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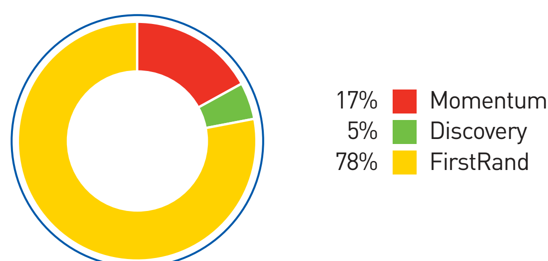
JOHAN BURGER / Chief Financial Officer

Introduction

The CFO's report represents a high level overview of the Group's performance, risk and balance sheet management strategies, which form a major part of the Group CFO's portfolio. This overview covers the three main operating subsidiaries of the Group, FirstRand Bank, Momentum and Discovery. The chart below illustrates the relative contribution by these subsidiaries to the normalised earnings of the Group.

Normalised earnings – 2006



The Group's operational style is to break the main operating subsidiaries down into a portfolio of separately branded businesses. We are therefore structured along "federal" lines with autonomous business units, each responsible for the daily management of business, financial and operational risks and for the delivery of:

- targeted return on economic capital;
- growth in net income after cost of capital ("NIACC"); and
- improvements in efficiency.

The CFO's portfolio includes certain strategies designed to augment the business unit returns and reduce earnings volatility through the economic cycle ("the cycle"). These strategies relate to:

- performance management;
- risk management; and
- balance sheet management.

Performance management strategy

As outlined in last year's report, FirstRand's performance management strategy is a key component of the Group's overall strategy. Its focus is to deliver superior, sustained returns to shareholders.

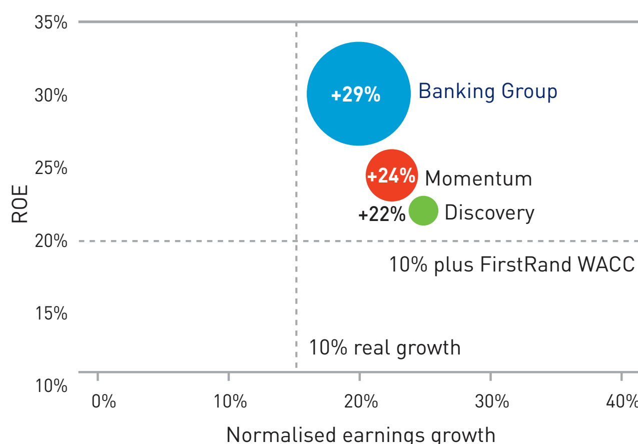
Our approach to performance management is to maximise the spread between return on equity ("ROE") and cost of equity ("COE") and to measure ourselves on our ability to maintain and grow that spread over time.

We continue to monitor the effectiveness of our performance management strategy using two financial targets, namely 10% real growth in normalised earnings and return on equity of 10% plus FirstRand's weighted average cost of capital.

During the year, FirstRand produced excellent results, growing normalised earnings by 21%. Headline earnings also grew 21%, however we believe normalised earnings most accurately reflects the operational performance, given non-operational and accounting anomalies that impact headline earnings. The table below shows the reconciliation between normalised earnings and headline earnings.

R million	Year ended 30 June 2006	2005	% change
Headline earnings – audited	**8 115**	6 723	21
Adjustments	**703**	553	
Private equity realisations	**219**	406	
Agreement with National Treasury	**30**	–	
Discovery BEE transaction	**102**	–	
Treasury shares	**352**	147	
Normalised earnings – unaudited	**8 818**	7 276	21

During the year to 30 June 2006, against all relevant targets the three main operating subsidiaries operated in the top quadrant, thus delivering superior value for shareholders.



The business units within the Banking Group also delivered ahead of targeted return on economic capital as indicated in the table below.

ROE	**2006**	2005
For the year ended 30 June 2006		
FNB	**32%**	32%
RMB	**36%**	33%
WesBank	**29%**	22%
FirstRand Africa and Emerging Markets	**29%**	29%
Total	**29%**	28%

Since the year end, a further enhancement to our performance measures, net income after cost of capital ("NIACC"), was introduced across the Group. Maximising NIACC to generate economic value has become a key focus for each business unit and drives strategic and economic allocation of capital to generate sustainable profits.

Risk management strategy

Risk management provides the business units with risk frameworks to ensure sustainable performance by maintaining ROE within a band of acceptable return volatility and avoiding undesired outcomes. The risk framework incorporates the quantification of risk appetite, qualitative assessment, regular monitoring and corrective action.

Balance sheet management strategy

The Group CFO has responsibility for the strategic positioning of the balance sheet, including both the assets and liabilities originated by the individual business units. At the core of our balance sheet management approach is a belief that the balance sheet and its income statement streams can be both protected and enhanced throughout the cycle through the active management of:

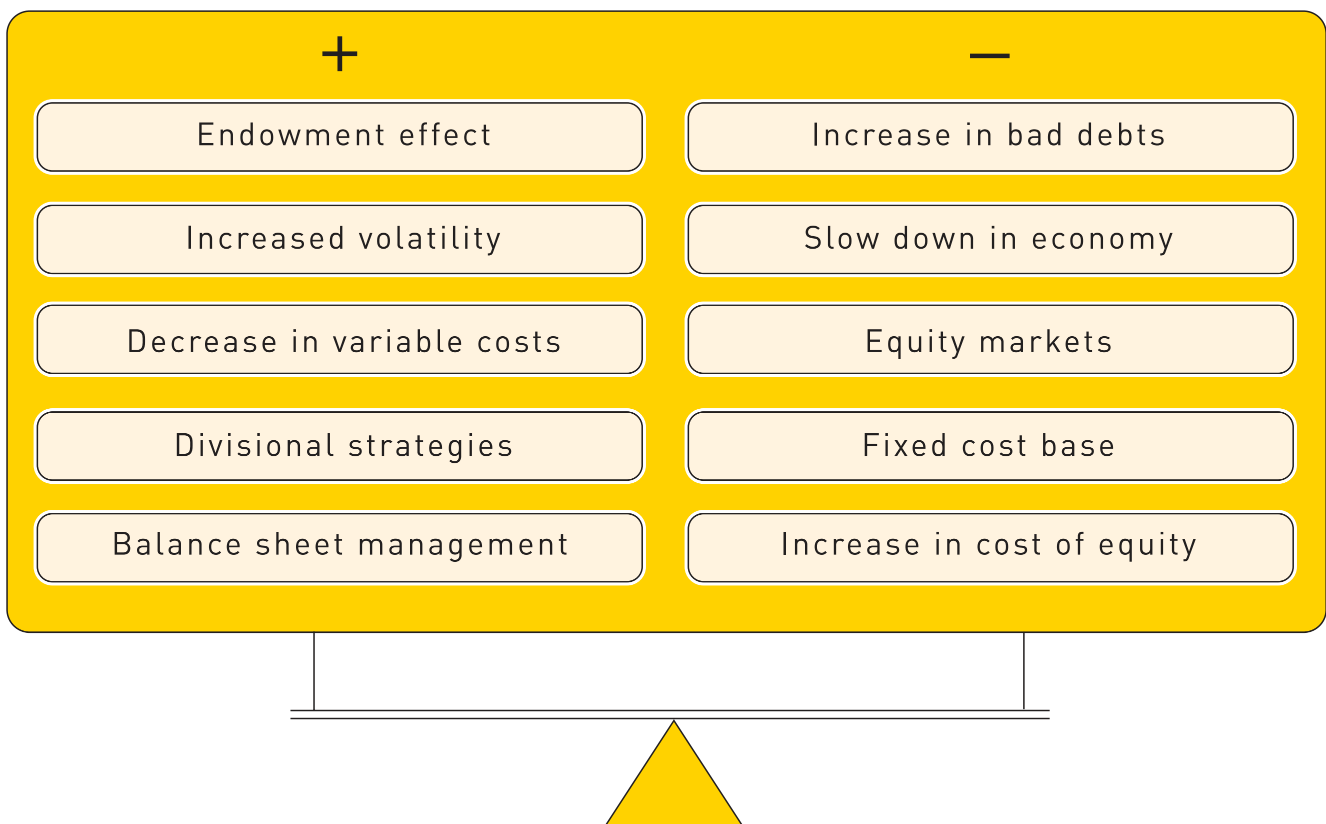
- interest rate risk;
- credit portfolio risk;
- capital risks; and
- strategic funding risks.

We take a holistic view of the balance sheet. This allows for pro-active management of the natural position of the balance sheet and the related risks that impact upon it. This also allows us to protect and enhance returns by "increasing alpha", reducing volatility and best positioning the balance sheet through the cycle.

(Alpha in this context implies the extra returns that can be separated from the market returns achieved, by actively trading the natural position of the balance sheet such that our returns are not as negatively impacted as the general market.)

To achieve this objective we have implemented an integrated balance sheet management approach. This approach requires a detailed understanding of the economic cycle and the interplay between the risks created by the cycle and the "levers" that can be used to mitigate those risks. Ultimately, we seek to optimise the natural position of the balance sheet and look for natural hedges in the current structure.

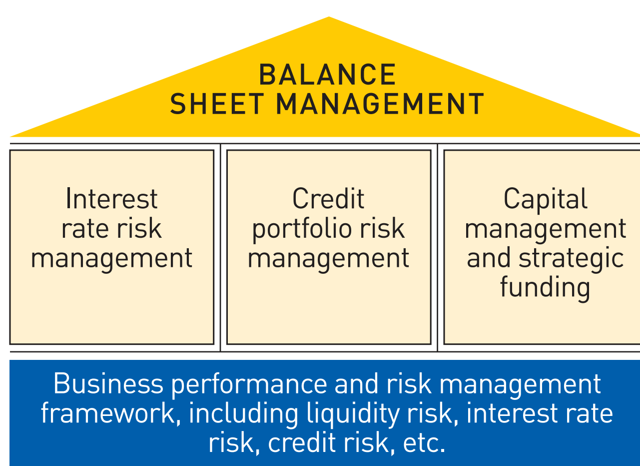
The illustrative diagram below reflects some of the positive and negative factors that can impact our balance sheet and its income streams in an increasing interest rate environment. Through actively managing the balance sheet through the cycle we try to mitigate the negative and enhance the positive impact of these factors.



Our integrated balance sheet management approach is aligned to the objectives of performance management in that it facilitates optimisation of the spread between ROE and COE.

The integrated balance sheet management structure is depicted below and consists of three key pillars, namely:

- interest rate risk management;
- credit portfolio risk management; and
- capital management and strategic funding.



Below we explain in more detail the high level objectives and activities of these three pillars. These are currently fully implemented in the Banking Group and we are in the process of introducing some of these objectives and activities in the Momentum Group.

Interest rate risk management

Interest rate risk management ("IRRM") has responsibility for identifying and quantifying interest rate risk in the Bank's assets and liabilities, excluding trading assets and liabilities.

The net interest rate risk profile of the Bank is managed by changing the profile of liquid assets or through derivative instruments, based on our interest rate outlook with reference to other risk factors impacting the balance sheet, notably credit risk.

Our risk positioning is an important source of net interest income and its primary objective is to protect the Bank against adverse movements in interest rates (ie a drop in interest rates). A secondary objective is to enhance or optimise the net interest income of the Bank by capitalising on temporary mispricing in the market.

Risk positioning has been very successful to date. For example, through certain hedging strategies implemented, we effectively protected earnings against the 6.5% drop in rates between 2003 and 2005. Going forward our balance sheet has been positioned to benefit fully from the positive endowment effect in the increasing rate environment.

Credit portfolio risk management

Credit risk management ("CRM") is responsible for the oversight of the Bank's credit portfolio risk. It is concerned with the review of credit risk quantification models and scorecards used by business units and provides independent oversight on aspects such as credit rating models and implementation of the credit risk management framework.

CRM plays a portfolio management role for the underlying business units. This role focuses on:

- determining the risk appetite;
- reviewing origination strategies through different economic cycles;
- monitoring arrears and non-performing loans;
- assessing the adequacy of credit provisions; and
- determining credit loss protection strategies, if necessary.

CRM also ensures that business units price appropriately for the credit risk taken and that the returns are managed within an acceptable level of volatility. CRM will work with IRRM to seek added protection for the income streams in the case of a negative interest rate cycle.

As credit risk forms the largest component of economic risk capital, CRM also allocates economic capital and monitors returns. The allocation of economic capital is aligned with Basel II principles and the implementation of Basel II across the Group is the responsibility of CRM.

Capital management

The objective of capital management is to maintain the optimal level of capital in the most cost efficient way, given our risk profile and targeted credit counterparty rating. The optimal capital level is achieved through balancing the needs of regulators, rating agencies, depositors and shareholders.

We aim to fulfil the requirements of shareholders and maintain an efficient capital structure with limited excesses, but which supports our short-term growth requirements. We do not hold surplus capital for acquisitions and the need for raising additional capital is assessed on a transaction by transaction basis.

Our policy is to capitalise the Group at the higher level of economic or regulatory capital. At the same time, we seek to provide a capital buffer to give confidence to debt holders, depositors, regulators and rating agencies. We strive to achieve the highest possible credit rating in South Africa, but are currently constrained by the sovereign credit rating. A strong credit rating places us in a strong position to attract debt funding at a lower cost.

The table below indicates our actual and target capital ratios.

R million	Target %	Actual %
Banking Group		
Target capital adequacy	12 – 13	12.8
Tier I	8.8 – 10	9.0
– Core Tier I	7 – 8	7.8
– Non-cumulative non-redeemable preference shares	1.8 – 2	1.2
Tier II	2.2 – 3	3.8
– Other qualifying instruments and tertiary capital	1.1 – 1.5	0.9
– Subordinated debt (maximum)	1.1 – 1.5	2.9
Momentum Group	1.8 – 2.2	3.1

IRRM invests the capital in risk-free assets and the profile of these assets depends on our interest rate view. The benefits of this approach mean that business units are protected from the volatility of the interest rate cycle and therefore can focus on operational and strategic priorities to maximise the return on the risk assumed through their own strategies.

Our capital investment strategy and economic capital allocation approach allows the business units to price correctly for the risk they assume. Our approach also provides the business units with a stable cost of equity.

The introduction of Basel II in 2008 is expected to bring closer alignment between regulatory and economic capital requirements and to increase the cyclicality in the amount of capital required. We aim to use the Basel II advanced internal ratings based approach for credit risk in the local banking operations and the standardised approach for our offshore banking subsidiaries. For operational risk, we will first adopt the standardised approach, but will move to the advanced measurement methodology in the medium term.

Strategic funding

The objective of strategic funding is to secure funding at an optimal cost from diversified and sustainable funding sources.

It is critical that we achieve maximum market share in retail, commercial and corporate deposits, which represent the most cost effective source of funding. Extra market share in these deposits will create a competitive advantage for us as it provides a natural liquidity buffer, and our liability strategy is focused on achieving this objective.

In order to be in a position to take full advantage of changes in financial markets, we have embarked on a strategy to liquefy the balance sheet, which will enable us to optimally fund growth across a broad range of sources and through economic cycles. Given the market conditions and this strategy, our objective is to make use of either our deposit franchise or the capital markets to fund the asset growth.

To ensure maximum efficiency and flexibility in accessing funding opportunities, we have established a range of debt programmes.

The ability to differentiate through new and innovative funding mechanisms is one of our strengths and we constantly review new proposals regarding funding strategies based on forecast balance sheet structures. This allows us to anticipate and plan for future funding and structural liquidity requirements.

We place great value on the establishment of strong relationships with all our debt investors and we have an active marketing approach underpinning our funding strategy with a strong focus on existing and new relationships. The relationships with the rating agencies, namely Moody's, Fitch, Standard and Poor's, and the maintenance of our credit rating, are central to the funding strategy.

Capital and funding actions

As part of our strategy to improve capital efficiency and provide funding for anticipated growth, we undertook the following actions:

- In November 2005, FirstRand Limited raised R1.5 billion through the issue of non-cumulative non-redeemable preference shares to further enhance the level and structure of its capital base. R500 million was deployed to Momentum for its acquisition strategy and R1 billion was utilised to refinance the vendor component of the BEE transaction, which was previously funded by the Banking Group. This eliminated the capital impairment in FirstRand Bank.
- During the year, Momentum issued a further R1 billion subordinated debt to further improve efficiency of its capital structure.

- In October 2005, FirstRand Bank issued R1 billion subordinated bonds. In June 2006, there was a further issue of R3 billion. We considered the market conditions to be favourable and therefore took maximum opportunity to raise debt capital and this resulted in an excess of debt capital of R1.5 billion. The strategy is to utilise this excess for future funding and capital requirements.
- Momentum has an excess of 0.9 times over its target range of between 1.8 and 2.2 times Capital Adequacy Requirement ("CAR") cover. As a result a special dividend of R500 million has been declared to FirstRand on 30 June 2006, which the Group utilised to reduce debt at the centre. Our strategy is to utilise Momentum's remaining excess capital for further organic growth requirements.

FirstRand Bank securitised R2 billion of motor loans originated by WesBank during the year. We obtained approval from SARB to securitise up to R15 billion of asset-backed securities, primarily home loans and vehicle finance loans originated by FNB HomeLoans and WesBank, respectively.

Securitisations enhance a bank's liquidity position, diversify its source of funding across the maturity spectrum and optimise the composition of its balance sheet. It improves the liquidity risk position of the Bank through matched funding as the cash flow profile of the securitisation bonds generally match the cash flow profile of the assets securitised.

Conclusion

Since the creation of FirstRand in 1998, the diversified earnings base of the Group has delivered strong growth in earnings, assets and dividends. The two graphs below reflect our track record of successfully achieving our objectives of growing earnings at a compound annual growth rate of 20%, in improving and maintaining ROE, in reducing cost of equity and growing net asset value.

Johan Burger
Chief Financial Officer
FirstRand Limited

Sandton
19 September 2006

Delivering shareholder value