2004 was the year when the FirstRand integrated structure really started to **make its mark** on the business

CEOs' REPORT

[left] **PAUL HARRIS / CEO, FirstRand Banking Group**
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In this report last year we spent some time explaining what we believe is FirstRand's unique value proposition in an attempt to address perceptions within the investment community that the Group is complex. We do not intend to cover the same ground again this year – except to show concrete examples of how this strategy and structure is beginning to deliver real value for shareholders.

To re-cap...

Much of the perceived complexity rests in the "integrated" model that we have adopted for the Group, based on the belief that this structure allows us to operate more effectively in the financial services arena particularly as the boundaries between products and services have become blurred. We believe this structure has unlocked meaningful growth opportunities.

To add to this complexity we structured our businesses into "clusters" across industries, which represented particular key segments of the market, namely retail, corporate, wealth and health. The clusters were simply a management construction to ensure the most effective segment focus.

Lastly, the way we "chunked" the business units into small profit centres, operating within the strategic alignment created by the clusters but run by autonomous, empowered management teams, means that we see ourselves as lots of little growth stories, not one big theme for growth.

We have made a slight adjustment

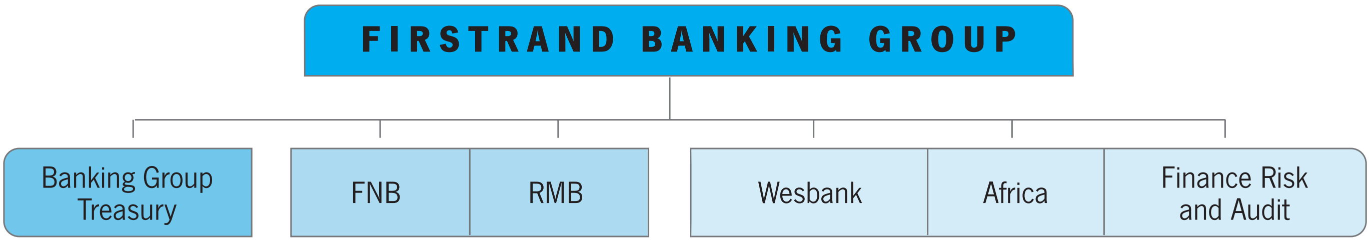
Post the year end we made an adjustment to our structure which resulted in the dismantling of the clusters. We took the decision to merge FNB Corporate and FNB Retail under one FNB management team as we believe that one of the major areas of future growth will be the business and medium corporate markets, which were previously separately housed in FNB Retail (business segment) and FNB Corporate (medium corporates).

By combining medium corporates with business we can achieve an even more powerful focus on this segment and deliver an integrated and coordinated offering to this customer base.

The management of large corporate relationships, previously serviced by FNB Corporate, will move to Rand Merchant Bank ("RMB"), with the transactional business of the large corporates outsourced to FNB. We can leverage the RMB brand into the top end of the corporate segment, creating some very exciting opportunities for providing value-add advisory and structuring skills to the large corporate customer base.

We have also moved RMB Private Bank (previously part of the wealth cluster) under the "one" FNB as it focuses on the top end of the retail sector and much of what the private bank does, cheque books, debit cards etc. is serviced by FNB. There are also some synergies with the medium corporate segment.

Following the restructure, the main banking operations consisting of FNB, RMB, WesBank, Africa, Banking Group Treasury and Finance Risk and Audit, will report directly into FirstRand Bank.



The resultant effects on the management and operating structures are shown in the chart above.

The five underlying business units are each run by a CEO, who sits on the newly formed FirstRand Bank executive committee, chaired by Paul Harris, the CEO of FirstRand Bank. The existing CEOs of the divisions are Ronnie Watson – WesBank, Mike Pfaff – RMB and Johan Burger (CFO) – Finance Risk and Audit. Two new appointments are Michael Jordaan who will become the CEO of FNB and Zelda Roscher will become the CEO of Banking Group Treasury.

We believe that this slight adjustment to the structure reinforces and strengthens the Group's segment focus, and it will allow the Group to maximise growth opportunities in the mid-corporate and business segments. In addition, any dilution of the FNB brand that may have occurred by having two separate entities operating in different markets, is eliminated.

Turning now to the year under review

It is our view that 2004 was the year when the FirstRand integrated structure really started to make its mark on the business and it positioned the Group strongly in all its markets.

Why? Because underlying this structure is a very simple, consistent growth strategy, with four pillars:

1. Organic growth – driving new business volumes and generally functioning as efficiently as possible.
2. Acquisitions – finding load to put on the existing infrastructure.
3. Innovation – coming first to market or "changing the game" with new products and delivery channels. The owner-manager, entrepreneurial culture that is now fully entrenched in all the businesses creates a strong focus on innovation
4. Greenfields – introducing extra sources of revenue through the creation and development of completely new businesses.

The relative contribution of these growth pillars varies from year to year, for example the impact of acquisitions this year was modest, whilst organic growth and innovation featured very strongly. Ever-increasing collaboration, both within the segments and across them, also unlocked pockets of natural growth.

Our results in a nutshell

The big driver of this year's results was organic growth, which was a function of both external factors, in particular the low interest rates, and internal factors such as innovation, accelerating collaboration and an improved sales culture. This is reflected in the growth in new business volumes and transactional income and significantly improved bad debts.

The table below shows the excellent new business growth generated in retail, corporate and investment banking as well as certain components of our insurance business.

WesBank new business	26%
FNB HomeLoans new business	67%
FNB Card advances	21%
RMB Private Bank advances	44%
Medium corporate advances	31%
Knowledge based fees	42%
Myriad risk products new business	51%
Discovery Life new business	31%

Looking at these new business figures one would have intuitively expected even higher profit growth, however the reality is that low interest rates are a double-edged sword in that they boost credit demand but we earn less on our capital, which hurts the bank's margins. Fortunately the Group had a hedging strategy in place which protected our margins and saved us R556 million.

Collaboration is delivering

As already mentioned, collaboration was a big driver of organic growth. We have always emphasised that collaboration at FirstRand has a much broader meaning than simply cross-selling. The integrated structure of the Group allows us to leverage off all the building blocks of the businesses, such as IT systems, client bases, skills etc. An example of where we leveraged two sets of intellectual skills is the Group's affordable housing initiative, a joint effort by RMB and FNB. This is a first in the country and is already delivering profits.

We believe that **innovation** is a real differentiator for FirstRand and it is key to winning new business in a low interest rate, low inflation market

Client base leverage was also successful. FNB Corporate sourced new business of R400 million and R2 billion for RMB Private Bank and WesBank respectively and OUTsurance sourced R280 million of gross premium income from HomeLoans.

In fact FNB's bancassurance income grew very strongly this year with profits up 48% to R563 million. To place this into context, it is larger than the profit we made from HomeLoans and represents 13% of FNB's pre-tax profits. Bancassurance is becoming meaningful for the Group.

Another initiative we are very excited about is the collaboration between Discovery and FNB Card. Discovery is launching its own branded credit card, using FNB card's administrative infrastructure. This will be a very significant offering as we are projecting that in two years Discovery will issue 325 000 cards. Given that the card is both a credit card, with some excellent benefits with major retailers such as Woolworths, and a Discovery Medical Scheme membership card, we believe that a large number of these cards will be taken up and activated.

Greenfields continued to grow

One of our core competencies over many years has been the establishment of businesses started from grassroots. The two most significant businesses in the Group that were started in the last twelve years, OUTsurance and Discovery, both delivered excellent results with Discovery growing operating profits by 102% to R708 million and OUTsurance growing profit before tax by 89.4% to R161 million. Meaningful shareholder value has been created through these ventures.

Innovation is a key differentiator

We believe that innovation is a real differentiator for FirstRand and it is key to winning new business in a low interest rate, low inflation market.

The Group's leadership in innovation is a direct result of its entrepreneurial culture. In the review of operations later on in this report, there are many examples of innovation across the entire Group, for example:

- RMB, which delivered an outstanding performance this year, continued to innovate, particularly in the area of structuring black empowerment deals, where they have developed a strong leadership position.
- We are also pleased to see that the pace of innovation at FNB Retail started to accelerate, for example it launched a highly innovative product in the One Account, which is the first "single credit facility" account to be offered to the middle market and is likely to change the face of that market.

The year to come

The view of our in-house economists is that there is a high probability that the low inflation environment will continue into the coming year. Given the impact of sustained low interest and inflation rates on our business, we have devoted some time to reflecting on the future scenarios.

We believe that such an environment is generally beneficial for banking, impacting favourably on credit demand and asset prices. However there are challenges too. In a high inflation environment, it is generally easier for an organisation to pass on cost increases, including inefficiencies, to customers. In a low inflation environment this is not the case (this applies to most businesses, not just those in financial services). There is also the risk that the inflation expectations of wage and salary earners can lag reality as it takes time for wage and salary earners to gain confidence that low inflation is enduring and therefore moderate their expectations regarding pay increases. The Group therefore needs to guard against getting into a "pincer" squeeze where costs are inflating faster than revenues.

Recognising this, we are busy with an extensive cost benchmarking exercise at FNB Retail with the assistance of McKinseys and significant cost savings have already been identified. We are also embarking on a Group-wide productivity drive which aims to achieve steady and consistent productivity improvements over the next three years.

Momentum has the dual problem of a low inflation environment and a tough insurance market to contend with, and it recognises that it must manage its administration expenses down aggressively. It is aiming to reduce its management expenses by 15% in real terms over the next three years.

The international strategy after Ansbacher

As already mentioned by the chairman, the Group has reached an agreement to dispose of Ansbacher, which will result in the release of approximately R1.2 billion of capital.

We will only move into an international market if we believe we have a **sustainable competitive advantage**

As I outlined in my report last year, the Group is driving its international expansion at business unit level. We currently favour starting niche operations rather doing large acquisitions. Discovery's expansion into the US has taught us that JVs can solve the challenges of brand, distribution, capital and local knowledge. **We will only move into an international market if we believe we have a sustainable competitive advantage and if the initiative has a sound strategic fit with the overall business – we will not be chasing hard currency for the sake of it!**

And Africa

We see Africa as an important market and we have had a good track record in our current African operations. We have three very solid retail banking operations in Botswana, Namibia and Swaziland. These are now receiving more attention from us as we believe there is some low hanging fruit to be harvested by migrating some FNB Retail "best practices". Our corporate and merchant banks continue to do well in Africa.

We appointed a new head of Africa during the year and the region has been receiving a great deal of focus. We believe that the nature of banking profits in Africa will change. Historically money was made taking deposits and lending to government at large spreads, however we think that is now largely over as donor-imposed fiscal and monetary discipline has led to structurally lower interest rates, thus eroding margins.

Cash is the key to Africa as "financial deepening" will drive profitability in the future and we believe this is where the opportunity lies. Low gearing and deposit penetration will increase as economies mature. However, many countries do not have the necessary "soft infrastructure" critical to retail banking such as a proper legal framework, credit bureaus, ID systems etc. In many countries these are not in place.

Against this background our entry strategy will be opportunistic, and it will depend on market maturity whether we enter via a wholesale or retail route. We believe it is important to have a portfolio of investments to ensure proper diversification, and we need to "think out the box" and be unconventional if it is appropriate.

In conclusion

We believe that FirstRand is very well placed to benefit from a continuing benign retail banking environment. Our unique federal structure, our entrepreneurial culture, strong brands and highly motivated and empowered people will ensure that we continue to seek out every possible growth opportunity in pursuit of our stated objective of achieving a minimum of 10% per annum real growth.

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13 September 2004