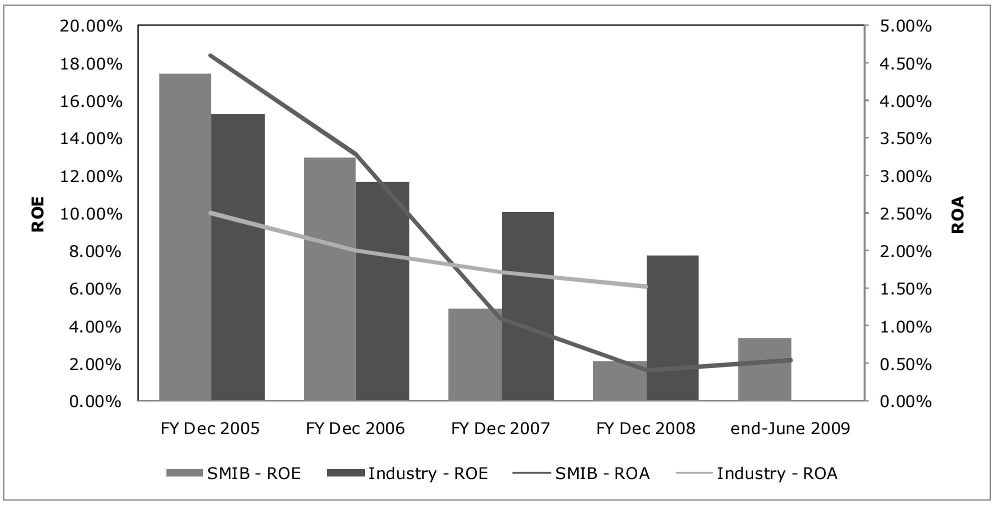
Table 1: SMIB's interest spreads

	FY Dec 2005	FY Dec 2006	FY Dec 2007	FY Dec 2008	end-Jue 2009
Interest Income/Interest Earning Assets	14.38%	15.12%	14.46%	16.92%	17.82%
Interest Expense/Interest Bearing Funding	7.86%	9.26%	12.58%	16.49%	16.08%
Interest Differential	6.52%	5.86%	1.88%	0.43%	1.74%

Lower ROA and ROE

In line with its declining NIM, the Bank's ROA and ROE have also been heading south. Its ROA eased from 4.30% as at end-FY Dec 2004 to a mere 0.40% as at end-FY Dec 2008 (refer to Chart 4) - much weaker than the industry's slipping average of 1.53% as at end-FY Dec 2008 (end-FY Dec 2004: 2.72%). In tandem with this, SMIB's ROE also descended to 2.18% as at the same date (end-FY Dec 2004: 16.71%), paling in comparison to the industry average of 7.75% (end-FY Dec 2004: 17.71%). Going forward RAM Ratings Lanka expects SMIB's performance to improve, albeit still lagging behind the industry.

Chart 4: SMIB's ROA and ROE vs the industry



Recurring non-interest income

Meanwhile, SMIB's income base, which was traditionally dominated by interest income, tilted towards non-interest income in FY Dec 2008. The Bank's proportion of interest income to non-interest income had averaged at 95:5 prior to FY Dec 2008; that year, it shifted to 80:20 due to increased fee income. We note that the Bank had begun offering legal services to its customers through its legal department, and thereby augmenting its non-interest income.

Cost-to-income ratio inflated by drop in income

Apart from depressed gross income, the Bank's overheads had also weighed down its profit performance. Overheads augmented 13.33% from LKR 473.06 million in FY Dec 2007 to LKR 536.13 million in FY Dec 2008. Nevertheless, gross income only edged up 3.47%, from LKR 569.47 million to LKR 589.24 million, over the same period. This is reflected in the Bank's cost-to-income ratio which deteriorated from 83.07% to 90.99%. That said, SMIB's overheads are in line with those of the industry, with staff costs accounting for 56.63% of its total overheads as at end-FY Dec 2008 (end-FY Dec 2007: 58.49%).

Funding & Liquidity

Adequate funding and liquidity positions

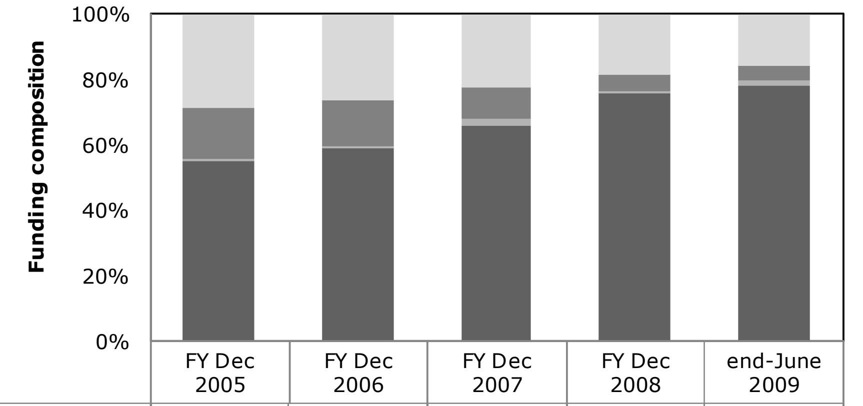
RAM Ratings Lanka perceives SMIB to have adequate funding and liquidity positions, as the Bank's funding profile is dominated by deposits. The Bank's deposit base is in turn fortified by its deposit franchise, derived through its state ownership. That said, we note that SMIB has an inherent mismatch in its ALMM, as bulk of its loans span for 5 years or longer, while its deposits are skewed to shorter tenures; the Bank had not been able to isolate itself from rising interest rates, which had resulted in the Bank's negative ALMM widening further in FY Dec 2008.

Funding base dominated by deposits

Deposits took up the lion's share of SMIB's funding base as at end-FY Dec 2008, accounting for 75.92% of its total funds (end-FY Dec 2007: 65.80%) (refer to Chart 5). The Bank's deposit base has been charting strong growth over the last 2 years, supported by its high interest rates. Due to its state linkage, the Bank had attracted LKR 2.01 billion of deposits by end-June 2009 as public confidence in private deposit-taking institutions had waned. Meanwhile, long-term borrowings accounted for 5.37% of SMIB's funding base as at end-FY Dec 2008 (end-FY Dec 2007: 9.80%). We note that the GOSL has provided a LKR 250 million loan to the Bank, with an unspecified maturity date; this accounted for 34.76% of SMIB's total long-term borrowings as at the same date. The remaining loans are at concessionary rates, extended by Asian Development

Bank, USAID, and the MOF. The Bank's shareholders' funds (18.32%) and short-term borrowings (0.39%) accounted for the remainder of the funding base.

Chart 5: SMIB's funding composition



	FY Dec 2005	FY Dec 2006	FY Dec 2007	FY Dec 2008	end-June 2009
Shareholders' funds	28.23%	26.12%	22.10%	18.32%	15.87%
Long term borrowing	15.97%	13.86%	9.80%	5.37%	4.44%
Short term borrowing	0.55%	0.55%	2.30%	0.39%	1.71%
Customer deposits	55.24%	59.47%	65.80%	75.92%	77.98%

Concentration risk arising from deposit base

Although SMIB's deposit base is exposed to concentration risk, our concerns are limited as these are long-term deposits from government institutions. As at end-FY Dec 2008, its top 10 depositors accounted for 33.18% of SMIB's deposit base. In addition, the Bank is diversifying its deposit base; exposure to institutional depositors, which took up 50.03% of its deposits as at end-FY Dec 2008, receded to only 24.73% as at end-June 2009.

Short-term maturity mismatch widened

As retail deposits are skewed towards shorter tenures owing to lofty interest rates, the Bank's asset-liability mismatch has widened. Short-term mismatches are inherent to the Bank as its loan tenures generally exceed 5 years. The cumulative gap in the "less than 1 year" bucket widened to LKR 6.96 billion as at end-FY Dec 2008 (refer to Table 2), compared to LKR 5.13 billion a year earlier (end-June 2009: negative LKR 7.16 billion). Nonetheless, we note that the Bank has been successful in increasing deposits within the "3-12 months" bucket. SMIB's deposits within the "3-12 months" age bracket increased from LKR 3.50 billion in FY Dec 2007 to LKR 6.10 billion in FY Mar 2008. This apart, liquidity risk is mitigated by a LKR 800 million standby facility and the Central Bank's mid-year payment on defaulted EPF-backed loans.

Table 2: SMIB's ALMM

	FY Dec 2008				
	<3 months	3 -12 months	1 - 3 years	3 - 5 years	> 5 years
Interest earning assets (LKR million)	546.65	1,289.49	1,808.20	1,682.03	8,995.14
Interest bearing liabilitied (LKR million)	2,695.57	6,098.17	667.97	111.75	1,425.91
Gap	(2,148.91)	(4,808.68)	1,140.23	1,570.28	7,569.23
Cumulative gap		(6,957.59)	(3,668.45)	2,710.50	9,139.51

	FY Dec 2007				
	<3 months	3 -12 months	1 - 3 years	3 - 5 years	> 5 years
Interest earning assets (LKR million)	1,220.05	814.58	2,317.30	2,019.70	5,685.84
Interest bearing liabilitied (LKR million)	3,665.79	3,501.59	447.42	26.38	1,257.79
Gap	(2,445.73)	(2,687.01)	1,869.88	1,993.32	4,428.05
Cumulative gap		(5,132.74)	(817.13)	3,863.20	6,421.38

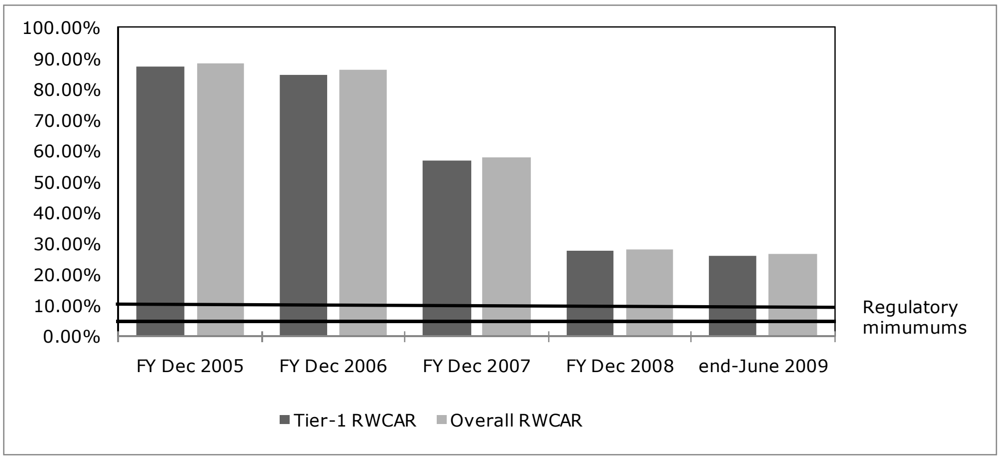
In terms of statutory requirements, the Bank reported a liquid-asset ratio of 12.84% as at end-FY Dec 2008 (end-FY Dec 2007: 10.44%). Under an earlier direction issued by the Central Bank in 1997, SMIB had been required to maintain a liquid-asset ratio of 10%. The revocation of this direction in 2007 meant that the Bank had to meet a liquid-asset ratio of 20% (bringing it in line with all other LSBs) by end-December 2008. As at end-June 2009, the Bank reported a liquid-asset ratio of 23.84%.

Capital Adequacy

Capital adequacy deemed healthy

SMIB's capital position is deemed healthy, underscored by its higher-than-required capital-adequacy ratios and the implied backing from the GOSL. The Bank recorded tier-1 and overall RWCARs of 27.81% and 28.47%, respectively, as at end-FY Dec 2008 (end-FY Dec 2007: 56.95%, 57.98%) (refer to Chart 6), which were well above the corresponding regulatory minimums of 5% and 10%. We note that its RWCARs have been weakening since end-FY Dec 2007, following the Bank's adoption of BASEL II, which required mortgage-backed loans that have not been valued to carry 100% risk weighting (previously 55%).

Chart 6: SMIB's capital-adequacy ratios



Payments to GOSL crimped capital growth

In the meantime, regular contributions to the GOSL have hampered the growth of SMIB's reserves. The amount to be paid is determined by the MOF and no standard determination is made; over the last 5 years, payments to the GOSL have ranged from 11% to 45% of SMIB's net profits. Furthermore, a one-off tax payment in FY Dec 2008 had shaved off LKR 69.90 million from the Bank's shareholders' funds to LKR 2.45 billion as at end-FY Dec 2008 (end-FY Dec 2007: LKR 2.52 billion). The tax payment had arisen due to under-provision of tax between fiscal 2004 and 2007.

Industry Overview

Sri Lanka's gross domestic product ("GDP") expanded 2.1% in 2Q 2009. Although this pales in comparison to the 7.0% attained in 2Q 2008, the slower growth has to be put in the context of the present global downturn. Not surprisingly, all 3 major sectors in Sri Lanka have been hit by the global upheaval.

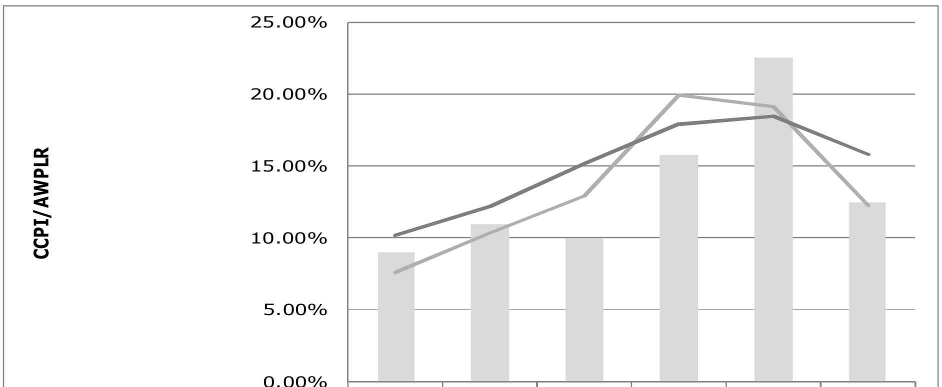
The performance of the primary sector (i.e. agriculture, forestry and fishing) has been dented by a steep fall in tea prices, drought and diminished demand. Although value addition in tea shrank 11.7% in 1Q 2009, this was partially cushioned by the expansion of other food crops, including fishing. Nonetheless, virtually all sub-sectors within the industrial and services industries had advanced at a slower pace, principally due to dampened export demand (refer to Table 3)

Table 3: Sectoral contributions to GDP

Sector	1Q2008	1Q2009
Agriculture, Forestry and Fishing	7.4%	4.4%
Industry	6.9%	3.0%
Services	6.9%	1.1%
GDP	7.0%	2.1%

On a more positive note, the end of the 25-year war against the separatist Tamil Tigers has spawned renewed hope for the country. The arrival of the long-awaited stand-by-facility from the International Monetary Fund has also helped augment Sri Lanka's depleted foreign-exchange reserves. Moreover, both inflation (as measured by the Colombo Consumer Price Index) and interest rates - which peaked in 2008 - have been consistently easing since early 2009 (refer to Chart 7). While these augur well for the economy, sluggish export demand is still a concern. We observe that the tapering interest rates represent a reversal of the Central Bank's tight monetary policy. While continually lower interest rates may not be sustainable given the country's budget deficit, RAM Ratings Lanka also notes that interest rates would not be as high as in 2008. On the whole, however, we envisage the credit cycle to chart a rising trend.

Chart 7: Movements in Colombo Consumer Price Index and average-weighted prime lending rate



	2004	2005	2006	2007	2008	2009 June
Colombo Consumer Price Index	9.00%	11.00%	10.00%	15.80%	22.60%	12.50%
1-Year Treasury Bill Rate	7.65%	10.37%	12.96%	19.96%	19.12%	12.34%
AWPLR	10.23%	12.24%	15.19%	17.95%	18.50%	15.89%

In this context, the LSB sector, which accounts for 9.1% of the finance industry's assets, has remained quite resilient. Even though there are 14 institutions within this sector, National Savings Bank alone takes up about 67% of its assets; this bank single-handedly exerts a significant influence on the sector's overall performance. Meanwhile, the LSB sector is a unique segment that had been created to finance long-term projects, housing, and small and medium-scale enterprises. The sector has also been the primary recipient of concessional-rate international and state funding. As low-cost funding has receded, however, these institutions have increased their reliance on public deposits. The altered funding structure has also compelled most players to focus on medium-term financing; hence the distinction between LSBs and licensed commercial banks ("LCBs") has become blurred. That said, the crucial difference between LSBs and LCBs is that the latter are able to operate current accounts and are therefore an integral component of the payment system.

The environment of escalating interest rates has constrained the sector's loan expansion. Overall, the LSB sector registered a sobering 5.6% loan growth in 2008 (2007: 21.0%). Weakening macroeconomic factors had also contributed to rising delinquencies, which had pushed up the sector's gross NPL ratio from 6.7% in 2007 to 9.8% end-March 2009.

On a more positive note, tapering loan growth and an easier monetary stance have resulted in an improvement in liquidity levels for the LSB sector. The industry's statutory liquidity ratio improved from 61.0% in 2007 to 64.7% as at end-March 2009. However, this pattern is not expected to carry through in the medium term, as these banks resume lending.

Not surprisingly, slower loan growth and rising deposit costs have exerted pressure on the sector's margins. Concurrently, the environment of high inflation have elevated overheads. These 2 factors have crimped the sector's bottom line, as reflected by its lower pre-tax ROA of 1.6% as at end-March 2009 (2007: 1.7%).

In respect of capitalisation, the industry has traditionally maintained healthy capitalisation levels. RAM Ratings Lanka notes that all state-owned LSBs have ample regulatory capital. However, we also acknowledge that rising NPL levels have weakened the sector's capital buffer, as underlined by the weakening of its ratio on net NPLs to shareholders' funds, from 23.0% in 2007 to 30.2% as at end-March 2009. All said, however, RAM Ratings Lanka envisages this segment's risk profile to improve based on its brighter medium-term prospects.

Note: Industry statistics are based on Central Bank data; 2008 and 2009 figures are provisional.

Relevant Central Bank Directions Applicable to Licensed Specialised Banks

Capital adequacy	Every licensed specialised bank must maintain a minimum capital-adequacy ratio of 10% in relation to its risk-weighted assets, with core capital constituting not less than 5%, on both bank-only basis and consolidated basis; supplementary capital can make up the balance. Core capital means: (a) permanent shareholders' equity; and (b) reserves created or increased by appropriation of retained earnings or other surpluses, including share premiums, retained profits, general reserves and legal reserves, excluding revaluation reserves and general provisions. Supplementary capital means revaluation reserves, general provisions, hybrid capital instruments, minority interests arising from preference shares issued by subsidiaries, and approved subordinated debts. It is recommended that the basis of computation for capital-adequacy ratios, i.e. capital adequacy and the inclusion of non-banking and non-financial subsidiaries, be disclosed as a footnote.
Minimum capital requirements	All licensed specialised banks are required to maintain a minimum core capital of LKR 1.5 billion by end-2009. However, the capital of the bank should have been enhanced by at least 50% of any deficiency by end-2008. The required capital for a new specialised bank would also be LKR 1.5 billion
Liquid assets	Every licensed specialised bank must maintain minimum average monthly liquid assets of not less than 20% of its total monthly deposit liabilities. Liquid assets mean: (a) Cash in hand (b) Balance in a current account in a licensed commercial bank (c) Balance in a deposit account in a licensed specialised bank or licensed commercial bank, provided such account has a maturity of not more than 1 year (d) Money at call in Sri Lanka (e) Treasury bills and securities issued or guaranteed by the Government of Sri Lanka, which have maturities of not more than 1 year. (f) Goods receipts (g) Import and export bills (h) Inland bills (i) Cash items in process of collection (j) Treasury bonds (k) Such other assets as may be determined by the Monetary Board
Classification of non-performing loans and treatment of unearned interest	Loans and advances are classified as non-performing when the principal and/or the interest have been in arrears for 3 months or more. Any unpaid interest on loans and advances where interest has been in arrears for 3 months or more cannot be considered as income by a bank.

<table>
<tr>
<td>Classification of non-performing loans and provisioning</td>
<td>
(a) Sub-standard accounts
– where loans have been in arrears for 6 months or more, but less than 12 months
– specific provisions to be made on 20% of the outstanding amount

(b) Doubtful accounts
– where loans have been in arrears for 12 to 18 months
– specific provisions to be made on 50% of the outstanding amount

(c) Loss accounts
– where loans have been in arrears for more than 18 months
– specific provisions to be made on 100% of the outstanding amount
</td>
</tr>
<tr>
<td>Single-borrower limit</td>
<td>
Granting of loans and advances is limited to 30% of the capital funds of the bank as at the end of its preceding financial year:
(a) to any single company, public corporation, group of people or individual
(b) in aggregate to
1. an individual, their close relations or a company or firm in which they have substantial interest
2. a company and one or more of the following
- its subsidiary
- its holding company
- its associate company
- a subsidiary of its holding company, or
- a company in which such company or its subsidiary, or its holding company, or a subsidiary of its holding company, has a substantial interest

If loans and advances granted to any customer referred to in (a) above or in aggregate to any customer belonging to (b) above exceeds 15% of the capital funds of the bank, such loans and advances granted in aggregate to all such customers should also not exceed 50% of the total loans and advances of the bank as at the end of the preceding financial year.
</td>
</tr>
</table>

Corporate Information

Date of Incorporation:	17 March 1975	
Commencement of Business:	1 January 1979	
Major Shareholders:	Government of Sri Lanka	100%
Directors:	Mr C Weerakkody	Chairman
	Mr AM Mohideen	Director
	Mr PW Kodippilli	Director
	Mr D Weerasekera	Director
	Mr N Diddeniya	Director
	Mr WN Abeysiri Perera	Observer
	Mr PGRUB Higgoda	Director
	Mrs C Wijewardena	Director
	Mrs MPE Rukmanie	Director
	Mr MSM Zuhair	Director
Auditor:	Auditor General	
Listing:	Not listed	
Key Management:	Mr Ajith Weerasinghe	General Manager
	Mrs I Wimalasena	Deputy General Manager
	Mr RM Gunathilake	Chief Risk Officer
	Mr TMJ Wickremasekara	Assistant General Manager – Mortgage
	Mr RPU Pathirana	Assistant General Manager – EPF
	Mrs DK Hidellearachchi	Assistant General Manager – Recoveries
	Mr IU Hapuarachchi	Assistant General Manager – IT
Major Subsidiaries and Associates:	None	

Capital History:

Year	Remarks	Amount (LKR million)	Cumulative Total (LKR million)
1979	Capital contribution from the Government of Sri Lanka	889.81	889.81

Financial Summary - Company

BALANCE SHEET (LKR million)	31-Dec-05	31-Dec-06	31-Dec-07	31-Dec-08	30-Jun-09
ASSETS					
Cash & Money At Call	16.21	26.82	23.70	41.26	37.69
Deposits & Placements With Financial Institutions	0.00	0.00	0.00	0.00	0.00
Securities Purchased Under Resale Agreements	179.00	235.98	0.00	75.50	169.00
Securities					
Securities Held For Trading	8.00	8.00	5.00	5.00	5.00
Securities Available-For-Sale	347.36	286.06	953.24	814.31	2,574.86
Securities Held-To-Maturity	0.00	0.00	0.00	0.00	0.00
Gross Loans & Advances	8,610.39	9,594.42	11,073.85	13,220.40	13,606.98
Interest-Income-In-Suspense	432.85	394.47	427.77	778.25	1,110.19
General Loan Loss Reserves	135.17	106.67	34.14	19.93	0.00
Specific Loan Loss Reserves	0.00	0.00	45.00	58.07	81.79
Net Loans & Advances	8,042.37	9,093.28	10,566.94	12,364.16	12,414.99
Investments in Subsidiaries/Associates	0.00	0.00	0.00	0.00	0.00
Other Assets	545.89	530.00	665.74	1,220.26	1,659.87
Property, Plant & Equipment	31.51	30.31	37.10	37.01	41.68
TOTAL ASSETS	**9,170.33**	**10,210.46**	**12,251.71**	**14,557.50**	**16,903.10**
LIABILITIES					
Customer Deposits					
Demand	0.00	0.00	0.00	0.00	0.00
Savings	129.92	183.72	239.42	332.21	0.00
Fixed	4,559.69	5,479.58	7,277.18	9,842.56	12,186.51
Negotiable Instruments of Deposits	0.00	0.00	0.00	0.00	0.00
Interbank Deposits	0.00	0.00	0.00	0.00	0.00
Bills & Acceptances Payable	0.00	0.00	106.73	0.00	209.31
Securities Sold Under Repurchase Agreements	0.00	0.00	0.00	0.00	0.00
Other Borrowing	1,152.69	1,122.27	1,025.63	521.91	501.56
Subordinated Debt & Hybrid Capital	250.00	250.00	250.00	250.00	250.00
Other Liabilities	666.62	687.88	828.28	1,156.25	1,275.72
TOTAL LIABILITIES	**6,758.92**	**7,723.45**	**9,727.24**	**12,102.93**	**14,423.09**
Paid-up Capital	889.81	889.81	889.81	889.81	889.81
Minority Interest	0.00	0.00	0.00	0.00	0.00
Share Premium & Other Reserves	711.15	711.15	711.15	711.15	1,479.90
Statutory General Reserve	91.61	102.26	106.42	108.59	110.29
Retained Profits/(Accumulated Losses)	703.92	783.78	817.08	745.01	0.00
TOTAL SHAREHOLDERS' FUNDS	**2,396.49**	**2,487.01**	**2,524.47**	**2,454.57**	**2,480.00**
TOTAL LIABILITIES & SHAREHOLDERS' FUNDS	**9,155.41**	**10,210.46**	**12,251.71**	**14,557.50**	**16,903.10**
COMMITMENTS & CONTINGENCIES	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**
TIER 1 CAPITAL	**2,396.49**	**2,487.00**	**2,491.77**	**2,462.75**	**2,480.00**
CAPITAL BASE	**2,430.79**	**2,523.61**	**2,536.77**	**2,520.81**	**2,541.87**

Financial Summary - Company

INCOME STATEMENT (LKR million)	31-Dec-05	31-Dec-06	31-Dec-07	31-Dec-08	30-Jun-09 6 months
Interest Income	1,213.22	1,378.96	1,532.72	2,101.98	1,269.69
Less: Accretion Of Discount/(Amortisation Of Premium)	0.00	0.00	0.00	0.00	0.00
Less: Net Interest Income Suspended	0.00	0.00	0.00	0.00	0.00
Less: Interest Expense	(468.06)	(607.98)	(1,002.26)	(1,636.30)	(968.46)
Net Interest Income	745.16	770.98	530.46	465.68	301.23
	0.00	0.00	0.00	0.00	0.00
Non-Interest Income	28.22	46.73	39.01	123.56	15.77
Gross Income	**773.38**	**817.71**	**569.47**	**589.24**	**317.00**
Less: Personnel Expenses	(186.07)	(267.18)	(276.69)	(303.62)	(153.48)
Less: Other Operating Expenses	(188.94)	(261.03)	(196.38)	(232.51)	(117.35)
Less: Loan Loss Provisions	16.48	28.50	27.51	1.14	(3.80)
Less: Non-Recurring Items	0.00	0.00	0.00	0.00	0.00
Share of results of Associated Companies	0.00	0.00	0.00	0.00	0.00
Pre-Tax Profit/(Loss)	**414.85**	**318.00**	**123.92**	**54.26**	**42.37**
Less: Taxation	(102.35)	(104.99)	(40.64)	(10.85)	(8.47)
Net Profit/(Loss)	**312.50**	**213.00**	**83.29**	**43.41**	**33.90**
Less: Minority Interests	0.00	0.00	0.00	0.00	0.00
Less: Transfer To Statutory Reserves	0.00	0.00	0.00	0.00	0.00
Less: Transfer To Other Reserves	0.00	0.00	0.00	0.00	0.00
Less: Dividend	0.00	0.00	0.00	0.00	0.00
Post-Appropriation Profit/(Loss)	**312.50**	**213.00**	**83.29**	**43.41**	**33.90**

Financial Ratios - Company

KEY FINANCIAL RATIOS (%)	31-Dec-05	31-Dec-06	31-Dec-07	31-Dec-08	30-Jun-09
PROFITABILITY					
Net Interest Margin	8.26%	7.96%	4.72%	3.47%	3.83%
Net Financing Margin	8.26%	7.96%	4.72%	3.47%	3.83%
Non-Interest Income Margin	0.31%	0.48%	0.35%	0.92%	0.20%
Cost To Income	48.49%	64.60%	83.07%	90.99%	85.43%
Cost Over Total Average Assets	4.16%	5.45%	4.21%	4.00%	3.44%
Return On Assets	4.60%	3.28%	1.10%	0.40%	0.54%
Return On Equity	17.48%	13.02%	4.95%	2.18%	3.43%
Dividend Payout	0.00%	0.00%	0.00%	0.00%	0.00%
ASSET QUALITY					
Gross NPLs Ratio	37.41%	33.01%	31.43%	27.58%	31.41%
Net NPLs Ratio	37.41%	33.01%	31.14%	27.24%	30.96%
3-months Past Due Ratio	37.41%	33.01%	31.43%	27.58%	31.41%
Net NPLs To Total Assets	33.36%	29.74%	26.94%	23.18%	22.74%
Specific Loan Loss Provisions For Current Period	0.00%	0.00%	0.00%	0.00%	0.06%
Gross NPLs Coverage	4.42%	3.51%	2.37%	2.27%	2.08%
Loan Loss Reserve Coverage	1.65%	1.16%	0.74%	0.63%	0.65%
General Loan Loss Reserve Coverage	1.65%	1.16%	0.32%	0.16%	0.00%
LIQUIDITY & FUNDING					
Liquid Asset Ratio	11.60%	9.72%	12.60%	9.14%	22.37%
Interbank Deposits To Total Interest Bearing Funds	0.00%	0.00%	0.00%	0.00%	0.00%
Customer Deposits To Total Interest Bearing Funds	76.98%	80.50%	84.47%	92.95%	92.69%
Loans To Deposits Ratio	171.49%	160.57%	140.58%	121.52%	101.87%
Loans To Stable Funds Ratio	93.60%	94.73%	92.53%	92.38%	79.66%
CAPITAL ADEQUACY					
Shareholders' Funds To Total Assets	26.13%	24.36%	20.61%	16.86%	14.67%
Tier 1 Risk Weighted Capital Adequacy Ratio	87.35%	84.93%	56.95%	27.81%	26.07%
Overall Risk Weighted Capital Adequacy Ratio	88.60%	86.18%	57.98%	28.47%	26.72%
Internal Rate Of Capital Generation	13.17%	8.72%	3.32%	1.74%	2.75%

Note :
* annualised
NA = Not available / Not applicable

Financial Ratios – Company

KEY FINANCIAL RATIOS	FORMULAE
PROFITABILITY	
Net Interest Margin	Net Interest Income / Average Total Assets
Non-Interest Income Margin	Non-Interest Income / Average Total Assets
Cost To Income	(Personnel & Other Operating Expenses) / Gross Income
Cost Over Total Average Assets	(Personnel & Other Operating Expenses) / Average Total Assets
Return On Assets	Pre-Tax Profit/(Loss) / Average Total Assets
Return On Equity	Pre-Tax Profit/(Loss) / Average Shareholders' Funds
Dividend Payout	Dividends / Net Profit/(Loss)
ASSET QUALITY	
Gross NPLs Ratio	(Total Non-Performing Loans - Interest-Income-In-Suspense) / (Gross Loans - Interest-Income-In-Suspense)
Net NPLs Ratio	(Total Non-Performing Loans - Specific Loan Loss Reserves - Interest-Income-In-Suspense) / (Gross Loans - Specific Loan Loss Reserves - Interest-Income-In-Suspense)
3-months Past Due Ratio	3-months Past Due Loans /(Gross Loans - Interest-Income-In-Suspense)
Specific Loan Loss Provisions For Current Period	Specific Loan Loss Provisions For The Period / Average Gross Loans
Gross NPLs Coverage	General & Specific Loan Loss Reserves (B/S) / (Total Non-Performing Loans - Interest-Income-In-Suspense)
Loan Loss Reserve Coverage	General & Specific Loan Loss Reserves (B/S) / (Gross Loans - Interest-Income-In-Suspense)
General Loan Loss Reserve Coverage	General Loan Loss Reserves / (Gross Loans - Specific Loan Loss Reserves - Interest-Income-In-Suspense)
LIQUIDITY & FUNDING	
Liquid Asset Ratio	Liquid Assets / Customer Deposits & Short-Term Funds
Loans To Deposits Ratio	Net Loans / Customer Deposits
Loans To Stable Funds Ratio	Net Loans / (Shareholders' Funds + Total Interest Bearing Funds + General Loan Loss Reserves - Interbank Funding - Property, Plant & Equipment - Investments in Subsidiaries/Associates)
Short-Term Funds	Interbank Deposits + Bills & Acceptances + Securities Sold Under Repos
Liquid Assets	Cash & Short-Term Funds + Securities Purchased Under Repos + Deposits & Placements With Financial Institutions + Quoted Securities (Excluding Securities Held-To-Maturity)
Total Interest Bearing Funds	Customer Deposits + Interbank + Bills & Acceptances + Securities Sold Under Repos + Borrowing + Supplementary Capital
CAPITAL ADEQUACY	
Internal Rate Of Capital Generation	(Net Profit/(Loss) + Extraordinary Income - Dividend + General Loan Loss Provision) / Average Shareholders' Funds

CREDIT RATING DEFINITIONS

(Financial Institution Ratings)

A Financial Institution Rating ("FIR") is RAM Ratings Lanka's current opinion on the overall capacity of a financial institution to meet its financial obligations. The opinion is not specific to any particular financial obligation, as it does not take in to account the expressed terms and conditions of any specific financial obligation.

LONG-TERM RATINGS

AAA	A financial institution rated AAA has a superior capacity to meet its financial obligations. This is the highest long-term FIR assigned by RAM Ratings.
AA	A financial institution rated AA has a strong capacity to meet its financial obligations. The financial institution is resilient against adverse changes in circumstances, economic conditions and/or operating environments.
A	A financial institution rated A has an adequate capacity to meet its financial obligations. The financial institution is more susceptible to adverse changes in circumstances, economic conditions and/or operating environments than those in higher-rated categories.
BBB	A financial institution rated BBB has a moderate capacity to meet its financial obligations. The financial institution is more likely to be weakened by adverse changes in circumstances, economic conditions and/or operating environments than those in higher-rated categories. This is the lowest investment-grade category.
BB	A financial institution rated BB has a weak capacity to meet its financial obligations. The financial institution is highly vulnerable to adverse changes in circumstances, economic conditions and/or operating environments.
B	A financial institution rated B has a very weak capacity to meet its financial obligations. The financial institution has a limited ability to withstand adverse changes in circumstances, economic conditions and/or operating environments.
C	A financial institution rated C has a high likelihood of defaulting on its financial obligations. The financial institution is highly dependent on favourable changes in circumstances, economic conditions and/or operating environments, the lack of which would likely result in it defaulting on its financial obligations.
D	A financial institution rated D is currently in default on either all or a substantial portion of its financial obligations, whether or not formally declared. The D rating may also reflect the filing of bankruptcy and/or other actions pertaining to the financial institution that could jeopardise the payment of the financial obligations.

For long-term ratings, RAM Ratings applies signs plus (+), flat or minus (-) in each category from AA to C. The sign plus (+) indicates that the financial institution ranks at the higher end of its generic rating category; the sign flat indicates a mid-ranking; and the sign minus (-) indicates that the financial institution ranks at the lower end of its generic rating category.

Short-Term Ratings

P1	A financial institution rated P1 has a strong capacity to meet its short-term financial obligations. This is the highest short-term FIR assigned by RAM Ratings.
P2	A financial institution rated P2 has an adequate capacity to meet its short-term financial obligations. The financial institution is more susceptible to the effect of deteriorating circumstances than those in the highest-rated category.
P3	A financial institution rated P3 has a moderate capacity to meet its short-term financial obligations. The financial institution is more likely to be weakened by the effects of deteriorating circumstances than those in the higher-rated category. This is the lowest investment-grade category.
NP	A financial institution rated NP has a doubtful capacity to meet its short-term financial obligations. The financial institution faces major uncertainties that could compromise its capacity for payment of financial obligations.
D	A financial institution rated D is currently in default on either all or he D rating may also reflect the filing of bankruptcy and/or other actions pertaining to the financial institution that could jeopardise the payment of the financial obligations.

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RAM Ratings (Lanka) Limited
No. 9 Arthur's Place
Colombo 4
Sri Lanka

Tel: (9411) 2553089 Fax: (9411) 2553090

E-mail: ram@ram.com.lk
Website: http://www.ram.com.lk

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