

Housing Development Finance Corporation Bank - 2019

1.1 Opinion

The audit of the financial statements of the Housing Development Finance Corporation Bank (“Bank”) for the year ended 31 December 2019 comprising the statement of financial position as at 31 December 2019 and the statement of income and the statement of comprehensive income, statement of changes in equity and statement of cash flow for the year then ended, and notes to the financial statements, including a summary of significant accounting policies, was carried out under my direction in pursuance of provisions in Article 154(1) of the Constitution of the Democratic Socialist Republic of Sri Lanka read in conjunction with provisions of the National Audit Act No. 19 of 2018 and Finance Act No. 38 of 1971. My comments and observations which I consider should be report to Parliament appear in this report.

In my opinion, the accompanying financial statements of the Bank give a true and fair view of the financial position of the bank as at 31 December 2019, and of their financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

1.2 Basis for Opinion

I conducted my audit in accordance with Sri Lanka Auditing Standards (SLAuSs). My responsibilities, under those standards are further described in the Auditor’s Responsibilities for the Audit of the Financial Statements section of my report. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my opinion.

1.3 Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation of financial statements that give a true and fair view in accordance with Sri Lanka Accounting Standards, and for such internal control as management determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Bank’s ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intend to liquidate the Bank or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Bank’s financial reporting process.

As per Section 16(1) of the National Audit Act No. 19 of 2018, the Bank is required to maintain proper books and records of all its income, expenditure, assets and liabilities, to enable annual and periodic financial statements to be prepared of the Bank.

1.4 Auditor's Responsibilities for the Audit of the Financial Statements.

My objective is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes my opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Sri Lanka Auditing Standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with Sri Lanka Auditing Standards, I exercise professional judgment and maintain professional skepticism throughout the audit. I also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for my opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the management.
- Conclude on the appropriateness of the management's use of the going concern basis of accounting and based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Bank's ability to continue as a going concern. If I conclude that a material uncertainty exists, I am required to draw attention in my auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify my opinion. My conclusions are based on the audit evidence obtained up to the date of my auditor's report. However, future events or conditions may cause the Bank to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

The scope of the audit also extended to examine as far as possible and as far as necessary the following;

- Whether the organization, systems, procedures, books, records and other documents have been properly and adequately designed from the point of view of the presentation of information to enable a continuous evaluation of the activities of the Bank, and whether such systems, procedures, books, records and other documents are in effective operation;

- Whether the Bank has complied with applicable written law, or other general or special directions issued by the governing body of the Bank;
- Whether the Bank has performed according to its powers, functions and duties; and
- Whether the resources of the Bank had been procured and utilized economically, efficiently and effectively within the time frames and in compliance with the applicable laws.

1.5 Accounts Receivable and Payable

1.5.1 Payable

| Audit Issue | Management Comment | Recommendation |
|--|--|---|
| The excess loan recoveries amounting to Rs. 1,835,959 in the “Equal Monthly Installments (EMI) Excess Account” is being remaining for more than five years without repaying to the respective customers. | The balance has reduced to Rs.227,963 as at 15/09/2020. Actions are being taken to refund. The money to the customer on their request or as and when customers are identified by the branches. | Necessary actions need to be taken to repay the excess balances to customers. |

1.6 Non-compliance with Laws, Rules, Regulations and Management Decisions etc.

| Reference to Laws, Rules Regulations etc. | Non-compliance | Management Comment | Recommendation |
|---|---|---|--|
| (a) Section 16(2) of Part IV of the Housing Development Finance Corporation Act, No. 7 of 1997. | Stated capital of the bank should be Rs.1,000 million. However, stated capital of the bank as at 31 December 2019 was Rs.962,092,936. | This matter has been discussed at several meetings with Treasury officials and waiting for a favorable answer. | Necessary action need to be taken to comply with the relevant act. |
| (b) Banking Act Direction No 05 of 2017 dated 26 October 2017 section 02 of the Central Bank | As per the direction the Minimum Capital of the bank should be Rs.7500 million commencing from 31 December 2020. As per the Board approved ICAAP document for 2019, bank will not be in a position to comply with | The Bank had made a request for the extension of the deadline for meeting Rs. 7500 million capital requirement. Nevertheless, by the letter issued by the CBSL dated 27/03/2020 (attached) the deadline | Necessary action need to be taken to comply with the relevant act. |

the minimum capital requirement by the end of 2020. has been extended up to end of 2022.

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|--|---|--|--|
| (c) Section 6.2.10 of Marketing and Business Development Policy of HDFC Bank | A product review should take place at least annually and should cover the profitability of the product or services, as well as marketing plans, staff training and any other features that the licensee considers material. It was noted that the bank has not carried any review of the major product or services at the end of December 2019. | We are in the process of reviewing the profitability of existing products. This matter would be addressed before the end of first quarter. | Take necessary steps for the adherence of cited direction. |
| (d) Section 4.1.1 of Loan Recovery Manual of the Bank | Capital with interest outstanding balance of loans categorized under Vested Properties as at 31 December 2019 was Rs. 161,951,448. Out of that Rs. 31,864,980 or 20 percent were remained over five years period. | Properties vested by the Bank from 1995, which had high demand, have already been sold. But there are other properties which are of poor demand due to the infrastructure of the surrounding area which has not been developed, and also offers made do not cover the Bank dues. However, we are awaiting in anticipation of offers which will at least cover the Bank dues. | Land value of the property should be properly evaluated before granting the Mortgage loans and steps should be taken to recover the outstanding balance. |

1.7 Non-compliance with Tax Regulations

| Reference to Laws, Rules Regulations etc. | Non-compliance | Management Comment | Recommendation |
|--|---|--|--|
| Inland Revenue Act, No. 24 of 2017 | | | |
| (a) Public Enterprises Circular No. PED 03/2016 of 9 April 2016, | The Bank had paid "Pay As You Earn" (PAYE) tax amounting to Rs. 16,950,345 for the year 2019 out of its own funds on behalf of its employees instead of being deducted from the salaries of the respective employees. | As per the Collective Agreement of the Bank, staff PAYE tax is borne by the Bank. However, since we have to comply with the government circulars issued on this subject, we will discuss same at the next Collective Agreement negotiations. | Take necessary steps to adhere with the cited direction. |

2. Financial Review

2.1 Financial Result

The operating result of the year under review amounted to a profit of Rs.476 million and the corresponding profit in the preceding year amounted to Rs.564 million. Therefore, a deterioration amounting to Rs.88 million of the financial result was observed. The reasons for the deterioration was the decrease of net fee & commission income, other operating income by Rs.22 million and Rs.12 million respectively and increase of impairment charges for loans & other losses by Rs.230 million.

2.2 Trend Analysis of major Income and Expenditure items

| Description | 2019 Rs. million | 2018 (Restated) Rs. million | Percentage of Change over previous year |
|-------------------------------|---------------------|-----------------------------------|---|
| Interest Income | 7,683 | 6,679 | 15 |
| Interest Expenses | (4,783) | (4,441) | 8 |
| Net Interest Income | 2,900 | 2,238 | 30 |
| Net Fee and Commission Income | 358 | 380 | (6) |
| Other Operating Income (Net) | 49 | 61 | (20) |

| | | | |
|--|--------------|--------------|-------------|
| Total Operating Income | 3,307 | 2,679 | 23 |
| Impairment Charges for Loans & Other Losses | 323 | 93 | 247 |
| Net Operating Income | 2,984 | 2,586 | 15 |
| Staff Cost | 1,164 | 1,114 | 5 |
| Other Expenses | 575 | 554 | 4 |
| Operating Profit Before Value Added Tax | 1,245 | 918 | 36 |
| VAT on Financial Services | 470 | 290 | 62 |
| Tax Expenses | 299 | 64 | 367 |
| Profit for the year | 476 | 564 | (15) |

2.3 Ratio Analysis

According to the information made available, some of the important ratios of the Bank for the year under review and the preceding year is as follows.

| Name of Ratio | Sector Ratio | 2019 | 2018 |
|--|---------------------|-------------|-------------|
| ----- | ----- | ----- | ----- |
| <u>Profitability Ratios</u> | | | |
| (i) Net Profit Ratio (Percentage) | - | 5.88 | 7.92 |
| (ii) Net Interest Income/ Interest Income (Percentage) | - | 37.74 | 33.50 |
| (iii) Interest cost to Interest Income (Percentage) | - | 62.26 | 66.47 |
| (iv) Return on Average Assets (times) | 0.4 | 0.91 | 1.14 |
| (v) Return On average Share Holders Fund (times) | 6.8 | 9.63 | 12.56 |
| <u>Capital Adequacy Ratios</u> | | | |
| Tier I (Minimum 8.5%) | 12.3 | 19.14 | 16.41 |
| Tier II (Minimum 12.5%) | 15.6 | 19.14 | 16.41 |
| <u>Liquid Assets Ratios</u> | | | |
| Liquid Assets Ratio | 53.1 | 26.07 | 20.56 |
| <u>Other Ratios (In Rupees)</u> | | | |
| Earnings Per Share | - | 7.35 | 8.72 |

| | | | |
|--|---|-------|-------|
| Net Assets Per Share | - | 79.11 | 73.51 |
| Market Value Per Share as at end of the Year | - | 32.00 | 26.00 |

* Source: -Central Bank Financial Sector Statistics 2019-Table 4.2 (Provisional Data)
The following observations are made in this regard.

- (a) Net Profit Ratio had declined by 25.75 percent and Net Interest Income had increased by 12.65 percent in the year under review compared with previous year.
- (b) Return on Average Assets (times) and Return on Average Share Holders Fund (times) had declined by 20 percent and 30 percent respectively in the year under review compared with previous year.
- (c) Earnings per Share had decreased by 15.71 percent and Market Value per Share had increased by 23 percent in the year under review compared with previous year.

2.3.1 The Market Share of the Bank based on the loans and advances and total deposits are shown below.

(a) Market Share based on Loans and Advances.

| | 2019 ----- | 2018 ----- | 2017 ----- | 2016 ----- | 2015 ----- |
|--|---------------|---------------|---------------|---------------|---------------|
| Total Loans and Advances of the Bank (Rs. million) | 42,360 | 38,827 | 35,737 | 31,052 | 27,316 |
| Total Loans and Advances of the Market (Rs. million) | 760,057 | 712,511 | 639,706 | 533,230 | 456,961 |
| Market share of the Bank (percentage) | 5.57 | 5.45 | 5.59 | 5.82 | 5.98 |

(b) Market Share based on Deposits

| | 2019 ----- | 2018 ----- | 2017 ----- | 2016 ----- | 2015 ----- |
|--|---------------|---------------|---------------|---------------|---------------|
| Total Deposits of the Bank (Rs. million) | 42,504 | 37,016 | 36,655 | 32,123 | 28,593 |
| Total Deposits of the Market (Rs. million) | 1,277,529 | 1,084,612 | 974,574 | 846,146 | 764,155 |
| Market share of the Bank (percentage) | 3.33 | 3.41 | 3.76 | 3.8 | 3.74 |

2.4 Maturity Analysis

| Audit Issue | Management Comment | Recommendation |
|---|---|--|
| Analysis of Financial Assets and Financial Liabilities by remaining contractual maturities as at 31 December 2019 revealed that Financial Liabilities for months 3-12 was far in excess over total assets, and the liquidity gap was Rs.12,156,403,000. | Alco has decided to continuously review this situation and brings it to in an acceptable level. | Take necessary steps to minimize the maturity gap in future. |

3. Operational Review

3.1 Management Inefficiencies

| Audit Issue | Management Comment | Recommendation |
|---|---|---|
| (a) Bank had invested Rs.50.95 million in debenture at the rate of 11.75 percent at MTD Walkers PLC on 01 October 2018 with one year maturity period. However, the capital of Rs.50,956,700 and the interest of Rs.7,512,188 had not been repaid by the company as at date of audit. Further, issuing company's rating had been downgraded during 2019 and negative financial positions were reported in 2018 and 2019 respectively. The recoverability of this investment is questionable. However, bank had made 100 percent impairment as at 31 December 2019. | Since, the other banks in the industry including BOC, Peoples Bank and other commercial banks have invested in the MTD Walkers debentures, HDFC is participating to recover the investment collectively with those banks. However, in HDFC, we have made 100% impairments. | Suitable decisions need to be taken not to occur this type of situations in the future. |
| (b) As per the Board Paper No 19/188/2015, the bank had planned to gain potential estimated annual return of 15 percent per annum for the funds and to manage the assets and liability maturity gap accordingly. However, no return had been received since the year 2015 from the investment amounting to Rs.25,000,000 made in Ceybank unit. Further the market price of the unit as at 31 December | This fund is a close-ended investment fund. The fund is closed for new investors and redemptions through the fund managers are not permitted during the five year period. However the NAV of the fund will be determined by the fund manager and liquidation of the fund will be done at the end of the five year period. | Investment should be made in line with the investment policy of the bank by paying attention to mitigate the risk of investment |

2019 is Rs.7.70 and trust value is significantly deteriorating from last 3 years when comparing with the investment price of Rs.10.00.

- (c) As per the circular No.GCL/2016/210 dated 28 September 2016 the bank had introduced housing loan facilities to Very Important Professionals (VIP) and 140 loans amounting to Rs.282,985,000 had been granted under this scheme. Fourteen loans amounting to Rs.42,255,020 or 12 per cent had categorized as nonperforming as at 31December 2019. There is no any secondary recovery option to the bank due to unavailability of security.
- This loan scheme was introduced in September 2016 for the first time. Majority of clients were Lawyers. At the point of granting the loans, income of Lawyers' has been confirmed by the Bar Association of relevant area, where the Lawyers were working and loans were granted based on these confirmations. Most of the Lawyers were not paying the loan not because of their income but purposely. We try our best to recover these loans by getting the support of respective Bar Association prior to take legal actions against the customers. But we have taken legal actions against some customers under Civil Procedure Court and we take same action if we cannot get support of respective Bar Associations. We have temporally suspended this loan scheme at the moment.
- Necessary preventive actions need to be taken not to occur this type of situations in the future.

3.3 Operational Inefficiencies

| Audit Issue | Management Comment | Recommendation |
|--|---|--|
| (a) Loans and Advances | | |
| i. The total outstanding balance of loans and advances as at 31 December 2019 was Rs.30,123 million and non-performing loans and advances as at that date was Rs.4,152 million or 13.78 per cent of total outstanding balance of loans and advances. | The Bank as at present is taking aggressive steps to recover NPL with a view to reduce the NPL ratio. | Take necessary steps to reduce non-performing Loans and Advances to an acceptable level. |
| ii. Total non-performing loans and advances ratio of 13.78 per cent is significantly higher than the sector ratio of 5.5 per cent. | Commercial Banks who are catering for high corporate institution and upper class network individuals, whereas we are catering to a class where the repayment capacity is very low. This trend has therefore resulted to | Take necessary steps to reduce non-performing Loans and Advances to an acceptable level. |

a rise in high NPL level. Further, since the average loan component is less than Rs.500,000 and the HDFC Bank cannot effect any recover through the use of “Parate Execution” whereas the loan components of other Banks are very much higher than Rs.5 Mn.

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|------|--|---|--|
| iii. | <p>Total outstanding value of loans which were granted against the Employee Provident Fund as at 31 December 2019 was Rs.10,151 million and out of that, a sum of Rs.6,020 million had been treated as non- performing and it is represents 59.3 per cent of the total outstanding. However, we noticed that non- performing ratio of EPF loan had been increased by 4 per cent compared with previous year.</p> | <p>This is an inherent issue to the HDFC from the inception of EPF loan. As a result of nonpayment of monthly installment by the borrower themselves the Bank was compelled to claim arrears together with interest and overdue interest in every year from the CBSL.As per the CBSL rules, the Bank is eligible to claim maximum of 12 months overdue amount of capital, interest and overdue interest through the annual claim. Because of this rule the Bank is not able to submit claims for some of the loans which have large outstanding balances. As a result of this NPL ratio and NPL value in the EPF loans reflect a higher percentage.</p> | <p>Take necessary steps to recover these loans</p> |
|------|--|---|--|

(b) Loans granted to Army officials by Ja-ela branch

The Ja-ela branch had granted 101 Guarantor Loans valued to Rs.110,700,000 for Army officials without getting relevant authority from the employer and verifying the repayable capacity of the customer. Therefore, these loans were turn in to non-performing category and total capital outstanding balance as at 31 December 2019 was Rs.98,464,870 and it was 89 percent of the original loan disbursed. Further satisfactory recovery actions were not taken to recover the outstanding balances from guarantors.

Due to irregularities done by the some army officers the, salary remittances have not been transferred as agreed. Therefore action has been taken to recover the loan under the supervision of Chief Manager Credit, Area Manager, Branch Manager and Senior Manager Recoveries.

Take necessary steps to recover these loans

(c) Exclusive loan Centre at Hyde Park Corner was opened on 02 August 2017 for granting loans over Rs.5 million under Housing Mortgage, EPF and Business Loans category. Following observation is made in this regard. Even though the bank has spent Rs.3,151,051 for construction of Exclusive loan Centre, only 10 numbers of loans amounted to Rs.284 million were disbursed up to the date of 31 December 2019 and there after services were terminated by this center. The Bank had failed to achieve the expected target of Rs.2,000 million from the aforesaid Loan Centre.

The initial objective was not achieved due to lack of customer response. The unit was opened in August 2017 and the services were terminated and officers attached were transferred in mid 2018 .

Proper feasibility study should be carryout prior to take this type of decisions.

(d) Advance on leasing facilities

The total outstanding balance of advances on Leasing as at 31 December 2019 was Rs.1,312,448,256 and non-performing balance of advances on Leasing as at that date was Rs.167,496,981 or 13 per cent of total outstanding balance of advances on Leasing. Further it was observed that 174 leasing facilities valued to Rs.221,859,148 were categorized under watch status which had a risk of subsequently become Non performing status, out of that 36 leasing facilities valued to Rs.62,623,507 or 28 per cent were represented by Embilipitiya Branch.

Total watch capital outstanding as at 31/12/2019 is Rs.60,586,078.50 from 36 facilities. Status of the said 36 facilities as at 28/02/2020 is as below.
 Watch: 29
 Norm: 5
 Closed: 2

Therefore it is observed that even though there had been Rs.60.57 Mn in watch as at 31 December 2019 there is no tendency in bulk of these facilities transferring to NPL. However we will strictly instruct Embilipitiya branch to reduce their Watch category and monitor same.

Proper actions need to be taken to reduce the NPL balances.

3.4 Human Resources Management

| Audit Issue | Management Comment | Recommendation |
|---|---|---|
| a) According to the section 9.2 (b) and (d) of Chapter 09 of the Public Enterprise Department Circular Number PED 12 dated 02 June 2003, each organization should | We are governed by the HDFC Act No.7 of 1997 and amended Act No.15 of 2003. According to that the Board has the authority to approve the organization chart and | Take necessary steps for the adherence of cited direction |

have an organization chart with an approved cadre and also it should be registered with General Treasury. However, the approval of General Treasury had not been taken by bank.

the cadre.
Board approved cadre is available.
Please refer minute No.
06/08/HR/2018.

- b) As per the section 9.3.1 of Public Enterprise Department Circular Number PED 12, every public enterprise should have schemes of recruitment and promotion for each post and it should be approved by the Board and the appropriate Ministry with the concurrence of the General Treasury. However, the approval of General Treasury had not been taken by the bank.

Scheme of Recruitment has been prepared and it will be submitted to the next Board for the approval.

Take necessary steps for the adherence of cited direction