Report by retiring CEO

PAUL HARRIS [RETIRING CEO]

INTRODUCTION

In 1931 Keynes famously wrote that "a sound banker is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional way along with his peers so that no-one can really blame him." Well the FirstRand Group does not always do things in a conventional way but has weathered a very tough cycle and a particularly challenging year, and is not ruined! In line with its peers, it has been impacted by the high levels of bad debts in the consumer lending books as expected at this point in the cycle. It has also been hurt by losses in its offshore trading portfolios – as expected given the massive volatility in those markets following the credit crisis. However, the Group is in great shape to capitalise on an improving environment.

FIRSTRAND'S UNIQUE CORPORATE CULTURE

Whilst the Group subscribes to sound banking practices there has always been a strong bias for innovation and entrepreneurialism both of which are deeply embedded in the corporate culture of FirstRand. The Group coined the phrase "greenfields" to describe its approach of growing new ventures from scratch. This approach has spawned some major businesses that have contributed significantly to the Group's performance over the years. The bigger ones are RMB Asset Management, RMB Private Bank, RMB Private Equity, Discovery and OUTsurance. The Group still focuses on "greenfields" and there are currently a number of new and fledgling businesses that are expected to be major contributors in the future.

Another characteristic that differentiates FirstRand is the relentless focus on maintaining and inculcating the unique corporate culture that has developed over many years. Senior management conducts workshops, almost on a monthly basis, aimed at embedding the culture. Under the new management team there will be changes in strategy but the essence of the corporate culture will remain. As GT Ferreira once said, "each successive CEO receives this jewel which they polish and pass on to the next person".

Central to the culture is that FirstRand is an employee-centric organisation that believes in empowering, rather than controlling people. The Group coined the phrase – "owner-manager" – to describe its culture. It means that the appropriate strategic framework is provided and then management is empowered to run their divisions with a minimum of bureaucratic interference.

THE GROUP COINED THE PHRASE – "OWNER-MANAGER" – TO DESCRIBE ITS CULTURE. IT MEANS THAT **THE APPROPRIATE STRATEGIC FRAMEWORK IS PROVIDED** AND THEN MANAGEMENT IS EMPOWERED TO RUN THEIR DIVISIONS WITH A MINIMUM OF BUREAUCRATIC INTERFERENCE.

The Group also remains committed to its multi-branding strategy, another point of differentiation, as it believes in creating champion brands in specific market segments. Alignment, cross sell and cost rationalisation remain important, however, separate brands are more powerful because customers identify with them more strongly. For example, despite FirstRand having a torrid time in the press, recently FNB was voted Number 1 Retail Banking brand in the Sunday Times survey of national brands and RMB swept the boards in the PwC peer group survey and The Dealmakers awards.

FirstRand has always emphasised the benefits of diversification derived from the portfolio of franchises. Therefore while they may not all fire at the same time, what is important is that on aggregate they do well, which has generally been the case. It is important that failure in some divisions, in any particular year, does not bring the house down.

Important to the Group's culture is to "tell it like it is" and consequently it is conservative in its financial reporting. The Group, does not "spin" to its shareholders, sometimes to its detriment. For example, FirstRand was the first bank to warn that performance would be hit hard by the financial crisis and at that time its view was considered controversial and overly bearish by some commentators and shareholders. For the Group however, the deteriorating macro environment came as no surprise, and over time this conservatism, or rather realism, has proved to be accurate and appropriate.

CONVENTIONAL WISDOM OF THE DAY

Looking back it is clear that one of the most difficult challenges facing a CEO is navigating the corporate ship through the conventional wisdom of the day. The investment themes and fads of the day often test managements' resolve and are constant distractions.

In the early days of FirstRand the conventional wisdom was that the branch network of commercial banks was a liability. It was all about internet banking and telephone banking. Branches were too costly. However banks eventually discovered that customers want all the channels, especially the branches. So the branch legacy became an asset, which in FNB's case is a particularly good asset.

The dot-com boom and outsourcing were also fads. Banks needed to have a dot-com strategy and outsource parts of the business. Those that didn't were considered "has-beens" with the favoured banks developing "convergent IT strategies", but the "dot-com bust" taught everyone that technology and the Internet are merely enablers and not the true drivers of sustainable growth in earnings and returns.

And then the big fad - that nearly tripped up the world's financial system – was the obsession with ROE. It turned out that the best way to improve ROE was to maximise leverage and reduce E. When the crash came it brought the financial system to its knees. Fortunately, Southern African banks showed some restraint and no South African bank ever risked "the house" as some of the foreign banks did. This crisis is the worst in living memory. It is a breach of the 100 year flood line. As it turned out, the Group had allocated too much capital to overseas investment and trading and given the unexpected severity of the crisis, lost even more than had been allocated. However, FirstRand was not beaten by the opposition. All the international banks that were also in those activities were swept away by the market crash. Many of them bet, and lost, the "house". FirstRand didn't bet the house, benefited from its diverse portfolio of businesses and lives to fight another day.

The conventional wisdom from about 2004 to 2007 was that banks were judged by market share of advances. Share prices responded after the publication of monthly BA returns. As it turned out the worst vintages for bad debts in this cycle were 2006 to 2008. FirstRand did tighten credit criteria towards the end of the cycle but still suffered from those same vintages, along with its local peers.

Added to this has been the pressure from politicians and the press regarding lending. First it was to provide more debt to the public under the guise of providing widespread "access to finance". Then there was the "accusation" that banks lent recklessly and now the pressure is again to lend more because banks are accused of "strangling the economy".

John Kenneth Galbraith was correct when he said: "The enemy of conventional wisdom is not ideas, but the march of events."

The $64 question of course is how the conventional wisdoms of today will turn out. Are the things that companies are doing today achievable and sustainable? FirstRand management and its board make decisions that are believed to be in the best interests of the company even if they fly in the face of conventional wisdom. The Group encourages its people to question conventional thinking and be innovative. Also, while it is difficult to ignore short term share price performance, it is important to have the fortitude and discipline to ignore the pressure to do things that intuitively don't make sense.

LESSONS LEARNT FROM THE GLOBAL FINANCIAL CRISIS

A big lesson that was learnt from the crisis is that in good times, when making money is easy, things tend to get loose. As Laurie Dippenaar once said "if you don't have a burglary you stop switching on the alarm and stop locking doors". When the cycle turns, bad and sloppy practices are exposed. This is the time to cleanse the system, improve risk management and capital allocation processes and eliminate the fat. This is what has been the Group's strong focus over the past year.

Another lesson is that minimum capital requirements and provisioning proved to be counter cyclical. FirstRand's bad debt provisions, because of the mechanistic manner in which they are calculated, were the lowest at the top of the cycle and highest at the bottom of the cycle. It should have been the other way round. Hopefully the accounting profession will come to its senses and find ways to allow banks to tuck away reserves for rainy days.

The Group recognises the value of its client franchises and operating brands because they provide sustainable earnings. However, the Group will not ignore the substantial but more volatile profit opportunities from investments and trading, focused in areas in which it has established client franchises. Trading and investing is part of FirstRand's DNA and has been a major contributor to the NAV. The Group will continue to pursue these activities but within the more robust process of determining risk appetite and capital allocation.

The Group strives to have a balance in its team. A successful soccer team has good forwards, sweepers, backs and a goalie. If too many goals are let in, then strengthen the defense. However, scoring goals requires good strikers. A match cannot be won with 11 goalies and nor with 11 strikers. FirstRand has improved its defensive line but not at the expense of its forward line.

FUTURE UNDER A NEW CHAIRMAN AND CEO

The new leadership team has put in the hard yards in realigning the strategy post the crisis and there is no doubt that shareholders will reap the rewards.

The Group's philosophy on management succession is that it is like a relay race. The incumbent runs alongside the person taking the baton, hands it over and then continues to run alongside the new runner until he is in his stride. It must be a seamless process and this is what GT Ferreira and I have done in handing over as Chairman and CEO respectively to Laurie Dippenaar and Sizwe Nxasana.

The Group is extremely fortunate to have an excellent board that works very well together under the chairmanship of Laurie Dippenaar. He brings a wealth of experience and is a master at focusing on the real business issues thereby bringing the best out of people.

Sizwe Nxasana is a highly respected leader both internally and externally with an empowering but firm style that is so appropriate at FirstRand. Under him he has a talented and experienced leadership corps that is settled and has a great team spirit. Johan Burger is the consummate banker, respected by all. The franchise CEOs Michael Jordaan, Alan Pullinger, Brian Riley, Nicolaas Kruger and Willem Roos are all on top of their games.

FirstRand has created an environment that breeds good leaders and there are lots of them coming through. The Group's unique corporate culture has been deeply bedded down and it is apparent that even if one considers this to be a "soft issue" when doing business, it has been central to FirstRand's success. Whilst it is appropriate that the new management team stamp their own character and personality on the Group, the essence of the values and corporate culture will prevail.

In conclusion, may I thank the two Chairmen I have served under, GT Ferreira and Laurie Dippenaar, and the board for its support and guidance. Finally, I wish to pay tribute to the fantastic leadership and staff of the greater FirstRand Group for their invaluable contribution to making FirstRand such a special company.

PK Harris

Chief executive officer
(retiring)