

OUR OPERATING CONTEXT

LBF’s operating context is defined by global and local drivers that influence our ability to do business. While changes in the operating environment are largely beyond our control, we remain vigilant of new developments and proactively analyse these trends to determine likely risks to our business model and identify potentially beneficial opportunities.



1 SOUTH ASIAN CONTEXT

The economies of the South Asia Region (SAR) continue to be adversely affected by shocks emanating from the Russian Federation’s invasion of Ukraine, including higher food and energy prices, alongside tightening global financial conditions giving rise to uncharacteristically high inflation. The repercussions of these developments saw many SAR economies witnessing contractions in trade, hospitality, construction activity and industrial output, coupled with severe pressure on disposable incomes. According to statistics published by the World Bank, deteriorating economic conditions appears to have led to a substantial increase in poverty in countries Afghanistan, Pakistan and Sri Lanka.

Source – Global Economic Prospects - January 2023 (World Bank)

2 SRI LANKAN ECONOMIC OVERVIEW

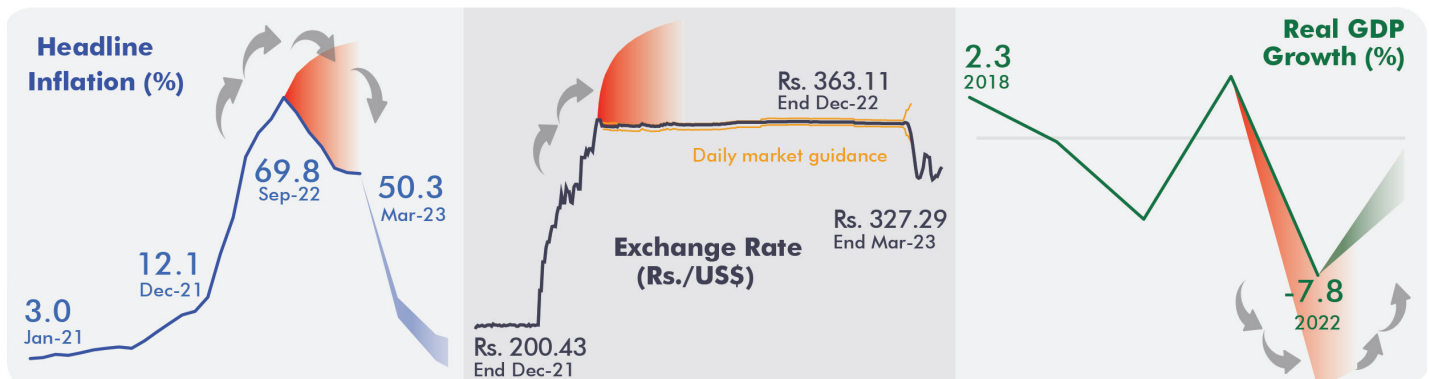
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Source Global Economic Prospects - January 2023 (World Bank)

3 NBFi SECTOR OVERVIEW

NBFi sector managed to continue its expansion during 2022 amidst the economic contraction experienced by the country. Driven mainly by loans and advances, the asset base of the sector expanded by Rs. 123 billion recording a growth of 8.3% to reach Rs. 1,611.2 billion by end 2022, compared to the 6.1% growth recorded in 2021. However amidst the significant economic deceleration, the NBFi sector total gross NPLs/Stage 3 loans increased by 66.1% as at end 2022 on a year-on-year basis, compared to the decrease of 13.9% recorded as at end 2021.

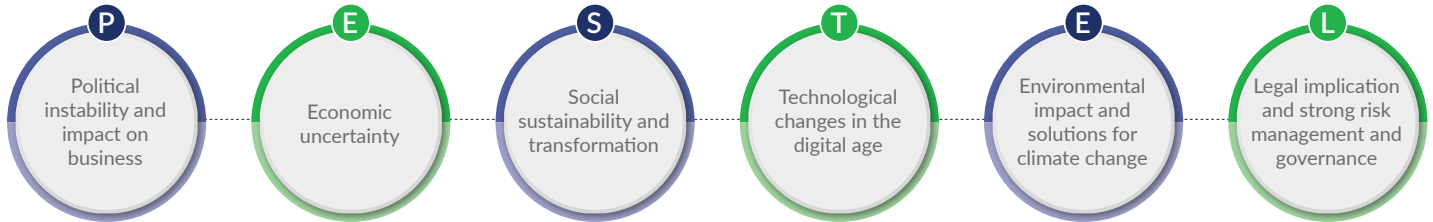
Source: CBSL AR 2022



Source: CBSL AR 2022

4 HORIZON SCAN

Based on the ongoing horizon scans carried out in the current financial year, we discovered several factors that likely influence our growth strategy in varying degrees of intensity. These factors are analysed in greater detail, below;



P Political instability and impact on business

Operating environment and its impact on NBF sector

To maintain leadership in the fast-evolving financial services sector, NBFs are seeking now more than ever, to create a differentiation based on closer ties with customers and other stakeholders.

Furthermore, given the rapid depletion in per capita income in recent years, NBF's have started focusing on expanding their product suite to promote inclusive finance. At the same time Companies are increasingly using digital platforms to encourage stakeholder participation to broaden their corporate CSR activities.

Key highlights

New guidelines were issued to manage the concentration risk of the gold loan portfolio

Drivers	Impact / Strategic Response	Opportunity/Threat	Rating
Unsustainable governmental policies	The restriction on vehicle imports remains in force and continues to adversely impact the LBF's core leasing business, which has urged the Company to pursue for alternative lending opportunities such as Gold Loans	Threat	High

Implications for value

Inability to support small business owners (MSME's) and individuals to safeguard their financial wellbeing

Impact on our business and Strategic Response

Higher recovery costs and increased risk of customer defaults

Related risks | Credit risk - default risk, concentration risk, recovery risk

Governance in action

The Board revisited risk appetite limits with a view to managing credit quality, while overall lending principles were also examined with more emphasis on strengthening the credit evaluation and approval procedures

Related opportunities

Pursue alternative opportunities for credit expansion through more secured lending models

Link to short-term strategies

Maintain liquidity levels in-line with regulatory benchmarks

Link to medium-term strategies

Establish reliable contingency funding lines to support business needs

Link to long-term strategies

Ensure adequate liquidity buffers to meet emergency requirements of customers

Materiality

CEC LRC

SDG impact

10 16 17

Capitals impacted

FC MC

Strategic focus

BS BO

OUR OPERATING CONTEXT

E Economic Uncertainty

Operating environment and its impact on NBF1 sector

The deceleration in economic activity had a major adverse impact on the MSME sector. Similarly, inflationary conditions saw MSME's facing severe cost escalations, resulting in extreme margin pressure. And with MSME's being the main market for the NBF1 sector, the NBF1 sector too experienced some notable challenges in terms of credit expansion and credit quality.

Moreover, consecutive downgrades of Sri Lanka's sovereign rating since 2020, continued to affect the country's credibility in the international arena, in turn restricting access to USD funding lines.

Another major issue was the lack of adequate market liquidity which raised concerns regarding possible restructuring of LKR denominated instruments (SLDB's).

Key highlights

Regular stress testing of LBF's asset portfolios to assess the impact of interest rate shocks under both normal and stress conditions

Drivers	Impact / Strategic Response	Opportunity/Threat	Rating
Upward trend in interest rates	The pressure on NII owing to frequent and ad-hoc increase in policy interest rates, prompted LBF to engage in strategic repricing of portfolios	Threat	High

Implications for value

The high price of credit may prove to be deterrent for many customer segments

Impact on our business model

Restricted credit expansion due to weak credit appetite from the market

Related risks | Interest rate risk

Governance in action

In order to deal with the economic instability, the Board amended LBF's short- and medium-term strategic plan to facilitate continuous realignment of business plans in tandem with findings from current risk assessments

Related opportunities

Drive fee based income sources

Link to short-term strategies

Systematically reduce the exposure to interest sensitive assets

Link to medium-term strategies

Implement variable lending schemes pegged to interest rate movements

Link to long-term strategies

Promote sustainable finance to mitigate the impact of interest rate fluctuations

Materiality

CBI CEC

SDG impact

8 10 12

Capitals impacted

FC MC IC

Strategic Focus

BS BSF

S Social Sustainability and Transformation

Operating environment and its impact on NBF sector

Financial institutions can play a vital role in finding solutions for climate change, mainly through their credit granting operations and also by strengthening green ethics among the wider society.

As organizations become more cognisant of their environmental responsibilities, many are adopting global best practices such as the carbon footprint calculation to make informed decisions that support the transition of low carbon economy.

Key highlights

LBF's Facebook page was used to create positive conversations revolving around solutions to ongoing challenges

Drivers	Impact / Strategic Response	Opportunity/Threat	Rating
Growing influence of social media	Social media serves as an excellent platform to drive customer intimacy. Having understood this, LBF has progressively increased its social media footprint over the past three years	Opportunity	Medium

Implications for value

Ability to strengthen customer trust and build a loyal customer base

Impact on our business model

Improved outcomes from the product development and service delivery processes based on customer insights

Related risks | Reputational risk

Governance in action

In light of the social unrest and other disruptions, the management decided to expand LBF's social media focus to bring more visibility to the industry leading initiatives undertaken by the Company to advance sustainability for the benefit of internal and external stakeholders

Related opportunities

Pursue value adding partnerships with customers

Link to short-term strategies

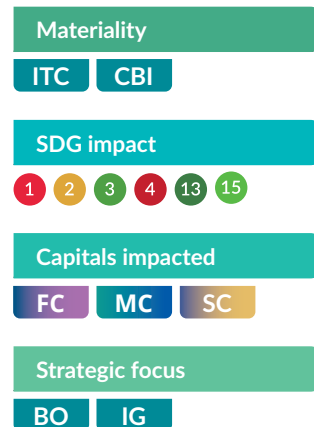
Further strengthen information security architecture to safeguard customer privacy

Link to medium-term strategies

Leverage social media to drive partnerships with customers for the purpose of value addition

Link to long-term strategies

Track customer satisfaction and loyalty as a more frequent indicator across the business



OUR OPERATING CONTEXT

T Technological Changes in the Digital Age

Operating environment and its impact on NBFi sector

Growing global technology trends continue to influence the perceptions and consumption of financial services, which has urged financial institutions to rethink the validity of the conventional brick-and-mortar model in the delivering financial services to customers. While the local NBFi too appears to be slowly embracing these trends, the current model represents a hybrid version involving a combination of both traditional channels and new age digital mediums.

Key highlights

A formal Technology Risk Management Policy was implemented encapsulating the requirements set out under the Finance Business Act Direction no. 1 of 2022 on Technology Risk Management and Resilience

Drivers	Impact / Strategic Response	Opportunity/Threat	Rating
Demand for financial solutions accessible from anywhere at anytime	Digital financial services are a quick and highly cost effective medium of satisfying the customers' financial needs. Leading by example, LBF has significantly accelerated its Digital channel architecture through broad based improvements to the LB CIM app	Opportunity	High
Decision making using AI	The advent of AI has significantly enhanced the effectiveness of decision making by providing deeper insight and 360-degree visibility into customer behaviour. LBF has started investing in AI to assimilate emerging requirements, determine behaviour patterns and understand customer pain points, all critical factors to support more effective decision making	Opportunity	Medium
Robotic Process Automation (RPA)	Although the initial investment in RPA is high, the cost advantages over time are significant. LBF's RPA journey which started a few years ago has steadily gathered momentum in the past two years.	Opportunity	Medium

Implications for value

New and updated products and services with 24/7-365 day availability to empower customers to manage their financial needs.

Meanwhile more informed decision making and greater cost efficiencies resulting from automation enable better returns for shareholders.

Impact on our business model

Increased resources being diverted towards in-house IT research along with the possibility of pursuing value adding external partnerships

Related risks | Operational Risk, Information Technology and Information Security Risk, Strategic Risk

Governance in action

Given the increased use of digital channels the Board increased the focus on building LBF's IT system resilience and effectively managing information security risks

Related opportunities

Realise significant cost efficiencies at all levels of the business.

Link to short-term strategies

Develop new technology-based solutions tailored to meet the needs of different customer segments

Link to medium-term strategies

Strengthen data science and behavioural capabilities to improve customer mapping

Link to long-term strategies

Improve operational efficiency by making sure that LBF's technology is stable, efficient, secure, and robust while automating our processes and transitioning to cloud-based solutions.

Materiality

ITC CBI

SDG impact

9 11 12

Capitals impacted

FC MC IC

Strategic focus

BS IG

E Environmental Impact and Solutions for Climate Change

Operating environment and its impact on NBF sector

Financial institutions can play a vital role in finding solutions for climate change, mainly through their credit granting operations and also by strengthening green ethics among the wider society.

As organizations become more cognisant of their environmental responsibilities, many are adopting global best practices such as the carbon footprint calculation to make informed decisions that support the transition a low carbon economy.

Key highlights

Reduction in paper waste due to digitisation and automation initiatives

Zero incidents of non compliance of environment regulations

Drivers	Impact / Strategic Response	Opportunity/Threat	Rating
Green financing	Green financing activities that focus on eco-friendly activities such as renewable energy and low carbon emissions pave the way for a cleaner environment. LBF has developed green finance schemes to provide funding for hybrid vehicles.	Opportunity	Medium
Growing concern within society about safeguarding the environment.	A more environmental conscious society brings incalculable benefits and LBF strives to do its part to support this endeavour by raising awareness among stakeholders.	Opportunity	Low

Implications for value

A greener and cleaner planet will be a strong legacy for generations to inherit.

Impact on our business model

Strengthens LBF's brand credentials as an environmental advocate

Related risks | Reputational risk

Governance in action

The Sustainability Committee reviewed the progress of LBF's environmental plan, including the LBF's response to climate actions through the EMS

Related opportunities

Accelerate the transformation to a fully digitized financial services provider

Link to short-term strategies

Focused strategies to demonstrate advocacy of environmental awareness

Link to medium-term strategies

Systematically increase process automation to cover at least 90% of internal operations

Link to long-term strategies

Expanded the coverage of green lending line to include renewable energy projects

Materiality

LRC CBI

SDG impact

8 9 17

Capitals impacted

FC SC NC

Strategic focus

BO IG

OUR OPERATING CONTEXT

L Legal and Regulatory Compliance and Best Practices

Operating environment and its impact on NBF sector

Increasing regulation has become a major part of the evolutionary process of the NBF sector. Global best practices are also now increasingly underscoring the stability and good standing of the NBF sector.

Key highlights

LBF began working towards early adaptation of the mandates set out under the Personal Data Protection Act No 9 of 2022

Drivers	Impact / Strategic Response	Opportunity/Threat	Rating
New Regulatory Directives	New developments in the legal and regulatory environment help to maintain the soundness of the financial system. LBF welcomes new regulations and strives lead by example in the early adoption of new regulations	Opportunity	High
Global Best Practices	Global Best Practices improves the credibility and stability of organisations. LBF seeks voluntary adoption of global best practices applicable to financial institutions.	Opportunity	High

Implications for value

A well-managed and compliant organisation is able to retain stakeholder trust over time

Impact on our business model

Increased resources being diverted to strengthen internal control systems and obtain independent validations regarding the efficacy of these systems

Related risks | Reputational risk

Governance in action

The LBF Board continued to exercise its zero-tolerance approach for non-compliance, while advocating for the voluntary adoption of global best practices

Related opportunities

Achieve recognition for compliance leadership

Link to short-term strategies

Maintain the commitment to compliance leadership

Link to medium-term strategies

Invest digital technology to automate compliance and best practice implementation and monitoring, where possible and practical

Link to long-term strategies

Pursue collaborative partnerships to drive more stringent independent oversight over regulatory matters

Materiality

LRC CEC

SDG impact

10 12 16

Capitals impacted





FC IC

Strategic focus

BS BSF

5 BEYOND THE SWOT - TOWS ANALYSIS

SWOT (strengths, weaknesses, opportunities, and threats) are the key pillars that underpin LBF's competitive position and industry standing. At LBF we consider the SWOT not as a fixed constituent, but rather as something that is continuously evolving. Premised on this, we frequently perform TOWS analysis to match our strengths against discernible opportunities and evaluate our threats vis-a-vis identifiable weaknesses.

TOWS MATRIX	 EXTERNAL OPPORTUNITIES 	 EXTERNAL THREATS 
		<ul style="list-style-type: none"> Promote financial inclusion Attraction of new customer Technology enhancement Increase Market Share
 INTERNAL STRENGTHS 		
<ul style="list-style-type: none"> Operational resilience Best brand amongst NBFs Widest geographical reach Experienced and qualified Board 	<ul style="list-style-type: none"> Increase market share through branch expansion (O4, S3) Investment on new ventures and expand the regional presence (O1, S1) Conducting brand loyalty programmes (O2, S2) 	<ul style="list-style-type: none"> Investment on research and development (S1, T1) Increasing product qualities and customized products (S3, T4) Focus on profit around customer (S1, T1) Board attention on green financing and green initiatives (S4, T3)
 INTERNAL WEAKNESSES 		
<ul style="list-style-type: none"> High attrition Untouched potential markets Possible automated areas 	<ul style="list-style-type: none"> Capacity building and increase investment on Training (O2, W1) Further strengthen the digital wallet to the MSME/SME (O1, W2) Capitalize on digital innovation and infrastructure (O3, W3) 	<ul style="list-style-type: none"> Install fully fledged digital branches (T3, W3) Technological empowered employees (T2, W1) Strengthen in-house software developments (T3, W2)

6 MARKET FORCES AND COMPETITIVE LANDSCAPE (FIVE FORCES)



1. Power of the customer

Big ticket loans (mainly leasing) customers are highly price sensitive and also have a higher bargaining power, whereas MSMEs have traditionally been less rate sensitive and have less bargaining power. However, as they become more financially savvy, it is quite likely that they will also be more price sensitive and consequently more demanding.

Strategic response

Focus on relationship building among existing customer base and channel resources towards finding new opportunities

Impact

H

MD's statement on pages 66 to 69, social and relationship capital on pages 170 to 191, business line review pages 99 to 118.

H High **M** Medium **L** Low

OUR OPERATING CONTEXT



II. Threat of new entrants

Even though the local financial sector consists of several banks and greater number of NBFIs, the possibility of new entrants cannot be ruled out. The likelihood of new entrants is also based on the decision by authorities to grant new licenses.

Strategic response

Build a strong and credible brand that stands out among peers

Impact



MD's statement on pages 66 to 69, business line review on pages 99 to 118



III. Competitive rivalry

Number of competitors

The financial sector of Sri Lanka consists of 33 banks and 43 NBFIs operating in the space

Switching cost

The switching cost for a customer is low due to a high concentration of service providers

Customer loyalty

Traditionally, Sri Lankan customers have been reasonably loyal; however, competitive tactics among entities have greatly reduced loyalty levels especially across high net worth customer segments

Strategic response

Improve product mix, customer service and process efficiency to attract and retain customers. Explore new ways of delivering value and innovative means of utilising existing resources to extend our range of offerings.

Impact



MD's statement on pages 66 to 69, social and relationship capital on pages 170 to 191, business line review on pages 99 to 118



IV. Power of the business partners

As a financial institution, our major suppliers comprise of support services. Given that they only provide support services, the bargaining power of business partners are low.

Strategic response

Focus on a diversified pool of support service providers to reduce risk of over dependence on any specific group of service providers

Impact



Social and relationship capital on pages 170 to 191, business line review on pages 99 to 118



V. Threat of substitute products

Low threat within the NBFIs industry. However, if we consider loan and leasing products from banks and non-bank sector as substitute products, then the threat is high. Additionally, for some segments, there exists a high threat of substitute products; for instance, in vehicle loans where some of the vehicle suppliers themselves offer the vehicles in installments, removing the need of getting a financier involved. There is a material threat in the medium and long run, with the potential for innovating alternative ways of creating value in meeting lending needs of businesses and individuals

Strategic response

Stay updated with industry best practices and new opportunities offered through technology and incentives

Impact



Social and relationship capital on pages 170 to 191, business line review on pages 99 to 118