COO & CFO's report

ACTIVELY MANAGING A DIVERSE PORTFOLIO THROUGH THE CYCLE

This report represents a high level overview of FirstRand Limited's financial performance, the drivers of that performance – both in terms of macro environment and Group strategy, the composition of the Group's portfolio and its current risk profile.

Performance commentary

Financial performance

FirstRand's diverse portfolio of banking and insurance businesses produced a strong performance. Normalised earnings improved 39% to R9.96 billion with a normalised return on equity ("ROE") of 18%.

GROUP KEY RATIOS

	2010	2009	% change
Normalised earnings (R million)	**9 963**	7 151	39
Normalised return on equity (%)	**18**	14	
Normalised earnings per share (diluted) (cents)	**176.7**	126.8	39

The Banking Group's results for the period under review reflect a significant recovery in profitability in comparison to the 12 month period ended 30 June 2009. The total banking portfolio produced R8.5 billion of normalised earnings, representing an increase of 41% compared to the previous comparative period.

This recovery in earnings was driven mainly by a modest increase in topline and the reversal of the two most significant negative issues from the previous comparative period, namely bad debts emanating from the large retail lending books and losses from certain offshore trading portfolios within the investment bank. Many of the banking operations also showed strong operational performances and a significant private equity realisation positively impacted earnings, despite further impairments that were created against certain portfolios.

Overall impairments decreased 29% from R8.0 billion to R5.7 billion, primarily in the retail franchises of FNB and WesBank, reflecting the positive benefits of the lower interest rate environment. A breakdown of bad debts by product and segment is reflected in the table below.

JOHAN BURGER [COO & CFO]

Percentage of average advances	6 months to June 2010	6 months to Dec 2009	6 months to June 2009
Retail	**1.41**	2.08	2.97
– Residential mortgages	**0.73**	1.17	1.76
– Credit card	**5.73**	8.14	12.51
– Vehicle and asset finance	**1.45**	2.20	2.70
Wholesale*	**0.81**	0.71	0.90
Total bad debt ratio	**1.13**	1.51	1.99

** Includes WesBank Business and Corporate.*

In addition, non interest income increased 32% from R20 billion to R26 billion representing a strong recovery in RMB's trading activities and the realisation of Life Healthcare which produced R1.25 billion of profit.

Pressure remained on the net interest income component of the earnings base, due mainly to declining asset growth and the negative impact of lower interest rates on capital and endowment balances. This was, however, partly offset by successful repricing strategies across all lending portfolios.

BANKING GROUP KEY RATIOS

	2010	2009	% change
Normalised earnings (R million)[1]	**8 535**	6 056	41
Normalised return on equity (%)[2]	**18**	13	
Return on assets (%)	**1.24**	0.80	
Credit loss ratio (%)	**1.30**	1.81	
Cost to income ratio (%)	**57.1**	58.1	

1 *Before deducting preference share dividends.*
2 *After deducting preference share dividends and capital.*

The earnings of the insurance subsidiary Momentum were positively impacted by a recovery in equity markets, particularly in the first half of the year, combined with a continued strong operational performance. Overall normalised earnings increased 10% to R1.81 billion with the return on equity remaining ahead of Momentum's target at 22% (2009: 23%). Volumes of new savings and retirement annuity business were subdued, as consumers remained under pressure, however, lump sum inflows showed strong growth and FNB insurance continued to perform well.

MOMENTUM KEY RATIOS

	2010	2009	% change
Normalised earnings (R million)	**1 810**	1 649	10
Normalised return on equity (%)	**22**	23	
Return on embedded value (%)	**14.9**	3.3	
CAR cover (times) (before dividend)[1]	**2.1**	1.8	

A breakdown of earnings from each operating franchise is shown below:

R million	2010	2009	% change
FNB	**4 303**	3 756	14
FNB Africa	**524**	514	2
RMB	**3 261**	1 536	>100
WesBank	**953**	324	>100
Corporate Centre	**(506)**	(74)	(>100)
Banking Group	**8 535**	6 056	41
Momentum Group	**1 810**	1 649	10
FirstRand Limited	**(38)**	(90)	(58)
Dividends paid on non cumulative non redeemable preference shares	**(344)**	(464)	(26)
Total normalised earnings	**9 963**	7 151	39

Performance drivers

The main drivers underlying the Group's performance can be broken down into three key areas; the current macro environment, the continuing reduction in losses from offshore and local legacy portfolios and the successful execution on certain strategies.

Improving macro environment

Whilst the macro environment continues to improve, high levels of consumer indebtedness and corporate capacity remain in the system and this resulted in very subdued lending during the year under review. This in turn placed pressure on net interest income, which was also adversely affected by the negative endowment effect on capital and deposits due to lower average interest rates, as well as the impact of higher term funding costs.

These negatives were offset by a 29% decrease in bad debts, primarily in the large retail lending books of FNB and WesBank. This rapidly improving trend reflects the impact and benefits of the lower interest rate environment and the resultant gradual deleveraging of consumers and contributed R2.4 billion to the Group's pre tax profit.

Reducing legacy portfolios

Absolute growth in the Group's non interest income was mainly driven by client/primary market activities, (representing 87% of normalised non interest revenue), however, the significant turnaround in fair value income resulted from reduced losses in RMB's offshore legacy portfolios, which was achieved despite further derisking and write downs in the local Dealstream portfolios.

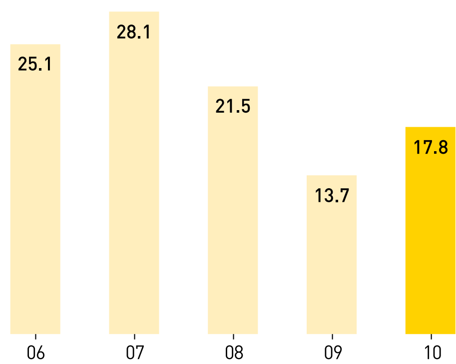
The remaining portfolio size was R1 739 million at 30 June 2010 (2009: R3 213 million), which management believes is manageable in the overall context of the Group, but it will still take time to realise value.

Banks have to focus on increasing the return on assets part of ROE.

The Group uses certain key performance indicators to monitor progress of strategy. These include:

Normalised ROE

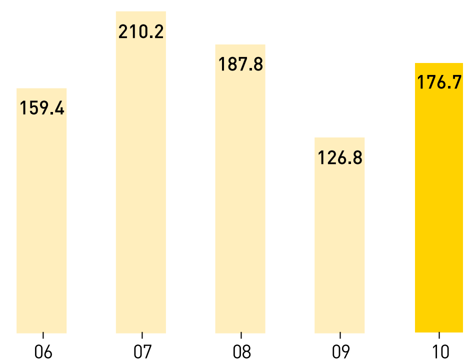
(%)



When the Group analyses ROE, it also takes into account the relationship between ROA and gearing levels.

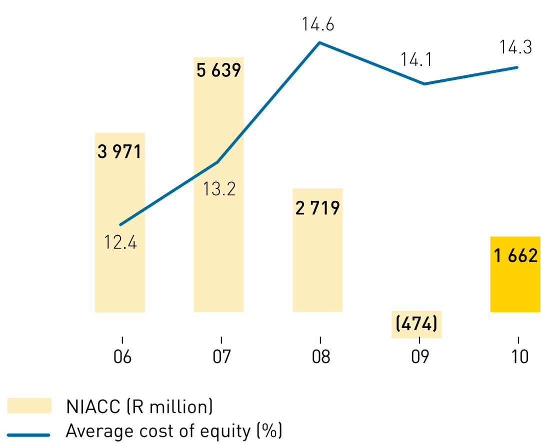
Normalised EPS

(cents)



The Group's target is nominal GDP + 3% to 5%.

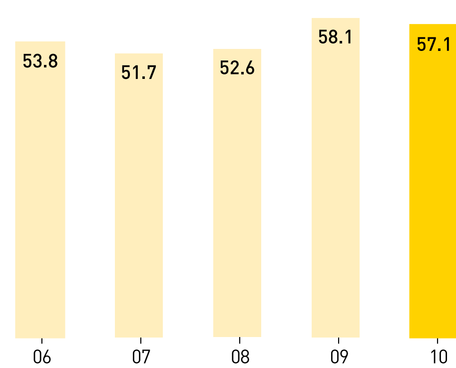
Net income after cost of capital ("NIACC")



Growth in NIACC is the Group's internal benchmark for assessing performance.

Cost to income

(%)



The Group monitors efficiency through the cost to income measure, taking into account both revenue and cost growth.

Refined strategy – rebalancing the portfolio

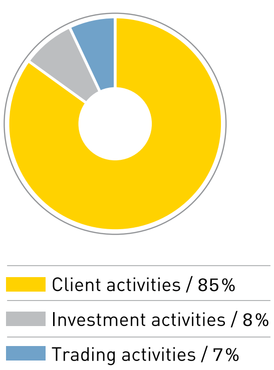
In last year's annual report the Group outlined its refined strategy and addressed specific issues relating to the composition of FirstRand's portfolio at the time. This year the CEO's report updates shareholders on the progress of that strategy (see page 12). The execution of growth plans in South Africa and Africa are explained in further detail by each operating franchise in the review of operations on pages 35 to 53.

A key component of the refined strategy is to improve quality of earnings and reduce volatility and the results for the year under review demonstrate that the Group has started to deliver on this component of its strategy.

Chart 1 (below) shows that the Group's portfolio now exhibits a more appropriate balance between revenues from client, investment and trading businesses compared to three years ago. The growth in revenue from client activities resulted in an improvement in the quality of earnings and was largely driven by a change in strategy in the investment banking franchise. As part of its strategy to rebalance its business and improve the quality of its earnings, RMB strengthened its domestic client driven activities and scaled its trading activities in line with its risk appetite framework. The key objectives of the new risk appetite framework are to manage the trade-offs between earnings, volatility, profitability and growth, and aim for a targeted business mix of 60% client income, 25% investing income and 15% trading income. RMB's current mix can be seen in Chart 2.

Chart 1: Group generating greater proportion of gross revenue from client activities compared to three years ago

2007



2010

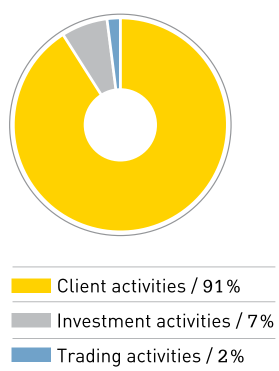
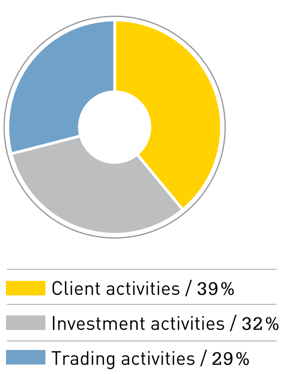
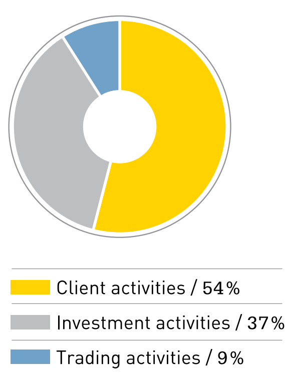


Chart 2: Shift in gross revenue composition of RMB over the past three years

2007



2010

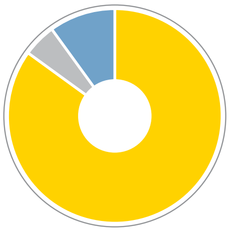


Growing geographical diversification

Approximately 90% of Group earnings are generated in South Africa. As a result, the Group's fortunes are closely linked to that of the South African economy. Given that the medium-term outlook for GDP growth in South Africa is muted, the Group is focused on growing its African franchise, targeting those markets which are expected to deliver above average growth and returns and that will benefit most from China/India/Africa trade and investment flows. Despite the current dominance of South Africa in the Group's earnings profile, Chart 3 below does illustrate some progress in this regard and that the contribution from the rest of Africa is gradually increasing.

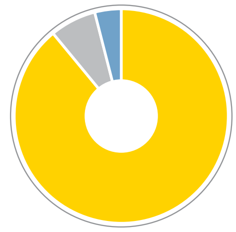
Chart 3: Geographical diversification – change in mix over the past three years

2007



South Africa / 85%
Rest of Africa / 5%
International / 10%

2010



South Africa / 89%
Rest of Africa / 7%
International / 4%

Strategy and risk profile aligned

The strategic planning process

FirstRand believes that effective risk management is of primary importance to the success of the Group and is a key component of the delivery of sustainable returns to its shareholders. It is therefore deeply embedded in the Group's tactical and strategic decision making.

As discussed previously and outlined in detail in the CEO's report, FirstRand's overall objective is to be the African financial services group of choice. To execute on these strategies, the Group will actively assume certain risks – including credit, market and investment risk. As a consequence of its banking activities it also incurs funding and liquidity, operational, interest rate and reputational risk. These risks are predominantly within South Africa and other select African markets.

In addition to the above risks, the Group's strategy can also be affected by external risks such as regulatory changes, political shifts and macroeconomic conditions.

The collective leadership of FirstRand, including the FirstRand CEO, COO and the franchise CEOs, determines the Group's strategy and is accountable for the overall performance of the Group. The strategy is approved by the FirstRand Board. The determination of the Group's strategy is a dynamic process as illustrated by the diagram on the next page. It is designed to achieve superior, sustainable economic returns to shareholders, within acceptable levels of earnings volatility. The Group's strategy is executed through its portfolio of leading franchises. The Group seeks be represented in all significant earnings pools across all chosen market segments playing across the full value chain (lending, transactional, savings and risk taking), therefore, this portfolio must represent the appropriate business mix and risk profile to deliver on this strategy.

On a regular basis, depending on certain macro dynamics or specific internal issues, the Group assesses whether the risk profile or business mix within its portfolio is optimal to deliver on its strategy; if not, it will take actions to adjust accordingly. A recent example of this is RMB's deliberate action to increase its focus on client driven activities rather than proprietary trading or investment activities in both the South African and international operations. In addition, RMB's secondary market activities will link to client activities, or leverage the existing primary market position. Whilst it is likely that this shift may result in slightly lower ROEs, it will improve the quality of earnings, reduce volatility, and still produce superior returns to shareholders. In another example, the large retail books in FNB and WesBank were too exposed to both cyclical and structural dynamics. Both businesses responded by improving the risk profile and repricing for new business. Such adjustments by WesBank and FNB will also reduce earnings volatility.

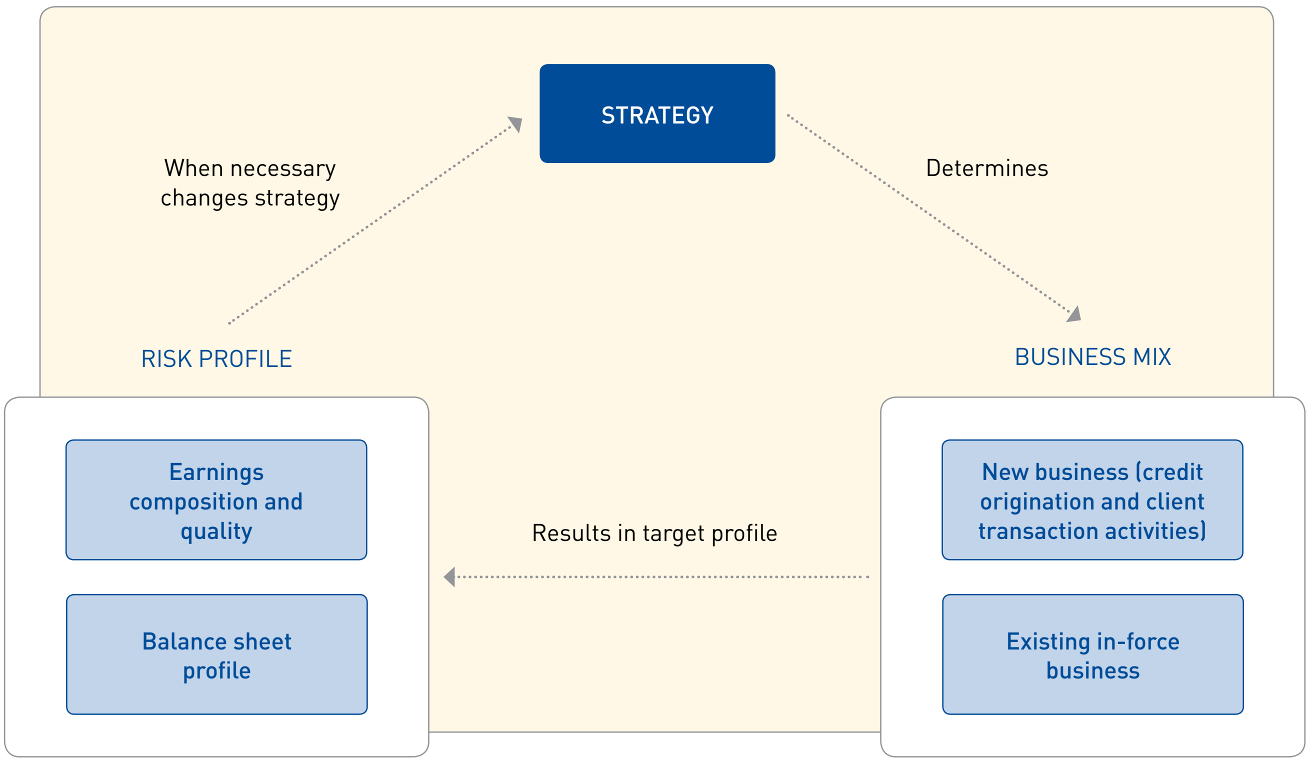
Applying the basic disciplines

A critical objective of the Group is to maintain a robust balance sheet and earnings profile through the cycle. To achieve this, the Group adheres to some basic disciplines:

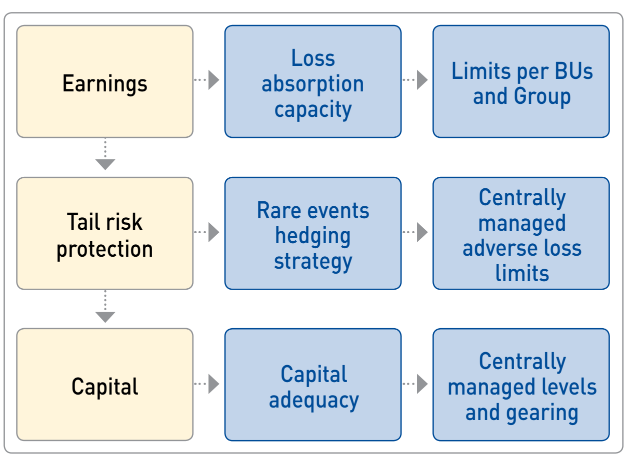
- it holds appropriate levels of core capital;
- manages liquidity prudently;
- manages its diversified portfolio on a holistic basis, utilising natural hedges and business mix to ensure sufficient loss absorbing earnings capacity;
- manages its asset profile in line with risk appetite ranges;
- drives operational efficiencies across its portfolio; and
- rebalances its portfolios for different macro scenarios.

The Group ensures that the quality and diversity of the earnings profile is such that it can absorb losses resulting from risk taking activities.

Determination of Group strategy



As illustrated in the diagram below, the Group views earnings as its first defence against adverse outcomes.



Beyond targeting suitable earnings streams, the Group can also enhance value by understanding, managing and mitigating tail risks to earnings stability. As part of its forecasting process, the Group considers outcomes beyond its core and risk scenarios which might have large adverse effects. As an additional layer of defence against tail risk, the Group also implements certain hedges.

In addition to earnings, capital provides a further buffer against unexpected losses. The Group is appropriately capitalised under a range of normal and severe scenarios, as well as under a range of stress events. The Group aims to back all economic risk with Tier 1 capital, as it offers the only real capacity to absorb losses. Currently, at least 90% of the Tier 1 ratio is equity capital.

Macro shifts impact risk appetite and strategy

Significant shifts in the macro environment are also critical to any strategic adjustments. FirstRand manages its business based on a single "house view" which inputs into the budgeting and forecasting process, informs credit origination strategies, funding strategies and capital stress testing, directs the interest rate positioning of the banking book, and is used for tail risk strategies.

There is a central unit tasked with formulating and communicating this macroeconomic view. It provides the business units with a forecast of key variables that impact the balance sheet and spans a three year forecast horizon. Given the volatility of the macroeconomic environment, a core forecast and two risk scenarios are presented to the business units for each key variable. A severe scenario is also included for stress testing purposes.

The Group believes that it is critical to align its strategy with its economic view by focussing on the key macro drivers of earnings. Based on fundamental research the Group assesses the macro-economic environment against the long-run trends and cycles of the economy which are defined as "highways". This allows the

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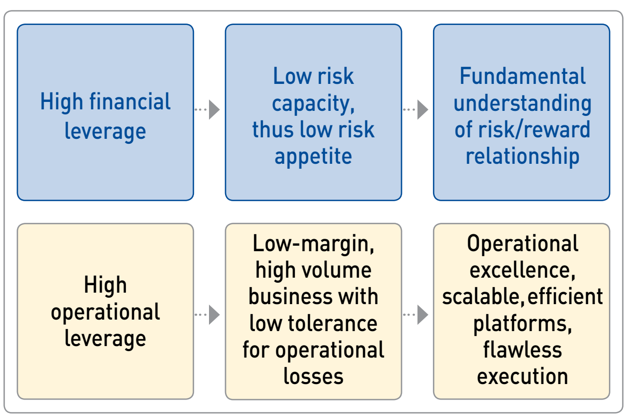
Group to take a counter cyclical approach by adjusting strategy when the macro drivers move outside of their respective highways.

By way of an example; the Rand's current strength has introduced a cyclically low inflation and interest rate environment, which in turn has pushed debt servicing cost to a cyclical low. Despite these key data points sitting at the bottom of their respective highways, the Group will adjust its credit origination strategy only on the basis that this reflects a cyclical rather than structural shift.

Refinements to business models

A further focus area is to understand at business unit, franchise and Group level, the relationship between financial/operating leverage, risk capacity/appetite and business mix (or portfolio composition) (see diagram below).



It is an improved understanding of these linkages which led RMB to reconfigure its business model to focus more on client activity and reduce its reliance on trading income (thus improving diversification and loss absorption capacity). These actions have improved the quality of RMB's earnings and enhanced the sustainability of the franchise.

A more thorough understanding of FNB HomeLoans' risk capacity and macroeconomic constraints has enabled management to adjust strategy and risk appetite appropriately, reducing the earnings volatility of the business unit, FNB and the Group overall.

Given the macro growth challenges in its domestic market, the group continues to focus on driving operational leverage. Where business units have high operational volumes, emphasis is being placed on ensuring that platforms are scalable, operational performance is excellent and that risk appetite is appropriate. Management feels that some of its platforms are not achieving optimal operational leverage or efficiency and this is a significant area of focus in the coming financial year.

Group risk profile

Income statement/earnings profile

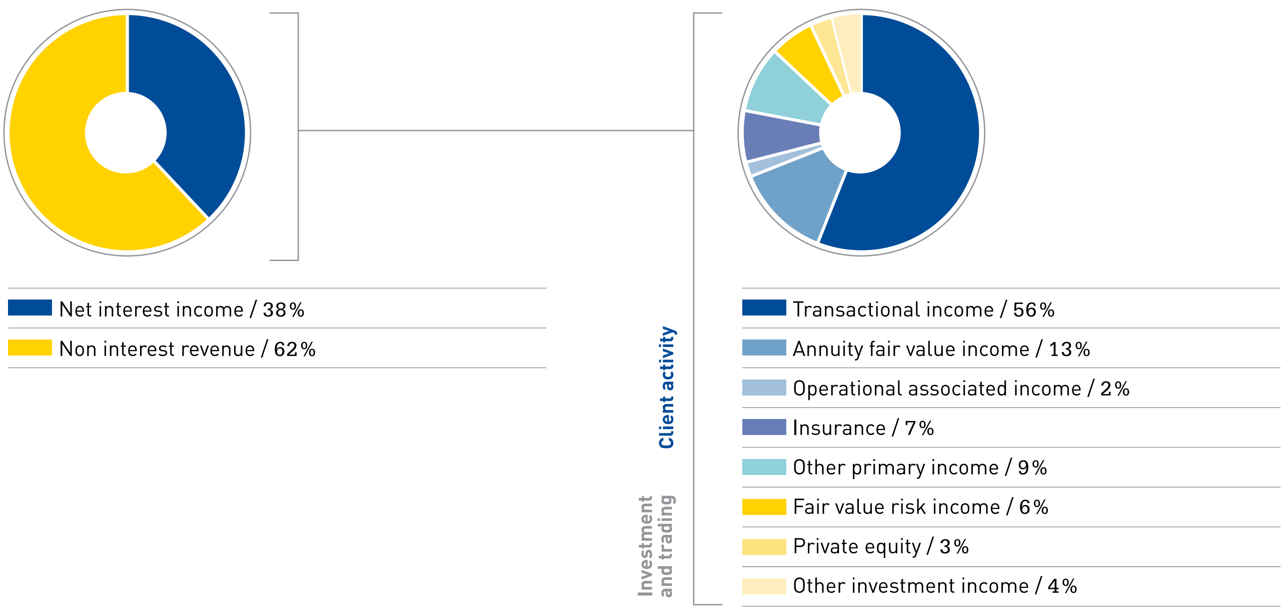
In line with the Group's objective to maintain a well diversified earnings pool across a broad range of business activities, the current earnings profile is made up of revenue relating to credit lending activities (net interest income or "NII") and revenue as a result of transactional and client activities (non interest revenue or "NIR").

Both revenue components are dependent on macroeconomic conditions:

- The interest rate and general credit environment will impact NII in terms of endowment and impairment levels (which are impacted by consumer indebtedness/affordability levels, unemployment, etc.), as well as the level of advances growth.
- Transactional income and fee and commission income (sources of annuity NIR) are more stable although dependent on the level of economic activity.

For the year ended 30 June 2010, normalised gross revenue comprised 38% NII and 62% NIR. The larger proportion of NIR is appropriate as it relates to transactional revenues that have low volatility and stable annuity profiles and this contributes significantly to capacity to absorb the impact of risks resulting from credit lending and other activities. NIR has been stable during the recent financial crisis and continues to grow at acceptable levels.

Gross revenue composition and breakdown of normalised non interest revenue components



Balance sheet structure

FirstRand's earnings are substantially driven by its balance sheet, and, through its integrated balance sheet management approach, the Group ensures appropriate alignment between credit, capital and funding strategies within the appropriate risk framework.

The Group's growth strategy can impact the composition of the balance sheet. The current profile is explained below.

Assets

Loans and advances

Advances resulting from lending activities constitute the largest portion (approximately two thirds) of assets on the Group's balance sheet. More than 90% of these advances relate to the South African market with the performance of the Group's advances thus largely dependent on macroeconomic conditions and the state of the South African economy. Approximately two thirds of advances result from retail lending activities. As a result, adverse conditions such as high interest rates and debt servicing cost, unemployment and asset price shocks could negatively impact the financial performance of the Bank.

Trading, investment and liquid assets

Investments, investment securities, derivatives, cash and other assets make up the remainder of the balance sheet. More than half of investment security assets relate to instruments the Bank holds in compliance with liquidity and prudential requirements. The remainder of derivatives, investment securities and cash holdings together with corresponding derivative liabilities represent an accounting based disaggregation of the Bank's portfolio of client deal structuring activities. The majority of these positions are offsetting from a risk profile perspective. The Group also has a private equity investment portfolio of approximately R6 billion.

Liabilities

The Bank's liabilities are comprised of:

- deposits from its retail, commercial and corporate customers (the nature and term of which are a function of customers' preferences);
- institutional funding (over which the bank can exert more influence, although it is limited by the structural constraints of the market in South Africa – more about this in the Funding and liquidity risk section); and
- short trading positions and derivatives, which represent the accounting based disaggregation relating to deal structuring activities as described in the Assets section above.

Financial risks

Credit risk

Credit strategy is managed as part of the broader balance sheet management process and is aligned with the Group's view of trends in the wider economy. The Group's current origination strategies are resulting in improving credit quality across all retail portfolios (as evidenced in the vintage analyses for the large retail portfolios on pages 164 to 165). These portfolios were also positively impacted by interest rates continuing to trend downwards, income growth and increasing wages. However, job losses also continued, albeit at a slower rate.

Interest rate reductions, which started in 2008 and continued into 2010, resulted in a reduction in NPL inflows and consequently in the credit impairment charges of most retail portfolios (the chart below shows the decline in NPL inflows at FNB HomeLoans, the Group's largest retail lending book). The level of NPLs remained high, however, due to the debt counselling process. As a result of the improvement in credit quality, the Group's retail portfolios now fall within the Group's desired credit appetite ranges.

FNB HomeLoans – trend analysis of new NPLs

Despite the reduction in debt servicing costs as a result of lower interest rates, the subsequent improvement in affordability and underlying asset recovery (e.g. house price growth), credit appetite has not increased considerably. Consumers remain leveraged and vulnerable to shifts in the external economic environment and concerns remain with regards to unemployment prospects and the timing and strength of the recovery.

Large corporate credit exposures arise mainly from:

- term-lending activities in RMB's Investment Banking division;
- short term exposures from overdraft and working capital facilities provided in FNB Corporate and Transactional Banking; and
- short term money market exposures in FICC.

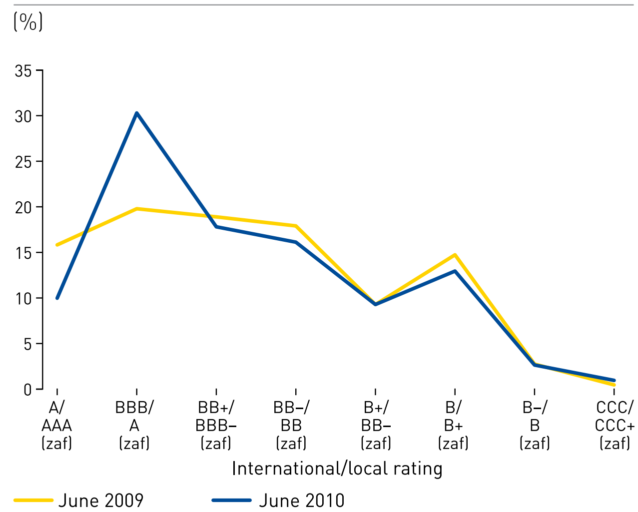
In addition, exposures resulting from financial market activities, such as cash placements by Group Treasury at other institutions, and credit exposure resulting from positive mark-to-market movements on derivatives and securities financing activities (e.g. reverse repos) are also managed as part of the wholesale credit process.

The performance of the Group could be negatively impacted by a large wholesale exposure default. These exposures are, however, diversified and actively managed to mitigate this risk. In addition, risk management processes and prudential limits are in place to limit the loss in the event of default for each exposure. Prudential limits for wholesale credit exposures are set considering the following:

- Credit risk capacity and appetite: the Bank's own credit risk capacity and appetite for wholesale lending activities has been determined considering an acceptable level of earnings volatility resulting from credit related losses.
- Counterparty debt capacity: the client's debt capacity, ability and willingness to repay its debt is a key consideration. A counterparty's prudential limit will be capped at its own debt capacity.
- Risk sharing: the Bank's appetite to participate in the counter-part's debt capacity is informed by when, and to what extent, the Bank will share risk with other banks.

The Wholesale portfolio has remained resilient in the face of the market downturn in the year under review, as can be seen in the graph on wholesale credit quality below. The majority of negative credit migrations were experienced in specific subsectors, such as property development and transportation, while most of the exposures in other industries showed resilience against the downturn. The strategy of rebalancing the Wholesale portfolio to more investment-grade lending has also already started paying off. Lending appears likely to remain tepid as corporates maintain high levels of cash and investment spending remains subdued.

Rating distribution – FRB Corporate book



In line with the Group's objective to rebalance its portfolio, it is increasing its exposure to large corporate credit. The existing in-force book, which has been originated by the investment bank, has historically performed well, but, due to the natural run-off profile of these exposures, capacity is available to write more high-quality credit. To support this initiative, the Group has created a corporate and investment banking unit, with an integrated client coverage team and has adjusted certain prudential limits in investment-grade and defensive counters.

Market risk

The financial performance of the bank and its ability to realise positions at a favourable return is dependent on market conditions

The South African market is characterised by a low discretionary savings rate. However, there is a higher degree of contractual savings, which are captured by institutions such as pension funds, provident funds and asset management providers.

and the environment in which it operates. The Bank's business in the market risk space is, in the main, affected by the level of underlying market activity and client flows, volatility of underlying markets, and the absence or presence of clearly trending markets.

FirstRand's market risk sits predominantly within the trading activities of RMB with the bulk resulting from activities in equity and fixed income markets in South Africa. As can be seen from the chart showing the daily regulatory trading book earnings vs. 1 day 99% VaR (page 176), the level of risk decreased towards the end of the financial year, mainly reflecting market conditions characterised by decreasing market volatility and reduced opportunities.

Going forward it is expected that RMB's increased focus on corporate client acquisition will result in increased client flows for the trading units, and therefore increased capacity for taking risk.

Equity investment risk

The majority of the Group's investment risk is represented by RMB's private equity portfolio. All private equity investments use an on balance sheet model, as opposed to a third party standalone fund model. This provides RMB with optimal flexibility in terms of timing of investments and realisations.

RMB takes sufficient stakes to allow it to exert a meaningful influence in medium sized counters, and it follows a partnership model. There are a number of different private equity teams, which concentrate on separate sectors and investment styles. This is reflected in the vintage profile of the portfolio and provides investment and realisation flexibility through the cycle and a level of protection from earnings volatility.

The portfolio is equity accounted, which results in lower volatility in the portfolio's earnings stream. The appetite for investment risk has remained constant. There is still significant unrealised value in the private equity portfolios (R1.4 billion at 30 June 2010).

Other sources of equity investment risk include listed equity stakes totalling R1.38 billion at 30 June 2010, and the three large investments acquired by RMB in 2008, following the default of Dealstream (a clearing client), which were written down in the current year, resulting in a significant derisking of this portfolio – the value in use at 30 June 2010 amounted to R320 million (2009: R1 019 million).

Funding and liquidity risk

The South African market is characterised by a low discretionary savings rate. However, there is a higher degree of contractual savings, which are captured by institutions such as pension funds, provident funds and asset management providers. A portion of this translates into wholesale funding for banks, which is more expensive and has a shorter term than traditional retail deposits. All major banks in South Africa are thus reliant on a significant portion of short term, expensive institutional deposits to fund longer dated assets such as mortgages. In other words, liquidity risk in the South African banking system is structurally higher than in most other markets. This situation is to some extent mitigated by the following factors (which helped the country to weather the global financial crisis without any disruptions to the interbank market):

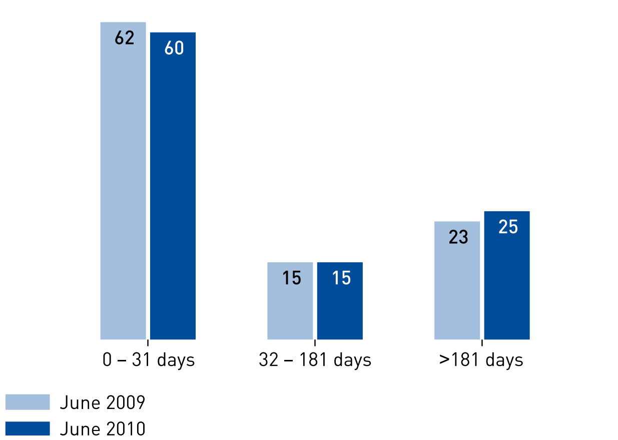
- The so-called "closed rand" system, whereby all rand transactions (whether physical or derivative) have to be cleared and settled in South Africa. FirstRand Bank is one of the major clearing/settlement agents. The payments and settlement system in South Africa is currently only open to registered banks in South Africa.
- The institutional funding base is fairly stable as it is, in effect, recycled retail savings.
- The country has a prudential exchange control framework in place.
- South Africa has a low dependence on foreign currency funding (i.e. low rollover risk).

Against this backdrop, FirstRand's objective is to fund its activities in a sustainable, efficient, diversified and flexible manner, underpinned by strong counterparty relationships. The Group has a strong and stable deposit franchise, which spans the consumer, commercial and corporate segments. Institutional funding represents a third of the Group's total funding. This reliance on funding from the institutional market remains a risk concentration that is actively managed through the holding of appropriate liquidity buffers and continued focus on lengthening the term profile of this funding. The Group conducts scenario and stress simulations to ensure it has a prudent liquidity buffer over and above the minimum statutory requirement. The term structure of liabilities is driven by the funding profile requirements of the Bank, and any associated interest rate risk that arises is managed as part of the banking book's net interest rate profile (discussed in the next section).

Over the past year the Bank continued to lengthen its funding profile (as shown in the chart below), and further increased liquidity buffers.

FirstRand Bank funding profile

(%)



Increased issuance by Government to fund the budget deficit and infrastructure investment places upward pressure on yields, however this has been tempered by the global shift in asset allocation to emerging markets. Liquidity premiums remain at levels higher than previous years but have significantly retraced from their peaks. Where the term is less than one year premiums have moderated as banks favour longer term funding and asset growth is expected to remain subdued.

Interest rate risk in the banking book

Interest rate risk in the banking book is made up of two components, namely the endowment effect and interest rate mismatch.

The endowment effect results from a large proportion of "endowment" liabilities (including sticky deposits and equity) that fund variable-rate assets (e.g. Prime-linked mortgages), therefore bank earnings are vulnerable to declining interest rates. The endowment effect currently accounts for approximately 80% of the interest rate risk in the banking book. The negative endowment effect had a severe impact on NII in the year to June 2010, as rates were on average 3.9 percentage points lower than in the comparative period.

The endowment risk is managed as part of the holistic balance sheet management approach, in conjunction with other factors such as credit impairments and balance sheet growth, and in accordance with the Group's house view. If required, the interest rate profile is adjusted through hedging strategies. From an interest rate mismatch perspective, the Bank also hedges its residual fixed-rate position, which has been adjusted for optionality (e.g. prepayments).

Non financial risks

Operational risk

Operational risk relates to the risk of loss arising from shortcomings or failures in internal processes, people or systems, or from external events.

Banks have to be able to process large numbers of simple and complex transactions on a daily basis. The ability to process these transactions effectively could be impacted by failure of IT systems, internal or external fraud, large litigation, business disruption or process failure. Disruption in power supply, complex systems and interconnectivity with other financial institutions and exchanges increase the risk of operational failure.

Operational risk could also cause reputational damage, and therefore efforts to identify, manage and mitigate operational risk should be equally sensitive to reputational risk as well as the risk of financial loss.

The Group manages operational risk using group-wide control standards supported by commitment of senior management, independent oversight by ERM, active participation by deployed segment and divisional risk managers, and training of staff in a process of identifying, measuring, monitoring and reporting operational risk. In this process, the Group uses a variety of best-in-class approaches and tools in the assessment and management of operational risk. ERM, a risk management function independent of the revenue-producing units, is also responsible for developing and implementing the framework to manage operational risks, and provides regular reports of operational risk exposures to the board.

Given the ever changing and complex nature of its business and processes, the Group employs a dynamic approach to managing operational risk, and this approach results in almost continuous change or renewal. It is common practice, when implementing change of this nature, to proactively address less than optimal operational procedures with meaningful adjustments to risk management. The Board and management are not satisfied with the current level of operational losses, albeit in line with industry experience, and have therefore embarked on a consistent and disciplined approach of linking business processes to the operational risk and control environment.

Going forward the Group will execute on its stated strategy, leveraging off an existing platform of diverse revenue streams and strong operating franchises. In the process, management aims to rebalance the current portfolio to achieve an appropriate mix.

Risk arising from the changing regulatory environment

The Group is subject to extensive regulation in the environments where it operates. Most notably this includes the Banks Act 94 of 1990 (as amended), the Regulations thereto and the Basel II framework. In terms of the Basel II framework, the Bank is subject to Tier 1 and Tier 2 minimum capital requirements.

The Group continues to monitor developments, search for opportunities to engage with regulators, and assess the impact of regulatory changes on its business operations. Two of the most significant regulatory changes impacting the bank are discussed below.

Basel Committee on Banking Supervision proposals on capital and liquidity

The recent global financial crisis is expected to result in increased political and regulatory pressure on banking systems worldwide. Some of these pressures are likely to materialise in South Africa, particularly given its G20 membership. For example, the South African Reserve Bank ("SARB") is expected to implement the Basel Committee on Banking Supervision ("BCBS") proposals on capital and liquidity.

The impact of the proposed new requirements is expected to be especially significant from a liquidity perspective. Given the structural funding challenges in South Africa, banks would not be able to comply with the net stable funding ratio and liquidity coverage ratio as set out in the original December 2009 proposals. The revisions to the proposals outlined in July 2010 have gone some way in addressing banks' concerns, and the most significant change affecting the South African banking sector relates to the implementation of new liquidity requirements. The Liquid Coverage Ratio ("LCR") will be revised by September 2010 to specifically cater for jurisdictions such as South Africa, where there are not sufficient liquid assets to meet the standard. The implementation of the Net Stable Funding Ratio ("NSFR") has been postponed to 2018. Combined with changed assumptions for run-off rates on deposits, funding for residential mortgages and the treatment of interbank funding, FirstRand views these amendments positively, as they reduce the potential for market disruptions inherent in the original proposals.

Government and industry have agreed to set up a task team to investigate the structural funding issues in the South African banking system. The task team will consider issues relating to the lack of retail savings, the disintermediation of banks which resulted from the growth in money market funds, and the different regulatory treatment of banks and money market funds.

FirstRand participated in the quantitative impact study ("QIS") that the BCBS conducted to assess the impact of the new proposals on banks. Preliminary calculations carried out as part of this exercise show that if the current proposals are implemented there would be a reduction in both the Tier 1 and total capital adequacy ratios. However, FirstRand Bank and the Banking Group would remain well above the current regulatory minimum requirement. Although the new regulations and new regulatory minimum have not yet been finalised, FirstRand believes it will be adequately capitalised to meet the new requirements.

Exchange control reforms

Reforms to exchange control (which involve a shift to a system of prudential regulation) were recently announced, which are part of the National Treasury's ongoing exchange control modernisation policy. Whilst these reforms do not represent the abolition of exchange controls, they are extremely positive developments for South Africa as whole. They introduce greater flexibility and efficiency to foreign exchange transactions, and further strengthen international confidence in South Africa's financial system. This should facilitate, over time, increased foreign flows into and out of the domestic economy. Customers will also benefit as the administrative procedures previously carried out by the SARB will now be managed by Authorised Dealers such as FirstRand Bank (and its divisions FNB and RMB), which means that foreign exchange transactions can now be serviced directly by existing branch networks to a much greater degree.

The introduction of the new exchange control prudential limit, which allows banks to invest up to 25% of adjusted liabilities in foreign currency assets, created new growth opportunities (the Bank's current utilisation is approximately 4%). Increased utilisation of the prudential limit will be subject to the Bank's internal limits and risk appetite.

Conclusion

As a large financial services provider in South Africa, it is imperative that FirstRand establishes a risk and earnings profile that protects it from undesirable volatility in its financial results, which may adversely affect its reputation.

The Group operates in an environment which results in certain balance sheet concentrations, e.g. the reliance of the SA banking market on institutional funding and large/lumpy wholesale credit exposures. In response to these concentrations, the Group aims to safeguard its reputation, targets a credit rating of A-, and manages its balance sheet profile such that it is in line with its peer group.

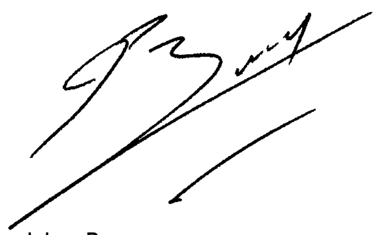
Going forward the Group will execute on its stated strategy, leveraging off an existing platform of diverse revenue streams and strong operating franchises. In the process, management aims to rebalance the current portfolio to achieve an appropriate mix between:

- retail and corporate assets;
- mass, consumer and wealth revenue streams within retail;
- client flows and secondary markets within corporate and investment banking;
- originating assets and liabilities; and
- South Africa and the rest of Africa.

FRANCHISE VALUE

Whilst effective management of risks incurred directly or indirectly is considered a key determinant of successful execution, certain external risk factors can impact on these objectives. The Group constantly monitors all of these risk factors and will adjust its strategy accordingly.

The macro environment going forward is likely to present challenges to topline growth for the Group. Banking earnings are particularly sensitive to domestic GDP growth and the South African economy is driven largely by consumer activity. Domestic households remain highly indebted and advances growth is therefore expected to lag economic activity. Corporate balance sheets continue to be robust, but investment levels remain muted, new employment sluggish, and this could constrain growth in the medium term.



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