CHAIRMAN'S STATEMENT

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Laurie Dippenaar | *Chairman*

In his preface to the Centre for the Study of Financial Innovation's 2014 publication of *Banking Banana Skins,* Andrew Hilton remarks that bank bashing may be emotionally satisfying but banks are there to perform a socially useful function. He goes on to say that unless they are given a bit of leeway, banks cannot do what we need them to do – to keep the economic wheels turning.

The reason he raises this is that the 2014 *Banking Banana Skins* research indicates that fear of regulation (particularly over-regulation) has re-emerged as the most severe concern for bankers worldwide, with political interference the second most cited concern. The research covers 656 respondents from 59 countries, both developed and developing, so it is probably a fair reflection of how the global financial services industry is feeling.

What is also interesting about the research is that it shows some interesting contradictions in the industry. On the one hand bankers complain about regulatory interference but at the same time they stress about reward systems that incentivise risk taking. I can't understand why the one thing banks don't seem to be able to do better is self-regulate – particularly given the legacy we face following the global financial crisis.

The industry's propensity for taking on too much risk to deliver "growth" continues to damage its credibility. Here in South Africa, since the year-end we have seen a systemically important bank go into curatorship, supported by the Reserve Bank and a consortium of large domestic banks, including ourselves. The main reasons for the event related to the bank's impairment and provisioning policies, rapid credit growth and the vulnerabilities of its business model (a mono-line). The fall out has seen blame laid at the doors of management (poor credit decisions in pursuit of book and earnings growth), the board (poor transparency for shareholders), the shareholders (not asking the tough questions in time) and the regulators (allowing possible reckless lending and not acting earlier).

This is an example of how accountability for the behaviour of banks lies in the hands of many parties, but clearly management has to take the most responsibility. They have the clearest line of sight of what is happening in their business and even the most rigorous regulator cannot second guess the appropriateness of risk management processes. What I am basically getting at is that if bankers fear more regulation – what are we doing to prevent it? Are we proving to regulators that we can be trusted to make the right decisions to keep our business sustainable? Banks are systemically critical to the economies they serve; management and boards, therefore, have an even greater accountability particularly as bank rescues erode the savings of the nation and the tax base in the process. We look after people's savings – we must never forget that.

If we don't prove that we can self-regulate, we will face the inevitable consequences. It's actually depressing that the fear of increased regulation topped the *Banana Skins* reports in 2005 and 2006. In nearly ten years, with billions of shareholder value wiped off the face of the earth, we appear to have learnt nothing.

RISK IS ON THE INCREASE BUT OUR FRANCHISES CONTINUE TO OUTPERFORM

The operating environment generally remained difficult characterised by ongoing uncertainty in the global macroeconomic arena combined with subdued domestic demand growth. This was exacerbated by protracted industrial action in the South African platinum sector, and there is absolutely no doubt this will have a significant knock-on effect on GDP in the current year.

Statements about quantitative easing from the US Fed continue to impact on foreign capital flows to emerging markets. South Africa is particularly vulnerable to slowing capital flows due to its large current account deficit, and this has translated into rand weakness and higher domestic inflation and has triggered the start of an interest rate hiking cycle. Constrained by its fiscal deficit, government spending has remained subdued.

One basic truth of banking is "macros matter" and growth in profits is inextricably linked to growth in GDP. This year the Group's performance has again outstripped what market growth there was on offer, and much can be attributed to the quality and strength of our franchises. We get more than our "natural share" of growth available in the system and this is because we go out and hunt for opportunities; it's one of the benefits of our entrepreneurial culture.

Innovation continues to flourish in all of our businesses. Our retail franchises, WesBank and FNB, have continued to outperform on the back of their differentiated customer propositions, which proves the point that in challenging times there is a flight to quality. WesBank is fundamentally a retail credit business, (albeit with growing diversification), and its fortunes are closely aligned to the domestic credit cycle. However, its credit books are proving extremely resilient, and are still trending below our through-the-cycle view; as a result we expect WesBank to weather this cycle much better than the previous one. FNB had another excellent year, on the back of its strategy to grow its customer base and transaction volumes. They have also deployed their balance sheet judiciously, with the credit tightening actions taken in the unsecured lending space as early as 2011, standing them in good stead.

RMB continued to perform extremely well, in a very difficult environment for corporates. There is still a great deal of work required to build the corporate transactional piece of the business, but the investment banking franchise remains a clear market leader. In terms of lending, most of the action has been in the rest of Africa, where significant infrastructure projects are

underway. Here in South Africa we need further government expenditure, public/private partnerships and foreign direct investment to kick start the corporate sector.

There are, however, some worrying signs. For instance, the current land reform proposals could have an extremely negative impact on agri-lending and this is a significant driver of domestic GDP. Although the mechanics are yet to be worked through, it is important to remember that many farms are bonded and one has to question whether the state plans to take over the outstanding debt should they take over the farm? There are risk dynamics here that hopefully the government will think through very carefully. However, I do also recognise that the land reform proposals are a part of the government's strategy to address one of South Africa's most difficult challenges – income inequality.

I acknowledge that those tasked with remuneration oversight have a duty to explain themselves, and no industry should be more aware of that than banking where historically excessively risky incentive structures have negatively impacted entire economies.

INCOME INEQUALITY – A STRATEGY OF REDISTRIBUTION

On a relative basis globally, South Africa is an upper-middle-income country with a per capita income similar to that of Botswana, Brazil, Malaysia or Mauritius. However, despite this relative wealth, the experience of many South African households is still either one of outright poverty, or of continued vulnerability to becoming poor. The distribution of income and wealth in South Africa has been described as the most unequal in the world particularly on the basis of Gini research data. This has been the source of much public debate between local economists who believe that the Gini calculation with reference to South Africa is seriously flawed.

Notwithstanding the mathematics, the government has recognised that such inequality is unacceptable over the long term, as it can ultimately undermine both the social and political stability of South Africa. In theory, system-wide capital accumulation can only be achieved in two ways, namely, a net addition to existing wealth or a redistribution of wealth. With regards to the former, certainly government is focusing on important grass roots drivers of capital accumulation such as education, inward investment and job creation; these will however take decades to deliver. Therefore the past decade has seen significant focus on a strategy of redistribution of wealth.

It is a basic truth that if more wealth is produced than there was before, a society becomes richer as the total stock of wealth increases. However, if some accumulate capital only at the expense of others, wealth is merely shifted from Peter to Paul. It is also possible that some accumulate capital much faster than others or that a few people or organisations accumulate capital and grow richer, yet the total stock of wealth of society actually decreases.

I have to own up that I haven't got the answer as to which of these scenarios applies to South Africa, I would hope that our society has become richer, and that the total stock of wealth has not decreased. Certainly many of the BEE transactions that are beginning to vest have created massive value. FirstRand's BEE deal comes to an end on 31st December 2014 and I will cover it in more detail next year, but what is clear now is that the value created (assuming a share price of around R40) will be in the region of R18 billion. This is a very significant number and we structured the transaction to deliver this value to an extremely broad base of beneficiaries. This transaction alone should over time allow for meaningful additional capital formation across many organisations and individuals.

However, whilst well-structured BEE transactions should contribute meaningfully to narrowing the income inequality gap, they cannot compensate for the other drivers I mentioned earlier – education and job creation.

We all recognise that unemployment is a major reason for inequality and World Bank data shows South Africa has the 11th lowest participation rate in the world and less than half of all working age men in South Africa actually work. Part of the reason for this is our low skill levels, with about 61% of the labour force unskilled. This indicates that education must play a big role in any solution as the level of education is also a big driver of the level of income.

Recent research from Stellenbosch University has also shown the importance of tertiary education as a predictor of income. Differential quality of school education is a major cause of unequal

labour market earnings and children of more educated parents progress better in school and fare better in the labour market once they leave school.

My personal view is that receiving a quality education from the state is a basic human right and it's extremely sad that so many children in South Africa are being denied this. My colleague, Sizwe Nxasana, is spending a great deal of his time and energy on the National Education Collaboration Trust project, which he is deeply passionate about. Whilst it is a complex project where the obstacles are huge and have been around for a long time, it is absolutely non-negotiable that we work to improve South Africa's education system, for the future of our children and our country.

INCOME INEQUALITY CANNOT BE FIXED THROUGH REMUNERATION PRACTICES

Whilst the unemployment rate in South Africa remains at unacceptable levels, a recent UBS report on earnings and spending around the world showed that since the 1970s, South Africans who do work get paid in purchasing power parity terms better than workers in Athens or Rome. Maybe not New York or London, but certainly more than 90% of developing cities and quite a few developed ones too.

The reason I find this statistic interesting is because of the increasing demands from lobbyists and other pundits for management of large listed companies to be "transparent" on the gaps between the lowest paid and the highest paid employees. I have been trying to work out in my own mind what this disclosure would actually achieve. It certainly won't help improve income inequality.

As I have described above, this is a structural issue that requires a highly complex set of responses. What the UBS research does show is that South Africans are, on average, well paid for what they do, which in turn suggests that company remuneration is not completely out of whack with value creation.

I honestly can't see the value of comparing what a bank teller earns compared to the CEO of our investment bank. Comparative pay is not a simple formula; reward must be commensurate with the volume of work, responsibility, complexity of role and a myriad of other considerations. That's why we run a balanced scorecard when assessing the performance and remuneration of a prescribed officer. Comparative numbers on a page, which are impossible to put proper context to, simply stoke emotional responses.

I acknowledge that those tasked with remuneration oversight have a duty to explain themselves, and no industry should be more aware of that than banking where historically excessively risky incentive structures have negatively impacted entire economies. I would welcome any shareholder to engage with me on this topic as I think the Group has a good track record of ensuring management and shareholder interests are appropriately aligned.

ALIGNING COMPENSATION WITH SHAREHOLDER VALUE CREATION

The remuneration committee at FirstRand focuses heavily on aligning remuneration with employee performance as it translates into the creation of shareholder value over and above the cost of capital deployed – we plot this alignment extremely diligently – and when I refer to shareholders I mean all stakeholders who benefit from the success of the business. After all it's important to remember that our institutional shareholders are managing the money of "the man on the street" through pension funds, unit trusts and other savings products.

On this point I would like to mention that if people want to properly understand this year's remuneration, they should be careful not to add the value of the prescribed officers appreciation rights (APRs) to 2014's compensation. These APRs were awarded in 2008 when the FirstRand share price was R10.48 and now finally vest at a share price ranging from R33 to over R35. Yes, the value unlock for management has been significant, but the team has delivered a five-year period of outperformance for shareholders. There is a graph on page 92 that shows the Group's share price and dividend have grown at way above 20% over the past five years. It is appropriate that the management team share in this value creation but it is also important to remember that if, during the five years, the Group's targets were not met, the APRs would not have vested (as when the 2007 APRs did not vest in 2012).

LOOKING FORWARD WE SEE MORE HEADWINDS ON THE HORIZON

South Africa is currently in an interest rate hiking cycle which will place further pressure on the consumer. Economic headwinds are increasing and growth in the system looks sluggish. I do believe however that, despite this deteriorating operating environment, FirstRand has a set of very robust strategies to continue to generate good organic growth.

The Group is well positioned to weather the difficult retail credit cycle as it emerges over the next 12 to 18 months thanks to our early counter-cyclical actions; our balance sheet is strong in that we are well capitalised and very well provided.

In closing, I would firstly like to thank Bruce Unser, the Group's long-serving company secretary, who retired during the year. I also want to thank the management team and every staff member of the Group for another year of strong profitability and superior shareholder returns. It is a team effort, and as a collective the "FirstRand team" has continued to demonstrate it can outperform the macros, the market and its competitors. Well done, but please stay humble – it gets harder from here.

Laurie Dippenaar
Chairman