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LAURIE DIPPENAAR / CHAIRMAN

A RECURRING THEME, BUT AN IMPORTANT ONE

One of the topics I have covered more than once in my recent statements is the **need for banks to build bridges with their regulators.** The first time I raised it was in 2010, when I warned that **unless global banks demonstrated appropriate discipline,** governments and regulators would continue to look for ways to rein them in. Last year I touched on the issue of trust and how that had been eroded between banks and regulators and the need for the banks **to earn that trust back,** or suffer the consequences of more draconian regulations.

As I write this statement towards the end of August 2012, I see no positive developments in this regard in the global banking sector. In the last six months alone we have witnessed the Libor fixing issue at Barclays, the money laundering fine for HSBC and Standard Chartered fined for circumventing US sanctions against Iran. Some banks seem to continue to push the boundaries from a risk and regulatory perspective to generate profits, and when this finally backfires it confirms what everyone thinks about banks – they can't be trusted.

It also begs the question – how much more bad news is there to come? Was this behaviour systemic during the golden years of banking, and now, following increased scrutiny from regulators, the accusations and fines will follow? I sincerely hope not as the effects are beginning to spill over into a broader negativity, which ultimately impacts customer perceptions of banks. The trust of depositors is a bank's fundamental licence to operate but it is also ephemeral in nature, therefore we need to guard against any kind of breakdown in this relationship.

So far the South African banking sector appears to have avoided similar behaviour and it is probably due to a combination of factors. Firstly, there is a very robust relationship with the regulator who has always had clear line of sight on the execution of banking strategies. Secondly, as emerging market banks we had significant natural growth to tap into without needing to seek it out in marginal type activities, which certainly seems to have been an issue for the more developed market global banks. Thirdly, the domestic banks have been, in the main, regionally focused, and management capacity has not been diluted by extended expansion into other markets, on different continents and in different time zones. Banks are incredibly complex organisms and when you replicate that complexity over and over again, it is extremely difficult to keep track of the most basic of principles and reliance on people's competence and integrity increases exponentially.

Even with robust risk management frameworks, human beings are such that if they deliberately choose to work outside of mandates, the impact of these actions can be hard to detect for some time. This year FirstRand suffered its own event where a few individuals hid bad business practices. A new management team, deployed into the FNB merchant acquiring business unit, uncovered collusion between certain members of staff, who had created an incredibly complex set of transactions to cover up their incompetence. These concealed transactions proved very difficult to detect by the risk management and internal audit processes and what this demonstrates is, that if people deliberately seek to circumvent frameworks, however robust, they can, and complexity creates opportunity for bad practice if you have the wrong people in place. This matter has been fully dealt with in the risk and capital management report.

There is also a strong link between pushing the boundaries and remuneration. One of the lessons learned from the banking crisis is that you get the behaviour you reward. This played out in very elevated levels of gearing and high risk strategies as bankers tried to maintain the trajectory of earnings their shareholders had become accustomed to and the commensurate growth in performance pay. This was not confined to the investment banking fraternity, eventually the universal banks also fell victim to remuneration practices out of kilter with their mandates. Over time this created massive excesses building up in the system and eventually it ran out of steam. The rest, as they say, is history. I will return to the topic of remuneration a bit later.

So the aggressive pursuit of growth and high levels of remuneration, which were in many cases inappropriate, led to financial Armageddon. Five years on and the legacy of that is still playing out across the world in the form of significant macro economic uncertainty which in turn continues to introduce major business challenges.

WE ARE OPERATING IN VERY UNCERTAIN TIMES BUT OUR FRANCHISES CONTINUE TO OUTPERFORM

During the year global policy makers had to deal with a number of significant negative issues, including the European sovereign debt and banking sector crisis which threatened to break up the euro zone on a number of occasions. Portugal and Greece received bailout packages and concerns over systemically important countries such as Spain became elevated. Faced with its own fiscal challenges, the US sovereign rating was downgraded by ratings agency Standard and Poor's, preceded by heightened volatility in financial markets over fears that the US government might default on some of its debt obligations. Conflict in the Middle East and the ever-present possibility of military action against Iran also contributed.

This uncertainty, along with high indebtedness of governments, ongoing stress in the European banking system and households that continued to rebuild their balance sheets, weighed heavily on economic activity in the major developed economies. This weakness subsequently spilled over into the large emerging economies and growth in countries such as China, India and Brazil slowed markedly during the latter part of the year.

South Africa was not immune to these global developments and although domestic growth picked up in the latter part of 2011, it moderated again at the start of 2012. Consumer demand remained resilient, particularly on durable goods, however falling business confidence resulted in subdued private sector investment spending and these factors directly impacted the Group's performance, albeit in very different ways.

Looking across our franchises, the businesses most exposed to the consumer, namely FNB and WesBank, delivered extremely strong topline growth, profits and ROEs. The investment bank, RMB, faced a tough trading environment and despite the significant base created last year, produced a really commendable performance.

Overall, the Group's normalised earnings grew 26% year-on-year, to R12.7 billion, and the ROE was 20.7%. This was definitely outperformance on every key metric. Taking a high level look at the Group's income statement, net interest income before impairments (NII) increased 21%, driven by good growth in advances at FNB and WesBank. Non-interest revenue (NIR) was underpinned by very strong growth of 14% at FNB and 27% at WesBank with a good contribution from RMB's client activities, particularly advisory and structuring and currency and commodity trading. However investment income was down, mainly due to the base created by the private equity realisations of last year and a poor performance from RMB Resources. This somewhat mixed picture still produced growth in overall NIR of 5%.

SUSTAINABLE STRATEGIES FOR GROWTH ARE DELIVERING

The Group's performance reflects the success of a number of key growth strategies executed by the franchises in the domestic market over the past few years. These strategies are closely aligned with the Group's overall growth objectives and a more comprehensive overview of the franchise performance can be found on pages 30 to 39 of this report.

Touching briefly on a few examples, FNB is reaping the benefits of a deliberate strategy to grow and retain core transactional accounts. It has built this strategy on the back of three basic banking fundamentals, namely, superior service levels, value for money and innovation. RMB's business is clearly benefiting from the strategic decision in 2009/10 to focus more on client-driven activities, which has delivered on the original objective of a healthier balance between these and trading or investment businesses. WesBank's excellent performance for the year reflects the success of its strategy to dominate point-of-sale through long-standing alliances with leading motor manufacturers and large dealer groups.

Outside South Africa, we continue to make steady progress and in his CEO's report on page 10, Sizwe Nxasana covers this topic in more detail. I would however like to add that whilst there are very compelling reasons to grow our franchises in other African territories, given our approach, it will take a long time to move the earnings needle and shareholders need to be patient. It's relatively easy to buy earnings but this Group has always been highly allergic to paying large amounts of goodwill, particularly given our obsession with maintaining the ROE. So whilst we will look to acquire platforms in certain markets where greenfields is not a viable strategy, we will continue to exercise discipline in how we deploy our capital. We also need to send our best people to Africa, avoid legacy thinking and drive innovation, which I think is a philosophy that underpins our entry strategy in the Indian market.

FirstRand's original strategy in India when we opened in Mumbai in 2009, was to mine the trade and investment flows between India and the African continent and initially the operation was staffed and managed by RMB. However, we now believe we have an appropriate platform for FNB to leverage to provide some of their innovative retail and commercial banking solutions, particularly in the electronic and digital space.

In line with the way we prefer to enter new markets, it's a greenfields approach. However, we want to commit early to growing retail as our technology and innovative products and channels should provide a real competitive advantage.

Whilst I would like to emphasise how important it is to take a long-term view of these strategies outside of our home market, it is equally important to recognise why we need to pursue them. FirstRand is a very large domestic player and, whilst we continue to grow profitable market share in the financial services revenue pools of the country, the reality is that from a future growth perspective there will be many more headwinds than tailwinds. This is an issue that occupies our minds a great deal as banks' growth is inextricably linked to the level of economic activity and GDP growth.

MEANINGFUL MACRO GROWTH GOING FORWARD REQUIRES MORE INVESTMENT

Without embarking on a lengthy economics review, it is obvious that the current structure of government spending is not the best answer to long-term higher economic growth. In fact the Minister of Finance himself has commented on a number of occasions that the country's significant exposure to the social wage worries him, and limits the government's ability to fund fixed investment, which is a potentially powerful driver of future job creation and growth.

The social grant structure has, to be fair, had some benefits (excuse the pun). It has ensured political stability, reduced poverty and the threat of social unrest, despite continued high levels of unemployment. It has also played its part in driving two years of strong consumption spending – which has underpinned growth for the retailers and the banks and the economy as a whole. However this is not sustainable in the medium to longer term.

The private sector continues to contribute significantly to fixed investment and the social wage. The total corporate tax paid on profits in the fiscal year to March 2012 (R154 billion) is the same amount as the social grants paid out in that same year. Statistics also show that 60% of current fixed investment is supplied by the private sector, corporate tax contributes 21% of total tax revenues and of the 8.4 million people employed in the formal non-agricultural sector, 6.4 million are in the private sector. If you then add the PAYE contribution of those 6.4 million, the multiplier effect is even more significant.

If nothing else, what these statistics indicate is that a strong private sector in this country is critical to its success. They send a powerful message to government that big business should be embraced as a force for social and economic prosperity not constantly threatened with the privatisation or confiscation of assets or criticised to the point where both parties glare at each other across an ever widening divide. South Africa has many world class companies and as a country we should view these as national assets and refrain from continuous corporate bashing. To this end, it is particularly pleasing to me that the Minister of Finance has recently opened a face-to-face dialogue with the financial services industry, to find a common path in addressing some of the structural issues we face. I look forward to more of these conversations and I fundamentally believe that building constructive bridges between government and the private sector will be the defining difference between whether South Africa grows or declines over the next decade.

Going back to the point above about the proceeds of PAYE, I have unearthed another statistic which resonates strongly with me. The income tax paid by the top 25 earners at FirstRand (assuming a marginal tax rate of 40%) would pay for child support grants of 100 000 children. I mention this point only because executive pay receives more and more public criticism and it is sometimes important to remember that the state also benefits from growth in remuneration.

ALIGNING EXECUTIVE PAY WITH PERFORMANCE

For me there are two key questions about remuneration – one, is the absolute number too high? Second, do executives, on a *pro rata* basis, receive more than the providers of the capital? The first one is, in some ways, the more difficult to answer as there is always an emotional reaction to very high numbers. The remuneration committee at FirstRand fully applies its collective mind to this question and in the process follows very rigorous formulas to get to an appropriate number. However I would also like to make the following point. At current market capitalisation levels (at time of writing R150 billion) if actions taken by the CEO of FNB (for instance) influenced the FSR share price up 5%, this would create R7.5 billion of value. Compared to this, what he receives in terms of remuneration is modest. Conversely this simple sum also demonstrates that if you have the wrong person in place, not properly incentivised, the potential for value destruction is equally high.

I have stated on a number of occasions that FirstRand fundamentally believes that executive remuneration must align with shareholder value and our key performance measure, net income after cost of capital, ensures that the link between pay and performance is direct. This year, as a compensation health check, I compared the growth in the combined remuneration of our leadership team (CEO, CFO and franchise CEOs) over a four-year period to growth in shareholder returns.

This analysis shows that growth in total return for FirstRand shareholders, between 2008 and 2012, was substantially above growth in leadership's remuneration, and therefore in line with what our reward philosophy seeks to achieve. A graphic representation of this analysis can be found in the remuneration report on page 79.

In addition, I commissioned some work comparing FirstRand to a universe of around 20 banks to test my assertion that in 2011 we rewarded our people appropriately. The analysis looked at value created attributable to employees versus ROE, and the universe we used consisted of our local peers; Brazilian banks (emerging market peers), Canadian banks (highest rated banking system globally) and a couple of international universal banks. What this analysis showed was that at one end of the spectrum, some of the international universal banks are producing ROEs well below cost of capital but paying between 65% and 80% out to employees. FirstRand, however, is situated in the upper quartile of the universe, producing an ROE of 20% and paying out 45% to employees. This is in line with some of the largest Brazilian and Canadian banks and is, in my view, appropriate. It is also in line with our overall remuneration objectives and pleasingly stands up to scrutiny. The final point I would like to make on this topic is that should it ever happen, we will not reward profits generated outside of our risk parameters, and this should ensure that people don't push the boundaries.

IN CLOSING...

Whilst all of the topics I have covered above are important ones, it is important in life to maintain a balanced perspective and in some ways they all pale in comparison to a singularly profound event that took place during the year, the loss of Thys Visser in a motor car accident. I had the privilege of knowing Thys for many years both as a friend and a colleague. He was a man I respected deeply, a man of few words but huge wisdom and an outstanding director of the Board. He is sorely missed.

All that is left to say is well done to every single FirstRand employee for another outstanding year.

LL Dippenaar

Laurie Dippenaar
Chairman