CFO's report

FirstRand acts as a strategic enabler to various businesses within the Group.

Johan Burger

The Group once again produced excellent results continuing a five-year trend which began with its formation.

Introduction

The FirstRand Limited Group of companies ("FirstRand" or "the Group") once again produced excellent results continuing a five-year trend which began with the formation of the Group in May 1998. Since 30 June 1999, the first full year after the merger, FirstRand has grown core headline earnings by 20% on a compound basis, from R2 516 million in 1999 to R5 151 million in 2003.

The relative contributions of the components of the Group on a pre-AC133 basis, are set out in the table below:

	2003		2002	
	R million	**%**	R million	%
Banking Group	**4 068**	**79**	3 223	77
Momentum Group	**956**	**19**	907	22
Discovery	**166**	**3**	117	3
FirstRand Limited	**(39)**	**(1)**	(61)	(2)
Total	**5 151**	**100**	4 186	100

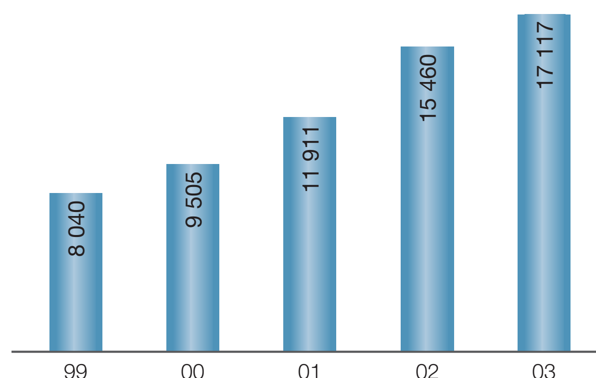
The impact of the strengthening Rand against the US Dollar is reflected in currency translation losses of R605 million (2002: gains of R548 million). As in the prior year, these gains and losses are excluded in the calculation of core headline earnings. The table below illustrates why the Group believes that core headline earnings have been a more sustainable measure of operational performance.

R million	Cumulative	**2003**	2002	2001
Headline earnings	12 969	**4 546**	4 734	3 689
Core headline earnings	12 787	**5 151**	4 186	3 450

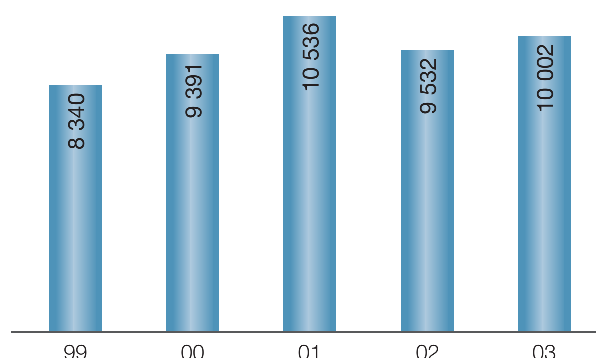
In the era of AC133, there is likely to be an increased focus on Net Asset Value ("NAV") and Return on Equity ("ROE"). The graphs that follow illustrate the Group's strong growth in NAV and its consistently high ROE. FirstRand will continue to target these measures as the most reliable indicators of shareholder value creation.

FirstRand covers the spectrum of financial service offerings and is, as a consequence, not an easy group to measure. The first graph measures NAV growth in the Banking Group. The second graph illustrates embedded value growth in the Momentum Group. These measures are considered reliable proxies for measuring the creation of shareholders' wealth in the respective industries.

Banking Group NAV



Momentum Group embedded value



The Momentum Group's embedded value was negatively impacted in 2002 and 2003 by poor equity markets and high dividend payouts.

Group reporting structure

Internally, FirstRand's management structure is aligned in accordance with target markets which groups the various businesses into four core clusters, targeting the Corporate, Retail, Wealth and Health markets.

Detailed reports relating to the performance of each of these businesses are set out on pages 28 to 55.

FirstRand is subject to regulation by the South African Reserve Bank and the Financial Services Board. To better comply with the legal requirements of each of these separate regulatory authorities, the Group's legal structure closely follows the mandate of each of the separate authorities. Consequently, the legal structure of the Group comprises distinct banking and insurance operations. As in prior years, the Banking and Insurance Group's results are dealt with in detailed CFO reports set out on pages 113 to 121 and 200 to 214 respectively. An overview of their results is set out on pages 19 to 21.

A comprehensive group structure is reflected on page 15.

Role of FirstRand

FirstRand has, at its core, a philosophy which fosters entrepreneurial thinking and action. At the heart of this philosophy are empowered and independent business units which are niche operators in their chosen markets. These businesses have the benefit of being backed by a large balance sheet and capital base, while simultaneously retaining all the benefits of being small and responsive.

This structure poses some unique risk challenges. The central finance and risk function provides the framework within which each of these business units must operate, and which is designed to maximise each unit's freedom of action while maintaining risk within the Board's established tolerance levels. The framework, which was put in place during the previous financial year, and refined during the current year, has been implemented across the Group and is designed to cover all business and financial management issues affecting business risks. The Group accepts that losses are inevitable within a financial services environment, and sets out to manage the risk factors within their desired outcomes.

FirstRand acts as the strategic enabler for the various entities within the greater Group. The central financial function has the following primary functions:

- capital optimisation;
- structural optimisation;
- risk management;
- corporate reporting; and
- investor communications.

FirstRand also co-ordinates the financial and risk management functions of the Group to optimise the use of resources and ensure that best practices are adhered to.

AC133 Financial Instruments: Recognition and Measurement – Overview

FirstRand adopted the new accounting statement on recognition and measurement of financial instruments (AC133) on 1 July 2002. The statement is the South African equivalent of IAS39, the International Financial Reporting Standard dealing with this issue.

The statement introduces fair value accounting to certain classes of financial assets and liabilities such as advances, derivative instruments and investments in debt and equity securities. The statement is not applicable to assets such as fixed assets or investments in subsidiaries and associated companies.

FirstRand co-ordinates the financial and risk functions to ensure optimal returns and best practices.

Depending on the asset classification used, fair value changes are reflected in income and expenditure or directly in equity.

There are four primary asset categories:

- Originated assets, such as most of the Banking Group's normal advances, which are carried at amortised cost.
- Held-to-maturity assets, such as certain government bonds, where the Banking Group has the intention to hold the asset until maturity, which are carried at amortised cost.
- Trading assets, such as most equities trading portfolios where the intention is to trade with a short-term profit motive, which is fair valued with changes in fair value recorded in the income statement.
- Available for sale assets, such as certain private equity investments where there is no trading intention, which are carried at fair value with unrealised fair value changes reflected in equity until realisation or impairment.

AC133 also allows for the designation of any financial instrument as "Held for trading", irrespective of the described categories above, with fair value changes on such assets reflected in the income statement.

FirstRand is required to designate financial instruments into these categories on initial recognition, and the designation is final, thereby effectively determining the future accounting treatment of the instrument on either an amortised cost or fair value basis.

AC133 is a prospective accounting statement and does not provide for the restatement of historical numbers. It has comprehensive transitional provisions, which affect opening equity balances.

Overview of results

Banking Group results

Introduction

The Banking Group produced excellent results, benefiting from diverse income sources, strong organic growth, benefits of scale achieved from the acquisitions made in the previous year, the higher interest rate environment which favoured bank deposits and the resultant endowment benefits thereof as well as lower bad debts.

Core operational headline earnings, which exclude translation gains and losses, increased by 26.2% from R3 223 million to R4 068 million, on a pre-AC133 basis. On a post-AC133 basis, earnings attributable to ordinary shareholders increased by 0.9% to R3 774 million (2002: R3 740 million).

Drivers of growth

Net interest income and interest margin

Net interest income before impairment of advances increased by 36.1% in the period under review. This can be attributed to a higher average interest rate environment and higher levels of average advances than in the prior period.

The interest margin based on average advances strengthened relative to the previous year to 4.81%, in spite of continued long-term pressure on margins. The retail banking operations benefited from above budgeted margins in the current year as a result of strong organic growth in advances and deposits, as well as the higher average interest rates. Corporate margins continue to reflect the pressure of a highly competitive and sophisticated market, and once again reflect a small decline.

The Banking Group has significant hedge structures in place in anticipation of the decline in interest rates, which should limit the negative endowment impact of a declining interest rate environment going forward. This strategy had the effect of lowering potential interest income in the period under review.

Non-interest revenue

Core non-interest revenue (excluding currency translation profits or losses) decreased by 3.3% to R7 518 million (2002: R7 771 million). Total non-interest revenue, including currency translation gains and losses, decreased by 16.9% to R6 913 million (2002: R8 319 million). Non-interest revenue represents 44.9% of the Banking Group's total income.

Banking fee and commission income increased by 22.7% to R5 116 million. Trading income as a component of total non-interest revenue reduced to 19.2% (2002: 22.8%). The decrease must be seen in context of the exceptional trading opportunities in the 2002 financial year resulting from extreme currency volatility.

Total non-interest revenue was further negatively affected by the currency translation loss of R605 million (2002: R548 million gain).

Balance sheet growth

Total gross advances grew by 8.0% in the 12 months ended 30 June 2003. Net advances increased by 8.2%. Compounded annual growth rate of net advances since the creation of FirstRand was 19.2%.

Total advances growth during the current year was satisfactory given the high interest rate environment. WesBank and FNB Card have shown exceptional growth with WesBank once again achieving record new production levels.

Non-performing loans and credit impairment charge

The credit quality of the advances book showed further improvement in the year under review. Non-performing loans as a percentage of gross advances decreased from 3.0% in 2002 to 2.4%. The total provision reflected in the balance sheet on a pre-AC133 basis, represents a conservative 2.3% of advances (2002: 2.5%).

The income statement charge for impairment of advances reflects a 19.8% decrease to R1 367 million.

The present value methodology prescribed by AC133 results in an additional R116 million impairment charge to the income statement and a R360 million increase in specific impairments in the balance sheet on a post-AC133 basis in the 2003 financial year.

Operating expenditure and efficiency

Non-interest expenditure increased by 13.8% in the current year.

Staff costs were limited to an increase of 11.3%. Other operating costs increased by a disappointing 16.6%, mainly as a result of a 40.0% increase in marketing expenditure and a 40.4% increase in depreciation. Marketing costs increased as the Banking Group aggressively moved to promote itself through increased media and sponsorship presence and new product launches. The increase in depreciation includes accelerated depreciation of property assets.

Continued strict management of costs together with the growth in income contributed to the improvement in the cost to income ratio from 57.6% to 57.0%. On a post-AC133 basis, the cost to income ratio in the current period was 55.3%.

Momentum Group results

Introduction

The Momentum Group produced solid headline earnings growth, despite challenging market conditions. Headline earnings increased by 9% to R1 116 million, subsequent to the implementation of AC133. The environment in which Momentum operates was affected by subdued demand for retail investment products, especially single premium products.

Drivers of growth

New business growth

The new recurring premium business of the Momentum Group increased by 30% to R3 940 million. The growth in new recurring

The Group has grown dividends at a compound rate of 23% over the past five financial years.

premiums generated by Momentum and Discovery Life of 27% and 33% respectively were especially pleasing. Lump sum inflows came under pressure due to the decline in investment markets.

The embedded value of Momentum's new insurance business increased by an excellent 33%, mainly as a result of the increased new business volumes and improved profit margins.

Growth in assets under management

Total assets under management or administration of the Momentum Group declined by 2% to R186.4 billion. This decline is mainly due to the weak investment markets and the negative effect of the strengthening Rand on offshore asset values.

Retention of funds

The Momentum Group improved its retention of client funds by reducing payments to clients by 13% during the year. It is also encouraging to note that Momentum now retains 28% of matured policy proceeds by value.

Expenses

The marketing and administration expenses of the Momentum Group increased by 20% from R2.6 billion to R3.1 billion. The main contributor to this rise was the 27% increase in the expenses of Discovery Holdings, which was negatively affected by the start-up costs of its US health initiative, Destiny Health.

Dividend policy

As indicated at the end of the previous financial year, the Group based its dividend declaration on pre-AC133 core headline earnings. On this basis, the Group maintained its dividend cover of 2.7.

The Group has grown dividends at a compound rate of 23% over the past five financial years. The Group will not be presenting pre-AC133 numbers in the future, and future dividends will therefore have to be based on post-AC133 numbers. The Group will however make adjustments, where necessary, for anomalies in the income statement arising from AC133. The table below sets out such issues as are relevant to the 2003 financial year:

	2003	
R million	**Post-AC133**	**Pre-AC133**
Core headline earnings	**5 429**	**5 151**
Principal AC133 anomalies		
– Profit on non-qualifying hedges	**(398)**	**–**
– Additional bad debt provisions	**133**	**–**
– Taxation on the above	**80**	**–**
Headline earnings for dividend calculation purposes	**5 244**	**5 151**

As reflected above, AC133 results in an upward adjustment in base earnings which, subject to the anomalies such as those highlighted above, is expected to be maintained into the future. Consequently, the Groups dividend cover has been changed going forward to reflect this change in base, from the current cover of 2.7 to 2.75.

Group restructure

Discovery funding transaction

Discovery's growth, together with its commitment to Destiny Health, necessitated a rights offer by Discovery during the latter part of the 2003 financial year to meet the company's capital requirements. The offer, structured as a claw back offer, was executed in two steps with an initial offer taken up by the underwriter and majority shareholder, Momentum, on 25 June 2003. The second step, executed on 26 July 2003, was successful. Simultaneously, R1.4 billion in preference share capital was raised by the FirstRand Group. This cumulative preference share capital is redeemable at the option of FirstRand, with dividends payable at a rate linked to the prime overdraft rate. The proceeds on the issue of the preference share capital were used to acquire Discovery from Momentum at its

book value on 1 July 2003. The acquisition effectively consisted of two tranches:

- the acquisition of Momentum's original shareholding in Discovery, acquired for R126 million and supplemented by consolidated earnings of R614 million; and
- the acquisition of Momentum's share of the rights offer of R586 million.

The final effect of the transaction is as follows:

- Discovery now has capital of R2 068 million. This should meet all the ongoing capital requirements of Discovery into the foreseeable future;
- Discovery has targeted a return on the new capital of 25%;
- FirstRand holds 62% of Discovery, which will in future be reported separate of the Momentum Group; and
- Momentum has swapped its investment in Discovery for cash of R740 million. In line with its capital investment strategy, this will be invested in cash and near cash instruments with a benchmark return approximating cost of capital.

Outperformance Share Scheme

During the year under review, the first tranche of the outperformance share scheme became due. Shares in FirstRand outperformed the FINI 15 index by 18%, resulting in a conversion ratio of 0.51 ordinary shares for every preference share. As a consequence, 29 282 500 preference shares were converted into 15 017 941 new FirstRand shares on 23 April 2003. This had the effect of diluting the earnings per share of the FirstRand Group as set out in the table below:

Cents per share	Earnings	Headline earnings
If Outperformance share scheme did not exist	84.4	89.9
Dilution due to shares issued in the current year	84.3	89.9
Dilution in future years	83.2	88.6

Capital Management

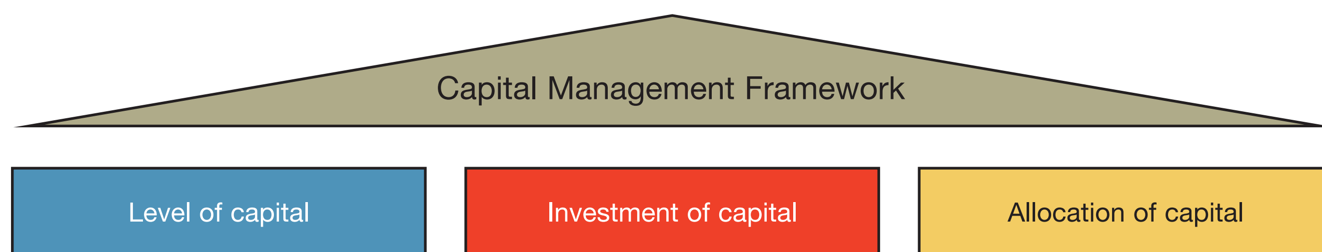
The Group's capital strategy plays an important role in growing shareholder value, and has contributed significantly to growth in the current year.

Active capital management

The objective of active capital management is to:

- enable growth in shareholder value; and
- protect the capital base.

FirstRand has a dedicated capital management function with the responsibility of the formulation, implementation and maintenance of the Group's capital management framework in order to achieve the above objectives. The capital management framework consists of three pillars, namely:



The Group's capital strategy plays an important role in growing shareholder value.

- Optimal capitalisation of the Group
  - The Group is committed to being an organisation with sound capital ratios and strong debt ratings.
  - FirstRand's overall capital needs are continually reviewed to ensure that its capital base appropriately supports its current and planned business and regulatory capital requirements.
  - The Group is always capitalised at the higher of economic or regulatory capital.
  - The Group ensures that the optimal capitalisation level and structure is maintained to ensure an efficient cost of capital.
- Investment of capital of the Group
  - The capital of the Group is invested in AAA rated asset categories.
  - The interest profile of a three-year rolling period is obtained, by using interest rate derivative instruments, dependent on the interest rate forecast. In such cases, the counter parties are AA rated financial institutions.
- Allocation of capital within the Group
  - The capital management function is responsible for the development and implementation of an economic capital allocation framework throughout the Group in collaboration with the various risk and business owners. An enhanced economic capital framework has been implemented in 2003 across the Group. This framework aligns closely with the requirements of the proposed new Basel Capital Accord ("Basel II").

The Basel Capital Accord

Basel II consists of three mutually reinforcing pillars:

- Pillar 1 sets capital requirements for credit risk, market risk and operational risk. Existing rules for market risk capital are substantially unchanged. The rules for credit risk capital will be more risk-sensitive than at present and banks will be permitted to use some of their own internal risk assessments to determine regulatory capital. The regulatory capital charge for operational risk is new.
- Pillar 2 involves regulatory assessment of models, controls, standards and processes in the organisation. Effectively it is a qualitative assessment to complement the quantitative assessment under Pillar 1.
- Pillar 3 requires enhanced disclosure by banks.

In 2002, the Banking Group launched a project to implement Basel II. The overall goals of Basel II are clearly compatible with the Group's ambition and past strategic decision to be among the leading institutions in risk management and control in South Africa, particularly in the areas of portfolio credit risk measurement, sophisticated internal models are indispensable.

FirstRand is well advanced to meet the requirements of Basel II. The implementation costs of Basel II will not be material as such costs have been absorbed for AC133 and other best practices initiatives.

The final proposed Basel II Capital Accord is expected to be published in 2004, for global implementation from 1 January 2007.

Capital initiatives in the current year

The Banking Group is investigating the creation of tertiary capital as well as the possibility of additional secondary capital issues for its African Subsidiaries. These instruments are attractive because of their relatively low cost, which means that, even if the proceeds are placed on overnight call, they will be neutral on the earnings.

The resolution of the final Ansbacher (UK) structure is anticipated to free up capital of the Group towards the end of the 2004 financial year.

The capital raising recently completed by Discovery should ensure that it is appropriately capitalised going forward, while the positive impact on the Momentum Group's capital ratios of the Discovery buyout places it in a strong capital position.

During the course of 2004, the Group will continue to look at ways of optimising its overall capital structure. This may involve the re-issuing of existing capital instruments in addition to other options set out above. The Group is however confident that it does not need to raise additional tier 1 equity.

Momentum shareholders' portfolio

FirstRand is currently in the process of implementing a major restructuring of the assets of Momentum's shareholder portfolio, with the objective of enhancing the return on equity, without compromising the security of policyholders' interests.

Investment of capital

Banking Group

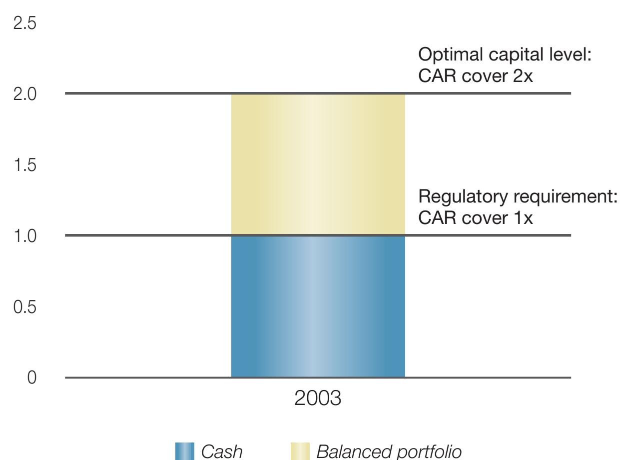
In terms of the investment of capital, and the objective to protect the capital base, the Banking Group entered into hedging structures to protect the endowment effect of the capital base in a low interest rate environment.

These hedging strategies have lessened the benefit achieved from the endowment margins in the current period, but which will protect the Banking Group from a reduction in margin on the retail deposit base and capital in a declining interest rate environment in the coming year.

Momentum Group

It is the stated objective to have a targeted Capital Adequacy Ratio ("CAR") cover of two times. The shareholders' portfolio, to meet the regulatory CAR cover of 1, will be held in cash or near cash instruments, which will result in a reduced CAR. The remaining shareholders' capital will be invested in a combination of strategic assets and a managed portfolio with a significant equity exposure.

The following diagram shows this strategy:



Research has shown that the strategy above is optimal for enhanced return on equity, without compromising, but rather strengthening the policyholder interest. The Momentum Group has a more robust capital structure, with reduced concentration risk and volatility inherent in the shareholders' portfolio.

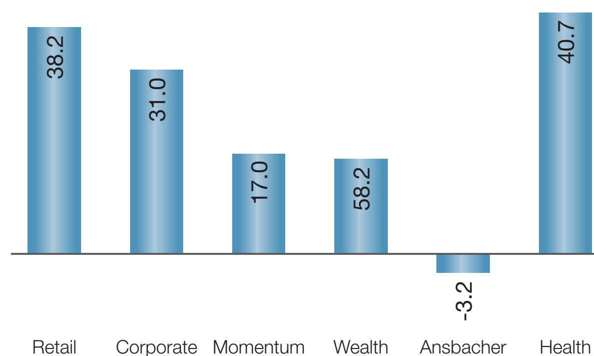
Allocation of capital within the Group

The objectives of allocating capital to the various business units are to:

1. allow business to price and reserve for risk;
2. assist in the strategic decision-making process;
3. align shareholders' interest with that of management;
4. provide performance measurement against benchmarks.

FirstRand enhanced its economic capital framework, in terms of which it allocates capital to the business units on economic capital principles. The following diagram reflects the return on some of the business units that have been achieved for the period under review.

Return on capital allocated (%)



FirstRand's risk grading and pricing ensures the Group an appropriate return for the credit risks it takes.

Risk Management

The Finance, Risk and Audit Division manages and monitors the risk management processes for FirstRand across the broad spectrum of business risks including:

- business strategy;
- quality of the workforce;
- product composition and delivery;
- return on capital;
- return on investment;
- tax;
- financial control;
- liquidity;
- sensitivity to changes in interest rates;
- credit exposures;
- market trading;
- legal;
- information security;
- compliance;
- business continuation;
- criminal activities; and
- process and systems

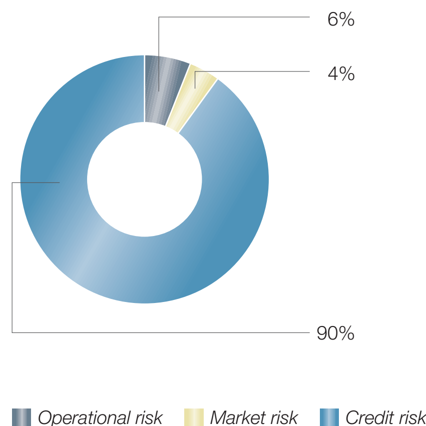
The strategic objective of risk management is to support the business units to achieve their desired objectives and to avoid adverse outcomes through determining:

- the appropriate degree of risk exposure and the pricing thereof;
- integrating risk management with the management processes;
- providing appropriate and innovative risk management solutions to business activities;
- allocating economic capital according to risk profile; and
- monitoring the return on capital to ensure an adequate reward for risk.

Banking Group

The main risk exposures in the Banking Group are business risks, credit risk (that is the exposure to counterparties in respect of their obligations to the Banking Group) and sensitivity of income to changes in interest rates and liquidity. The implementation of the Banking Group's interest rate hedging strategy is one of the key components of its strategy to protect its interest margin going forward. The Banking Group is also exposed to operational and market risk, but to a lesser extent.

Risk exposures



The credit risk and management process needs to identify all risk factors to enable such risks to be quantified and their impact on the pricing of credit risk to be taken into account. As risk takers, business units must align the rewards with the extent and nature of risk taken. Thus pricing for credit risk is a critical component of the risk management framework. Pricing for credit risk, once determined, should be aggregated with the risk premiums for all other risks to make up the total price for any given transaction.

Furthermore, measurement of credit risk should continue through the life of the exposure to monitor changes in the portfolio. The measurement of credit risk must take place on two levels: at an individual risk level, and at portfolio level.

Pricing should occur on a full cost of risk basis, including:

- the pure cost of credit in terms of bad debts;
- the cost of economic capital to support the variability inherent in bad debt experience, as well as the regulatory capital required;
- a profit margin to support returns required on capital employed; and
- any costs attributable to accepting and administering the particular credit risk.

The Banking Group managed its liquidity requirements well and was able to fund its obligations at market rates at all times. Operational losses were exceptionally well contained at levels

which are of no significance relative to net income. The market trading activities produced very good results while controlling their market and counterparty risk well.

More details of the risk management processes and the effectiveness thereof are contained in the risk report of the Banking Group on pages 122 to 133.

Momentum Group

The main risk exposures in the Momentum Group are mismatch risks between assets and liabilities to policyholders, returns generated by the income, property and equity portfolios versus expected actuarial returns, credit risk, liquidity risk and legal risk embedded in the contractual arrangements with clients.

Risk management within the Momentum Group focuses on four primary risk areas, namely business, operational, market and credit.

Business risk relates to the strategic decision making processes and is managed by the various executive committees in the profit centres.

Operational risk is defined as the risk of direct or indirect losses resulting from inadequate or failed internal processes, people or technology. Operational risks incorporate fraud, information security, business continuity, regulatory, legal and underwriting risks. These risks are managed centrally through the group actuarial, risk and audit functions.

Business units manage market risk returns within conservative, centrally monitored limits. Specific contractual guarantees are hedged by investing in assets which match the liability profile.

The Momentum Group has an internal credit risk function that performs ongoing management of the credit portfolio. This is overseen by a Group credit committee.

A more detailed overview of these risks is provided in the report of the chief financial officer of the Momentum Group on pages 200 to 214.

JP Burger
Chief Financial Officer

Sandton
15 September 2003