

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

1. REPORTING ENTITY

MCB Bank Limited-Sri Lanka Branch (the “Bank”) is a foreign branch of MCB Bank Limited, incorporated in Pakistan and commenced its business in 1994. The bank was approved to carry out both domestic and off-shore banking under the Banking Act 30 of 1988 and amendments thereto. The registered office of the bank is located at No.8, Leyden Bastian Road, York Arcade Building, and Colombo1.

The staff strength of the Bank as at 31st December 2014 is 138 including 7 out sourced staff. (2013: 123, 4).

1.1 Principal Activities and Nature of Operations

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

2. BASIS OF PREPARATION

2.1 Statement of Compliance

The Financial Statements of the Company which comprise the Statement of Financial Position, Statement of Profit or Loss & Other Comprehensive Income, Statement of Changes in Equity, Statement of Cash Flows and Notes thereto have been prepared in accordance with these Sri Lanka Accounting Standards (LKASs and SLFRSs) laid down by the Institute of Chartered Accountants of Sri Lanka and Banking Act No.30 of 1988 and subsequent amendments thereto.

2.2 Basis of Measurement

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

- Derivative financial instruments are measured at fair value;
- Available for sale financial assets are measured at fair value;
- Freehold land and buildings (Condominium) are measured at cost at the time of acquisition and subsequently at revalued amounts which are the fair values at the date of revaluation;
- Liability for defined benefit obligations is recognized as the present value of the defined benefit obligation.

2.3 Functional and Presentation Currency

Financial Statements are presented in Sri Lankan Rupees, which is the Bank’s functional currency. All amounts have been rounded to the nearest Rupee, except when otherwise indicated.

2.4 Use of Estimates and Judgments

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

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

Information about significant areas of estimation uncertainty and critical judgments in applying accounting policies that have the most significant effect on the amounts recognized in the Financial Statements are described in the relevant notes as follows.

- Recognition, classification and measurement of financial instruments (refer Note 3.10)
- Identification, measurement and assessment of impairment of financial instruments (refer Note 3.10.9)
- Impairment of non-financial assets (refer Note 3.16)
- Employee retirement benefits (refer Note 28.1)
- Deferred taxation (refer note 27)

An analysis of financial instruments measured at fair value as at the end of the reporting period, by the level of the fair value hierarchy is given in Note 34.d.

2.5 Materiality and aggregation

Each material class of similar items is presented separately in the Financial Statements. Items of dissimilar nature or function are presented separately unless they are immaterial.

3. SIGNIFICANT ACCOUNTING POLICIES

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

3.1 Foreign Currency - Foreign currency transactions

Transactions in foreign currencies are translated into the respective functional currency of the Bank at the spot exchange rates at the dates of the transactions.

Monetary assets and liabilities denominated in foreign currencies at the reporting date are translated into the functional currency at the spot exchange rate at that date.

Non-monetary assets and liabilities that are measured at fair value in a foreign currency are translated into the functional currency at the spot exchange rate at the date on which the fair value is determined. Non-monetary items that are measured based on historical cost in a foreign currency are translated using the spot exchange rate at the date of the transaction. Forward foreign exchange contracts and currency swaps are valued at the forward market rate ruling on the date of the Statement of Financial Position.

Unrealized foreign exchange gains and losses are recognized under 'Other Operating Income' in profit or loss.

3.2 Interest

Interest income and expense are recognized in profit or loss using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or liability. When calculating the effective interest rate, the

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Bank estimates future cash flows considering all contractual terms of the financial instrument, but not future credit losses.

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

Interest income and expense presented in profit or loss include;

- interest on financial assets and financial liabilities measured at amortised cost calculated on an effective interest basis;
- interest income on available-for-sale investment securities calculated on an effective interest basis is also included in interest income.

3.3 Fees and commissions

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

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

3.4 Dividend Income

Dividend income is recognised in profit or loss on an accrual basis when the Bank's right to receive the dividend is established. This is usually on the ex-dividend date for quoted equity securities.

3.5 Lease Income

The excess of aggregate lease rentals receivable over the cost of the leased assets constitutes the total unearned lease income at the commencement of a lease. The unearned lease income is taken into income over the term of the lease commencing with the month in which the lease is executed in proportion to the declining receivable balance (i.e in a manner that reflects a constant periodic rate of return on capital outstanding).

3.6 Tax Expense

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

I. Current tax

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

Provision for taxation is based on the profit for the year adjusted for taxation purposes in accordance with the provisions of the Inland Revenue Act No 10 of 2006 and the amendments thereto at the rates specified in Note 13.

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II. Deferred tax

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

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

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

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

Assets and Liabilities and Basis of Measurement

3.7 Cash and Cash Equivalents

'Cash and cash equivalents' include notes and coins on hand, unrestricted balances held with central banks and highly liquid financial assets with original maturities of three months or less from the date of acquisition that are subject to an insignificant risk of changes in their fair value, and are used by the Bank in the management of its short-term commitments.

3.8 Statutory Deposit with Central Banks

The Monetary Law Act requires that all Commercial Banks operating in Sri Lanka maintain reserves against all deposit liabilities denominated in Sri Lankan Rupees. The details of reserve requirements are given in Note 30.1 to the financial statements.

3.9 Financial Assets and Financial Liabilities

3.9.1 Initial Recognition and Measurement

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

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

3.9.2 Classification and subsequent Measurement

3.9.2.1 Financial Assets

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

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- Financial assets at fair value through profit or loss
- Loans and receivables
- Held to maturity investments
- Available for sale financial assets

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

3.9.2.2 Financial Liabilities

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

3.9.3 Subsequent Measurement

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

3.9.3.1 Financial assets and financial liabilities at Fair Value through Profit or Loss

A financial asset or a financial liability is classified as fair value through profit or loss if it is classified as held for trading or is designated as such upon initial recognition.

The Bank has not designated any financial asset/liability upon initial recognition at fair through profit or loss as at the reporting date.

3.9.3.2 Loans and receivables

Loans and advances' are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and that the Bank does not intend to sell immediately or in the near term.

Loans and advances to banks are classified as loans and receivables. Loans and advances to customers in the Bank include:

- those classified as loans and receivables;
- finance lease receivables.

Loans and advances are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortised cost using the effective interest method.

Loans and advances also include finance lease receivables in which the Bank is the lessor.

When the Bank purchases a financial asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date (reverse repo or stock borrowing), the arrangement is accounted for as a loan or advance, and the underlying asset is not recognised in the Bank's financial statements.

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3.9.3.3 Held-to-maturity investments

'Held-to-maturity investments' are non-derivative assets with fixed or determinable payments and fixed maturity that the Bank has the positive intent and ability to hold to maturity, and which are not designated as at fair value through profit or loss or as available-for-sale.

Held-to-maturity investments are carried at amortised cost using the effective interest method, less any impairment losses. A sale or reclassification of a more than insignificant amount of held-to-maturity investments would result in the reclassification of all held-to-maturity investments as available-for-sale, and would prevent the Bank from classifying investment securities as held-to-maturity for the current and the following two financial years. However, sales and reclassifications in any of the following circumstances would not trigger a reclassification:

- sales or reclassifications that are so close to maturity that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;
- sales or reclassifications after the Bank has collected substantially all of the asset's original principal; and
- sales or reclassifications that are attributable to non-recurring isolated events beyond the Bank's control that could not have been reasonably anticipated.

3.9.3.4 Available-for-sale financial investments

Available-for-sale investments are non-derivative investments that were designated as available-for-sale or are not classified as another category of financial assets. Available-for-sale investments are carried at fair value after initial recognition.

Interest income on Available-for-sale financial assets is recognised in profit or loss using the effective interest method. Dividend income is recognised in profit or loss when the Bank becomes entitled to the dividend. Foreign exchange gains or losses on Available-for-sale debt security investments are recognised in profit or loss.

Other fair value changes are recognised directly in equity through Other Comprehensive Income in the Available-for-sale Reserve until the investment is sold or impaired, whereupon the cumulative gains and losses previously recognised in Other Comprehensive Income are reclassified to profit or loss as a reclassification adjustment. The losses arising from impairment of such investments are recognised in profit or loss and removed from the Available-for-sale Reserve.

3.9.4 Amortised Cost Measurement

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

3.9.5 Fair Value Measurement

SLFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transactions between market participants at the measurement date.

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A Fair value measurement requires an entity to determine all the following

1. the particular asset or liability that is the subject of the measurement
2. for a non-financial asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use).
3. the principal (or most advantageous) market for the asset or liability.
4. the valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorized.

Fair value is a market-based measurement, not an entity-specific measurement. For some assets and liabilities, observable market transactions or market information might be available. For other assets and liabilities, observable market transactions and market information might not be available. However, the objective of a fair value measurement in both cases is the same to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (i.e. an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability).

When a price for an identical asset or liability is not observable, an entity measures fair value using another valuation technique that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs. Because fair value is a market-based measurement, it is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfill a liability is not relevant when measuring fair value.

When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price is the price paid to acquire the asset or received to assume the liability (an entry price). In contrast, the fair value of the asset or liability is the price that would be received to sell the asset or paid to transfer the liability (an exit price).

3.9.6 Determining Fair Values

The determination of fair value for financial assets and liabilities for which there is no observable market price requires the use of valuation techniques. For financial instruments that trade infrequently and have little price transparency, fair value is less objective, and requires varying degrees of judgment depending on liquidity, concentration, uncertainty of market factors, pricing assumption and other risks affecting the specific instrument.

- Level 1 - Fair value measurements using quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 - Fair value measurements using inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e.as prices) or indirectly (i.e. derived from prices); and
- Level 3 - Fair value measurements using inputs for the asset or liability that are not based on observable market data (i.e. unobservable inputs).

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3.9.7 Reclassifications

Reclassifications of financial assets, other than as set out below, or of financial liabilities between measurements categories are not permitted following initial recognition.

A non-derivative financial asset Held for Trading that would have met the definition of Loans and Receivables (if the financial asset had not been required to be classified as held for trading at initial recognition) may be reclassified out of the Fair Value through Profit or Loss category, if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.

Financial assets are transferred out of the Available-for sale category to the Loan and Receivables category where they would have met the definition of a Loan and Receivable at the date of reclassification and the Bank has the intent and ability to hold the assets for the foreseeable future or until maturity.

Held-to-maturity assets are reclassified to the Available-for-sale category if the portfolio becomes tainted following the sale of other than an insignificant amount of Held-to-maturity assets prior to their maturity.

Financial assets are reclassified at their fair value on the date of reclassification. For financial assets reclassified out of the Available-for-sale category into Loans and Receivables, any gain or loss on those assets recognised in Shareholders' Equity prior to the date of reclassification is amortised to profit or loss over the remaining life of the financial asset, using the effective interest method.

3.9.8 De-recognition

Financial assets

The Bank derecognises a financial asset when the contractual rights to the cash flows from the financial asset expire, or it transfers the rights to receive the contractual cash flows in a transaction in which substantially all of the risks and rewards of ownership of the financial asset are transferred or in which the Bank neither transfers nor retains substantially all of the risks and rewards of ownership and it does not retain control of the financial asset.

On derecognition of a financial asset, the difference between the carrying amount of the asset (or the carrying amount allocated to the portion of the asset derecognised) and the sum of

- (i) the consideration received (including any new asset obtained less any new liability assumed) and
- (ii) any cumulative gain or loss that had been recognised in Other Comprehensive Income is recognised in profit or loss. Any interest in transferred financial assets that qualify for derecognition that is created or retained by the Bank is recognised as a separate asset or liability.

The Bank enters into transactions whereby it transfers assets recognised on its statement of financial position, but retains either all or substantially all of the risks and rewards of the transferred assets or a portion of them. In such cases, the transferred assets are not derecognised. Examples of such transactions are securities lending and sale and repurchase transactions.

When assets are sold to a third party with a concurrent total rate of return swap on the transferred assets, the transaction is accounted for as a secured financing transaction similar to sale and repurchase

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transactions because the Bank retains all or substantially all of the risks and rewards of ownership of such assets.

In transactions in which the Bank neither retains nor transfers substantially all of the risks and rewards of ownership of a financial asset and it retains control over the asset, the Bank continues to recognise the asset to the extent of its continuing involvement, determined by the extent to which it is exposed to changes in the value of the transferred asset.

In certain transactions, the Bank retains the obligation to service the transferred financial asset for a fee. The transferred asset is derecognised if it meets the derecognition criteria. An asset or liability is recognised for the servicing contract if the servicing fee is more than adequate (asset) or is less than adequate (liability) for performing the servicing.

Financial liabilities

The Bank derecognises a financial liability when its contractual obligations are discharged or cancelled, or expire.

Where an existing financial liability is replaced by another from the same lender on substantially different terms or the terms of an existing liability are substantially modified such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability. The difference between the carrying value of the original financial liability and the consideration paid, including any non-cash assets transferred or liabilities assumed is recognised in profit or loss.

3.9.9 Offsetting

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

3.9.10 Identification, Measurement and Assessment of Impairment of Financial Assets

At each reporting date, the Bank assesses whether there is objective evidence that financial assets not carried at fair value through profit or loss are impaired. A financial asset or a group of financial assets is 'impaired' when objective evidence demonstrates that a loss event has occurred after the initial recognition of the asset(s) and that the loss event has an impact on the future cash flows of the asset(s) that can be estimated reliably.

Objective evidence that financial assets are impaired includes:

- significant financial difficulty of the borrower or issuer;
- default or delinquency by a borrower;
- the restructuring of a loan or advance by the Bank on terms that the Bank would not consider otherwise;
- indications that a borrower or issuer will enter bankruptcy;
- the disappearance of an active market for a security; or
- observable data relating to a group of assets such as adverse changes in the payment status of borrowers or issuers in the Bank, or economic conditions that correlate with defaults in the group.

In addition, for an investment in an equity security, a significant or prolonged decline in its fair value below its cost is objective evidence of impairment.

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Impairment of financial assets carried at amortised cost

The Bank considers evidence of impairment for loans and advances and held-to-maturity investment securities at both a specific asset and a collective level. All individually significant loans and advances and held-to-maturity investment securities are assessed for specific impairment. Those found not to be specifically impaired are then collectively assessed for any impairment that has been incurred but not yet identified. Loans and advances and held-to-maturity investment securities that are not individually significant are collectively assessed for impairment by grouping together loans and advances and held-to-maturity investment securities with similar risk characteristics

In assessing collective impairment, the Bank uses statistical modelling of historical trends of the probability of default, the timing of recoveries and the amount of loss incurred, and makes an adjustment if current economic and credit conditions are such that the actual losses are likely to be greater or lesser than is suggested by historical trends. Default rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure that they remain appropriate.

Impairment losses on assets measured at amortised cost are calculated as the difference between the carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate.

If the terms of a financial asset are renegotiated or modified or an existing financial asset is replaced with a new one due to financial difficulties of the borrower, then an assessment is made of whether the financial asset should be derecognised. If the cash flows of the renegotiated asset are substantially different, then the contractual rights to cash flows from the original financial asset are deemed to have expired. In this case, the original financial asset is derecognised and the new financial asset is recognised at fair value. The impairment loss before an expected restructuring is measured as follows.

- If the expected restructuring will not result in derecognition of the existing asset, then the estimated cash flows arising from the modified financial asset are included in the measurement of the existing asset based on their expected timing and amounts discounted at the original effective interest rate of the existing financial asset.
- If the expected restructuring will result in derecognition of the existing asset, then the expected fair value of the new asset is treated as the final cash flow from the existing financial asset at the time of its derecognition. This amount is discounted from the expected date of derecognition to the reporting date using the original effective interest rate of the existing financial asset.

Impairment losses are recognised in profit or loss and reflected in an allowance account against loans and receivables or held-to-maturity investment securities. Interest on the impaired assets continues to be recognised through the unwinding of the discount. If an event occurring after the impairment was recognised causes the amount of impairment loss to decrease, then the decrease in impairment loss is reversed through profit or loss.

Impairment losses on available-for-sale investment securities are recognised by reclassifying the losses accumulated in the fair value reserve in equity to profit or loss. The cumulative loss that is reclassified from equity to profit or loss is the difference between the acquisition cost, net of any principal repayment and amortisation, and the current fair value, less any impairment loss previously recognised in profit or loss. Changes in impairment attributable to application of the effective interest method are reflected as a component of interest income.

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If, in a subsequent period, the fair value of an impaired available-for-sale debt security increases and the increase can be related objectively to an event occurring after the impairment loss was recognised, then the impairment loss is reversed through profit or loss; otherwise, any increase in fair value is recognised through Other Comprehensive Income. Any subsequent recovery in the fair value of an impaired available-for-sale equity security is always recognised in Other Comprehensive Income.

The Bank writes off certain loans and advances and investment securities when they are determined to be uncollectible.

3.10.9.1 Collateral Valuation

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

Non-financial collateral such as real estate is valued by an external, independent valuation company, having appropriate recognised professional qualifications and recent experience in the location and category of property being valued.

3.9.11 Rescheduled Loans

Loans whose original terms have been modified including those subject to forbearance strategies are considered rescheduled loans. If the renegotiations are on terms that are not consistent with those readily available on the market, this provides objective evidence of impairment. Once terms have been renegotiated, any impairment is measured using the original effective interest rate as calculated before the modification of terms and the loan/ advance is no longer considered past due. Management continually reviews renegotiated loans and advances to ensure that all criteria are met and the future payments are likely to occur.

3.10 Derivative Financial Instruments

Derivatives are financial instruments that derive their value in response to changes in interest rates, financial instrument prices, commodity prices, foreign exchange rates, credit risk and indices. Derivatives are categorized as trading unless they are designated as hedging instruments. Bank uses derivatives such as forward exchange contracts and swaps. Bank has not designated any derivatives as hedging instruments and has not followed hedge accounting as at the reporting date.

All derivatives are initially recognised and subsequently measured at fair value, with all revaluation gains or losses recognised in profit and loss. All derivatives are carried as assets when fair value is positive and as liabilities when fair value is negative. Fair value is determined using the forward market rates ruling on the reporting date.

3.11 Repurchase and reverse repurchase agreements

Securities sold subject to repurchase agreements (repos) remain on the Statement of Financial Position; the counterparty liability is included under borrowings. Securities purchased under agreements to resell (reverse repos) are recorded as loans and advances to other banks or customers, as appropriate.

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3.12 Finance Leases

Assets leased to customers which transfer substantially all the risks and rewards associated with ownership other than legal title, are classified as finance leases. Leasing balances are stated in the Statement of Financial Position after deduction of unearned lease income and the impairment for rentals doubtful of recovery. Amounts receivable under finance leases are classified as Lease Receivables and presented within loans and receivables to other customers in the Statement of Financial Position.

3.13 Property, Plant and Equipment

Property, plant and equipment are tangible items that are held for use in the supply of services, for rental to others or for administrative purposes and are expected to be used during more than one period.

3.13.1 Basis of Recognition

Property, plant and equipment are recognised if it is probable that future economic benefits associated with the assets will flow to the Bank and cost of the asset can be reliably measured.

3.13.2 Measurement

An item of property, plant and equipment that qualifies for recognition as an asset is initially measured at its cost. Cost includes expenditure that is directly attributable to the acquisition of the asset and cost incurred subsequently to add to, replace part of, or service it. The cost of self-constructed assets includes the cost of materials and direct labour, any other costs directly attributable to bringing the asset to a working condition for its intended use and the costs of dismantling and removing the items and restoring the site on which they are located. Purchased software that is integral to the functionality of the related equipment is capitalised as part of computer equipment.

When parts of an item of property or equipment have different useful lives, they are accounted for as separate items (major components) of property, plant and equipment.

3.13.3 Cost Model

The Bank applies cost model to property, plant and equipment except for freehold land and buildings and records at cost of purchase or construction together with any incidental expenses thereon less accumulated depreciation and any accumulated impairment losses.

3.13.4 Revaluation Model

The Bank applies the revaluation model to the entire class of freehold land and buildings. Such properties are carried at a revalued amount, being their fair value at the date of revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Freehold land and buildings of the Bank are revalued every three years on a roll over basis to ensure that the carrying amounts do not differ materially from the fair values at the reporting date. On revaluation of an asset, any increase in the carrying amount is recognised in Other Comprehensive Income and accumulated in equity, under capital reserve or used to reverse a previous revaluation decrease relating to the same asset, which was charged to profit or loss. In this circumstance, the increase is recognised as income to the extent of the previous write down. Any decrease in the carrying amount is recognised as an expense in the Income Statement or debited in the Other Comprehensive Income to the extent of any credit balance existing in the capital reserve in respect of that asset. The decrease recognised in Other Comprehensive Income reduces the amount accumulated in equity under capital reserves. Any balance

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remaining in the revaluation reserve in respect of an asset is transferred directly to Retained Earnings on retirement or disposal of the asset.

3.13.5 Subsequent Costs

The subsequent cost of replacing a component of an item of property, plant and equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within that part will flow to the Bank and its cost can be reliably measured. The costs of day to day servicing of property, plant and equipment are charged to profit or loss as incurred. Costs incurred in using or redeploying an item is not included under carrying amount of an item.

3.13.6 Derecognition

The carrying amount of an item of property, plant and equipment is derecognised on disposal or when no future economic benefits are expected from its use or disposal. The gain or loss arising from the derecognition of an item of property, plant and equipment which is calculated as the difference between the carrying amount and the net disposal proceeds is included in profit or loss when the item is derecognised.

3.13.7 Depreciation

The Bank provides depreciation from the date the assets are available for use up to the date of disposal, at the following rates on a straight line basis over the periods appropriate to the estimated useful lives based on the pattern in which the asset's future economic benefits are expected to be consumed by the Bank of the different types of assets, except for which are disclosed separately. Depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale or the date that the asset is derecognised. Leased assets are depreciated over the shorter of the lease term and their useful lives unless it is reasonably certain that the Bank will obtain ownership by the end of the lease term

The estimated useful lives are as follows:

Straight-Line Basis

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

3.14 Intangible asset

An intangible asset is an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others or for administrative purposes.

3.14.1 Basis of Recognition

An intangible asset is recognised if it is probable that the future economic benefits that are attributable to the asset will flow to the entity and the cost of the assets can be measured reliably. An intangible asset is initially measured at cost. The cost of intangible assets acquired in a business combination is the fair value as at the date of acquisition.

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

Software

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All computer software costs incurred, licensed for use by the Bank, which are not integrally related to associated hardware, which can be clearly identified, reliably measured and it's probable that they will lead to future economic benefits, are included in the Statement of Financial Position under the category Intangible Assets and carried at cost less accumulated amortisation and any accumulated impairment losses.

3.14.2 Subsequent Expenditure

Expenditure incurred on software is capitalised only when it is probable that this expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance and this expenditure can be measured and attributed to the asset reliably. All other expenditure is expensed as incurred.

3.14.3 Amortisation

Intangible assets are amortised on a straight line basis in profit or loss from the date when the asset is available for use, over the best estimate of its useful economic life based on a pattern in which the asset's economic benefits are consumed by the Bank. The estimated useful life of software is three years.

Amortisation methods, useful lives and residual values are reviewed at each reporting date and adjusted if appropriate.

3.15 Impairment of Non-Financial Assets

At each reporting date, the Bank reviews the carrying amounts of its non-financial assets (other than investment properties and deferred tax assets) to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated.

For impairment testing, assets are grouped together into the smallest group of assets that generates cash inflows from continuing use that is largely independent of the cash inflows of other assets or CGUs. Goodwill arising from a business combination is allocated to CGUs or groups of CGUs that are expected to benefit from the synergies of the combination.

The 'recoverable amount' of an asset or CGU is the greater of its value in use and its fair value less costs to sell. 'Value in use' is based on the estimated future cash flows, discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset or CGU.

An impairment loss is recognised if the carrying amount of an asset or CGU exceeds its recoverable amount.

Impairment losses are recognised in profit or loss. They are allocated first to reduce the carrying amount of any goodwill allocated to the CGU, and then to reduce the carrying amounts of the other assets in the CGU on a pro rata basis.

An impairment loss in respect of goodwill is not reversed. For other assets, an impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

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3.16 Employee benefits

3.16.1 Defined benefit pension plan

A defined benefit plan is a post-employment benefit plan other than a defined contribution plan. The liability recognised in the statement of financial position in respect of the defined benefit plan is the present value of defined benefit obligation as at the reporting date. The defined benefit obligation is calculated annually by independent actuaries using Projected Unit Credit Method (PUC) as recommended by LKAS 19 - "Employees Benefits".

The assumptions based on which the results of the valuation were determined are included in the note 28 to the Financial Statements.

The liability is not externally funded.

The company recognizes all actuarial gains and losses arising from defined benefit plan in Other Comprehensive Income and expenses related to defined benefit plans in staff expenses in profit or loss.

Provision has been made for retirement gratuities from the first year of service for all employees in conformity with the LKAS 19. However under the payment of Gratuity Act No. 12 of 1983, the liability to an employee arises only on completion of 5 years of continued service.

3.16.2 Defined contribution Plan

Employees' provident fund

All employees of the Bank are members of the MCB Bank Limited Sri Lanka Branch Staff Provident Fund to which the Bank and employees contributes 12% and 8% of such employees' basic salary and allowances respectively.

Employees' Trust Fund

The Bank contributes 3% of the salary of each employee to the Employees' Trust Fund.

3.17 Deposits from Customers

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

3.18 Borrowings

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

3.19 Provisions

A provision is recognised if, as a result of a past event, the Bank has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. The amount recognised is the best estimate of the consideration required to settle the present obligation at the reporting date, taking in to account the risks and uncertainties surrounding the obligation at that date. Where a provision is measured using the cash flows estimated to settle the present obligation, its carrying amount is determined based on the present value of those cash flows.

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3.20 Capital commitments and contingencies

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

'Financial guarantees' are contracts that require the Bank to make specified payments to reimburse the holder for a loss that it incurs because a specified debtor fails to make payment when it is due in accordance with the terms of a debt instrument.

3.21 Cash Flow Statement

The Cash Flow Statement has been prepared using the "Direct Method" of preparing Cash Flows in accordance with the Sri Lanka Accounting Standard 07-Statement of Cash Flows.

3.22 Regulatory Provisions

Deposit Insurance Scheme

In terms of the Banking Act Direction No 5 of 2010 "Insurance of Deposit Liabilities" issued on 27th September 2010 and subsequent amendments there to all Licensed Commercial Banks are required to insure their deposit liabilities in the Deposit Insurance Scheme operated by the Monetary Board in terms of Sri Lanka Deposit Insurance Scheme Regulations No 1 of 2010 issued under Sections 32A to 32E of the Monetary Law Act with effect from 1st October 2010. The said scheme was renamed as the "Sri Lanka Deposit Insurance and Liquidity Support Scheme" as per the Sri Lanka Deposit Insurance and Liquidity Support Scheme Regulation No 1 of 2013. Deposits to be insured include demand, time and savings deposit liabilities and exclude the following;

- deposit liabilities to member institutions
- deposit liabilities to Government of Sri Lanka
- deposit liabilities to Directors, key management personnel and other related parties as defined in Banking Act Direction No 11 of 2007 on Corporate Governance of Licensed Commercial Banks
- deposit liabilities held as collateral against any accommodation granted deposit liabilities falling within the meaning of abandoned property in terms of the Banking Act and dormant deposits in terms of the Finance Companies Act funds of which have been transferred to Central Bank of Sri Lanka

Licensed Commercial Banks are required to pay a premium of 0.10% on eligible deposit liabilities if the Bank maintains a capital adequacy ratio of 14% or above as at the end of the immediately preceding financial year and a premium of 0.125% on eligible deposit liabilities for all other Licensed Commercial Banks calculated on the total amount of eligible deposits as at the end of the quarter within a period of 15 days from the end of the quarter.

4. Events occurring after the Reporting Date

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

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4.1 Comparative Information

The comparative information is re-classified wherever necessary to confirm with the current year's classification in order to provide a better presentation.

5. New Accounting Standards issued but not yet effective as at Reporting date

The Institute of Chartered Accountants of Sri Lanka has issued the following new Sri Lanka Accounting Standards. However these standards have not been applied in preparing these financial statements.

SLFRS 9 - Financial Instruments

The objective of this SLFRS is to establish principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows.

This standard will be effective for financial periods beginning on or after 01 January 2018.

SLFRS 14 - Regulatory deferral accounts

The Objective of this standard is to specify the financial reporting requirements of regulatory deferral account balances that arise when an entity provides goods or services to customers at a price or rate that is subject to rate regulations.

The amendments are effective for annual reporting periods beginning on or after 1 January 2016.

The extent of the impact of the above standards to the Financial Statements has not been determined as at 31 December 2014. Based on the preliminary assessment carried out by the Board, none of these is expected to have a significant effect on the Financial Statements of the Bank.

SLFRS 15 - Revenue from Contract with Customers

Establishes the principals that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with customer. This standard will be effective for financial periods beginning on or after 1st January 2017.

6. Financial Risk Management

6.1 Introduction and Overview

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

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

6.2 Risk Management Framework

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

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

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

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

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

The CRO performs following critical functions:

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

6.3 Credit Risk

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

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

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

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- Use of comprehensive credit appraisal process structured towards analyzing pertinent information at macro and micro levels.
- Delegated approval/ review authority assigned to officers/ executives with the necessary experience, judgment and integrity to properly evaluate the risks and rewards involved in the credit transactions.
- A hindsight review process to ensure the checks and balances has been instituted to ensure consistent application of the Bank's credit policies.
- Monitoring of credits with deteriorating credit ratings and inclusion of those advances on a watch-list that is regularly reviewed by senior management.
- Centralized credit administration unit to support the extension and monitoring of credit by the business units.
- Segregation of duties by independent units to carryout Credit approval, Risk Management, Credit administration, Credit review functions.
- Measurement and monitoring of credit risk at the counterparty level by using internal risk rating models.
- Development and adaptation of risk measurement techniques/models to suit the regulatory and industry requirements.
- Centralized Credit Administration unit to manage Problem credits and Non Performing Advances. This unit is responsible for all aspects of an overdue facility, follow up of rescheduled facilities, monitoring the value of the applicable collateral and liquidation, scrutiny of legal documents and liaising with the customer until all recovery matters are finalized.

6.3.1 Impairment Assessment

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

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

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

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the timing of the expected cash flows. Impairment allowances are evaluated at each reporting date, unless unforeseen circumstances require more careful attention.

6.3.2 Collectively Assessed Allowances

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

The Bank generally bases its analyses on historical experience. However, when there are significant market developments, the Bank would include macro-economic factors within its assessments. These factors include, depending on the characteristics of the individual or collective assessment unemployment rates, current levels of bad debts, changes in laws, changes in regulations, bankruptcy trends, and other consumer data. The Bank may use the aforementioned factors as appropriate to adjust the impairment allowances. Allowances are evaluated separately at each reporting date with each portfolio.

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

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

6.3.3 Concentration of Credit Risk

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

6.3.4 Fair Value of Collateral held Against Loans and Advances to Customers

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

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As at	12/31/2014	
	Gross Loans & Advances	Fair Value of Security
	LKR	LKR
Against Individually Impaired		
Immovable Property	161,799,703	
Others	7,580,337	41,500,000
Unsecured (Covered with loan agreement)		
	252,69,100	
Against Collectively Impaired		
Immovable Property	2,694,181,783	3,510,100,000
Deposits	1,318,818,179	1,318,818,179
Others	3,836,993,241	
Unsecured (Covered with loan agreement)	2,293,702,178	
Total	10,143,695,381	
Leases	10,396,385,481	
	142,028,293	
Total	10,538,413,774	

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

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

6.4 Market Risk

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

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

The Bank measures and manages market risk by using conventional methods i.e. notional amounts, sensitivity and combinations of various limits. The Bank also uses VaR (Value at Risk) technique for market risk assessment of positions assumed by its treasury. In-house and vendor based

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solutions are used for calculating mark to market value of positions and generating VaR (value at risk) and PVBP (Price Value of a Basis Point) numbers.

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

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

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

	2014		
	Carrying Amount Rs 000'	Trading Portfolios Rs 000'	Non Trading Portfolios Rs 000'
Assets subject to Market Risk			
Trading Assets	-	-	-
Derivative Financial Instruments	6,500	-	6,500
Loans & Receivables to Customers	10,336,085	-	10,336,085
Financial Instruments – Available for sale	2,409,140	-	2,409,140
Financial Investments – Loans & Receivables	1,611,905	-	1,611,905
	14,363,630	-	14,363,630
Liabilities subject to market risk			
Derivative Financial Instruments	546	-	546
Deposits	8,669,859	-	8,669,859
Borrowings	2,564,524	-	2,564,524
Other Borrowings	141,112	-	141,112
	11,376,041	-	11,376,041

6.4.1 Interest Rate Sensitivity on interest bearing assets and liabilities

The table below depicts the interest rate sensitivity based on the interest rate sensitive positions as at 31st December 2014. In its cumulative position up to 12 month time bucket, Bank carries an asset sensitive position. This asset sensitive position will vary for each time bucket up to 12 months period in which during the time bucket of over 1 – up to 3 months, the Bank would experience assets sensitive position of LKR 2,929 Mn. The interest rate sensitivity of the Bank indicates that in case of an interest rate decline, the Bank would tend to experience a loss of LKR 45 Mn in its Net Interest Income (NII) while in case of interest rate increase the Bank would enhance its Net interest income by LKR 45 Mn. This interest rate risk exposure is quantified based on the assumed change in the interest rates for each time period given in table shown below.

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Parameter	0 to 1 Month Rs.000'	Over 1- up to 3 Months Rs.000'	Over 3- up to 6 Months Rs.000'	Over 6 – up to 12 Months Rs.000'
Total interest bearing assets	7,162,467	3,699,790	2,357,266	774,846
Total interest bearing liabilities	4,839,428	3,093,790	668,926	800,684
Net interest bearing assets (liabilities)	2,323,039	606,000	1,688,341	(25,838)
Cumulative Gap	2,232,039	2,929,040	4,617,380	4,591,543
Assumed change in interest rates	1%	1%	1%	1%
Impact	23,230	6,060	16,883	(258)
Net impact on NII if interest rates increase				45,915
Net impact on NII if interest rates decline				(45,915)

6.4.2 Foreign exchange position as of 31 December 2014

Currency	Spot(Net)	Forward(Net)	Net Open Position	Overall position in LKR
AUD	(4,098)		(4,098)	(444,590)
EUR	4,608		4,608	741,569
GBP	(1,310)		(1,310)	(269,620)
HKD	(5,073)		(5,073)	(86,501)
JPY	(5,894,525)		(5,894,525)	(6,528,776)
SGD	(4,917)		(4,917)	(492,279)
USD	1,387,726	(1,500,881)	(113,155)	(14,968,129)
Total Exposure				(22,048,325)
Total capital funds as per the latest Audited Financial Statements (Capital base as at 31 December 2013)				4,164,214,845
Total exposure as a % of total capital				0.53%

6.4.3 Forex Risk in Net Open Position (NOP)

The table indicates the exchange rate risk exposure based on its net open position to deferent currencies. As of 31st December 2014, bank carried USD net open “Long” position. The bank will be exposed to exchange rate risk in case, LKR appreciates against USD. The sensitivity analysis on this exposure at deferent shock level is presented below.

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

Sensitivity Analysis for the Exchange Rate Risk Exposure as at 31st December 2014

Position as at 31st December 2014	Amount
Net exposure - USD	(166,679)
Overall exposure in LKR	(22,048,325)
Exchange rate (USD/LKR)	132.28
Effect on income statement (LKR)	
- If Exchange rate move down by 1%	(220,483)
- If exchange rates move down by 3%	(661,450)
- If exchange rate move down by 5%	(1,102,416)

6.5 Liquidity Risk

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

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

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

	2014	2013
	%	%
Net liquid assets to deposits from customers		
At 31 December	50.05%	48.23%
Average for the year	63.57%	42.68%
Maximum for the year	76.81%	58.83%
Minimum for the year	50.05%	18.14%

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

	2014	2013
Advances to Deposit Ratio		
Average for the Year ended	115.35%	129.79%
Minimum for the Year ended	100.23%	114.89%

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Maximum for the Year ended	126.50%	147.25%
As at	121.64%	124.13%
Statutory Liquid Asset Ratio		
Average for the Year ended	48.51%	43.10%
Minimum for the Year ended	40.29%	29.97%
Maximum for the Year ended	62.28%	52.74%
As at	38.02%	51.92%

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

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

6.6 Operational Risk

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

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

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

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

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

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

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6.7 Capital Management

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

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

6.7.1 Statutory minimum capital requirement and capital management

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

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

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

6.7.2 Regulatory Capital

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

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

As of 31st December 2014, Bank reported a Tier 1 ratio of 43.36% and a total CAR of 43.36% which remain comfortably above the CBSL's capital requirements.