FIRSTRAND
Banking Group

BASEL II PILLAR III DISCLOSURE

FirstRand Bank Holdings Limited ("FRBH")
for the year ended 30 June 2008

INTRODUCTION

This report on Basel 2 Pillar III disclosure includes the disclosure in terms of the Bank Act 1990 (Act No 94 of 1990), Section 43 Public disclosure required on a semi annual basis, for FirstRand Bank Holdings Limited ("FRBH"). FRBH, one of FirstRand Limited's (or referred to as "the Group") major subsidiaries, which is the regulated entity and includes all regulated bank subsidiaries and other entities.

The purpose of this document is to disclose the risk governance, risk management framework, risk reward appetite, capital adequacy requirements, 2008 achievements, focus areas for 2009, as well as its risk exposures and the policies and procedures to manage and measure the financial and operational risks of FRBH.

The Risk Management report included in the Annual report of FirstRand, reviews in detail FRBH's processes and procedures relating to the identification, management, measurement and reporting for the different risk types and complies with the risk disclosure requirements of Basel II Pillar III and IFRS 7 Financial Instruments: Disclosure ("IFRS 7").

FRBH subscribes to the business philosophy and risk management strategy of the Group. The Group defines risk as any factor which could prevent the Group from achieving its desired business objectives or result in adverse outcomes, including reputational damage. In line with its business philosophy, the Group recognises that effective risk management and governance is essential to the generation of sustainable profits, to safeguard its reputation, comply with regulations, create a competitive edge and achieve an optimal risk reward profile.

The Group's strategy and its day to day operating activities are underpinned by its risk management framework, which is designed to ensure that all risks across all subsidiaries are appropriately managed within the defined and approved risk reward appetite framework. The board is responsible for oversight of the business performance and risk management activities. The Group's Enterprise Risk Management ("ERM") function has independent oversight and is responsible for driving improvements in risk management. FRBH operates in a specific market that presents particular financial and non financial risks and opportunities, and risk management in FRBH is therefore governed by its own framework.

The major risk types faced by FRBH include strategic and business risk, credit risk, market risk, liquidity risk, interest rate risk in the banking book, operational risk and compliance risk. For each, the report outlines the definition, governance structures and processes, measurement, management/mitigation and an assessment of the risk.

A brief overview of the most important risks is presented below. For more detail on these as well as information on the types not covered in the introduction, please refer to the main body of the report.

Credit risk

Credit risk constitutes the most significant risk that FRBH is exposed to and its contribution to the total regulatory and economic capital requirement of FRBH is the highest of all risk types. Credit risk is managed within FRBH's risk reward appetite to ensure appropriate capital levels are maintained and that risk is priced for on an individual and portfolio basis.

Credit risk is managed through comprehensive policies and processes that ensure adequate identification, measurement, monitoring, control and reporting of credit risk exposure. The objective is to ensure a sound credit risk management environment with appropriate credit granting, administration, measurement and monitoring through the implementation of adequate risk management controls.

During the year under review FirstRand Bank Limited ("FRB" or "the Bank") received formal approval from the South African Reserve Bank ("SARB") to use the Basel II Advanced Internal Ratings Based ("AIRB") approach in its calculations of credit risk regulatory capital. The remaining FRBH subsidiaries are using the Standardised Approach for Basel II.

In its transition to the AIRB approach, the Group revised its risk management functions, creating a Group Credit Risk Control function within the Group's ERM division. This function is responsible for credit risk oversight. The Credit Pillar in Balance Sheet Management ("BSM") focuses on credit portfolio management (refer to the CFO report in FirstRand's annual report for more detail on the Group's balance sheet management approach).

At the end of June 2008, FRBH's advances totalled R456 billion (2007: R396 billion), of which R207 billion (45%) was derived from lending activities within FNB, and R130 billion (29%) from the Group's investment banking activities within RMB. The advances in the asset finance operations of WesBank totalled R99 billion, which is 22% of FRBH's total advances.

High interest rates and inflation have resulted in pressure on consumers' ability to repay debt. Affordability levels have been negatively influenced by these factors, resulting in further increases in bad debts and lower advances growth. The pressure on the consumer is expected to continue for some time, resulting in further increases in arrears, non performing loans and impairment charges for bad debts. The corporate environment is, however, showing resilience in current market conditions, while there is increased pressure on smaller businesses in the small and medium enterprise ("SME") market due to the economic environment. FRBH manages its credit portfolio actively to minimise the impact of the deteriorating macro economic environment. The focus is on keeping origination strategies in line with risk appetite and implementing credit portfolio hedges where possible. Credit impairment levels are also carefully considered to ensure adequate provisioning levels.

During the year under review, non performing loans increased to 2.9% (2007: 1.5%) while the income statement impairment charge on average gross advances increased to 1.28% (2007: 0.83%) before taking into account income from credit protection strategies. After taking this into account, the income statement impairment on average gross advances was 1.19% (2007: 0.79%).

Market risk

RMB has approval from the SARB to measure regulatory market risk capital for the local trading book under the internal model approach, as stipulated in the Basel II Accord. For all international legal entities, the Standardised Approach is used to calculate regulatory market risk capital. For economic capital measurement, the internal model approach based on distressed expected tail loss ("ETL"), is used for all legal entities.

In addition to the distressed ETL and Value at Risk ("VaR") methodologies, FRBH supplements its measurement techniques with defined stress tests and scenario analyses. The calibration of the stress tests are reviewed from time to time, which ensures that the tests are indicative of possible market moves under distressed market conditions and provide additional insight into possible outcomes under stressed market conditions.

The aggregate market risk VaR exposure for the trading book exposure increased from R265.5 million in 2007 to R304.7 million at 30 June 2008. The VaR risk measure estimates the potential loss over a 10 day holding period at a 99% confidence level.

Liquidity risk

During the year under review FRBH successfully complied with Basel II principles relating to liquidity risk and funding management. FRBH has a diversified funding mix by term, source and product to protect the Group against concentration risk and to mitigate possible market disruptions. To protect the balance sheet against a stress event, liquidity buffers (in excess of the statutory requirements) were accumulated and maintained over the past financial year. FRBH continues to maintain these buffers and actively manages and monitors these portfolios. Enhancements have been made to the measurement and analytical processes, applying best practice principles to high level international standards. Events in the global banking sector and recent international bank failures were examined to test the conservativeness of FRBH's liquidity risk assumptions and analyses. Processes have also been expanded to the extent that the risks arising from the off balance sheet activities are fully consolidated with the liquidity risk management, measurement and stress testing processes and are managed conservatively from a liquidity risk point of view.

Interest rate risk in the banking book

In line with the objective to protect and enhance FRBH's balance sheet and income statement, interest rate risk in the banking book is managed from an earnings approach over a specified horizon. Changes to economic value are also monitored and managed within defined risk tolerance levels. The net interest rate profile is adjusted by changing the profile of liquid assets or through transactions in derivative instruments. The desired profile is based on FRBH's interest rate outlook with reference to other risk factors impacting FRBH's balance sheet, most notably credit risk.

The natural position of the FRBH banking book remains asset sensitive (positively gapped), since interest earning assets reprice sooner than interest paying liabilities, making the projected net interest income ("NII") vulnerable to a drop in interest rates. Projected 12 month NII would decline by 11.39% for a 200bps instantaneous, parallel downward shift in the yield curve (assuming no management intervention to mitigate the impact of the changes in the level of interest rates). The banking book was positioned to benefit from the 250bps repo rate increase over the period.

Operational risk

FRBH obtained approval from the SARB to use the Basel II Standardised Approach ("TSA") for calculating operational risk capital for regulatory purposes from 1 January 2008. A more sophisticated operational risk quantification and capital calculation methodology has been developed and is being implemented using the Advanced Measurement Approach ("AMA") for operational risk in accordance with Basel II and SARB requirements. An application to use AMA on a partial use basis for the South African operations has been submitted to the SARB during the first quarter of 2008.

Independent monitoring of operational risk occurs through a number of functions within the Group's ERM division, including business continuity management, legal, information risk services, forensic services and operational risk governance.

PHILOSOPHY

The Group's Business Philosophy embodies sustainable business practices and good corporate governance. The values espoused in this philosophy include the importance of being a good corporate citizen, integrity, individual empowerment and personal accountability. In support of accountability all employees of the Group subscribe to the code of ethics which forms part of the Group's Board Charter. Adherence to the code of ethics is a strategic business imperative and a source of competitive advantage.

Management recognises the importance of good communication between non executive directors, executive management, and senior management across the Group to ensure compliance with banking, insurance and other regulations applicable to FRBH and communication with external stakeholders.

In line with the business philosophy, the Group recognises that effective risk management and governance is essential to generate sustainable profits, safeguard its reputation, comply with regulations, create a competitive edge and achieve an optimal risk reward profile.

RISK GOVERNANCE

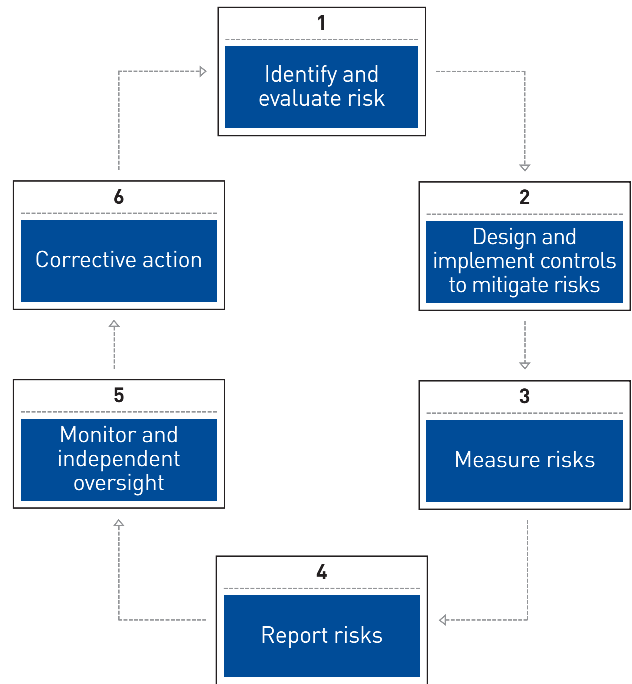
The ERM function of the Group is responsible for the independent oversight and discipline required to continuously drive improvement of the Group's risk management capabilities in a challenging and ever changing operating environment. The objective of the risk management programme is not only to protect, but also to add enterprise value to the Group's strategy, people, processes, technology and knowledge. Risk management

is embedded in the Group strategy and is integrated in its day to day operating activities. Direction and oversight of risk management occur at the top of the organisation.

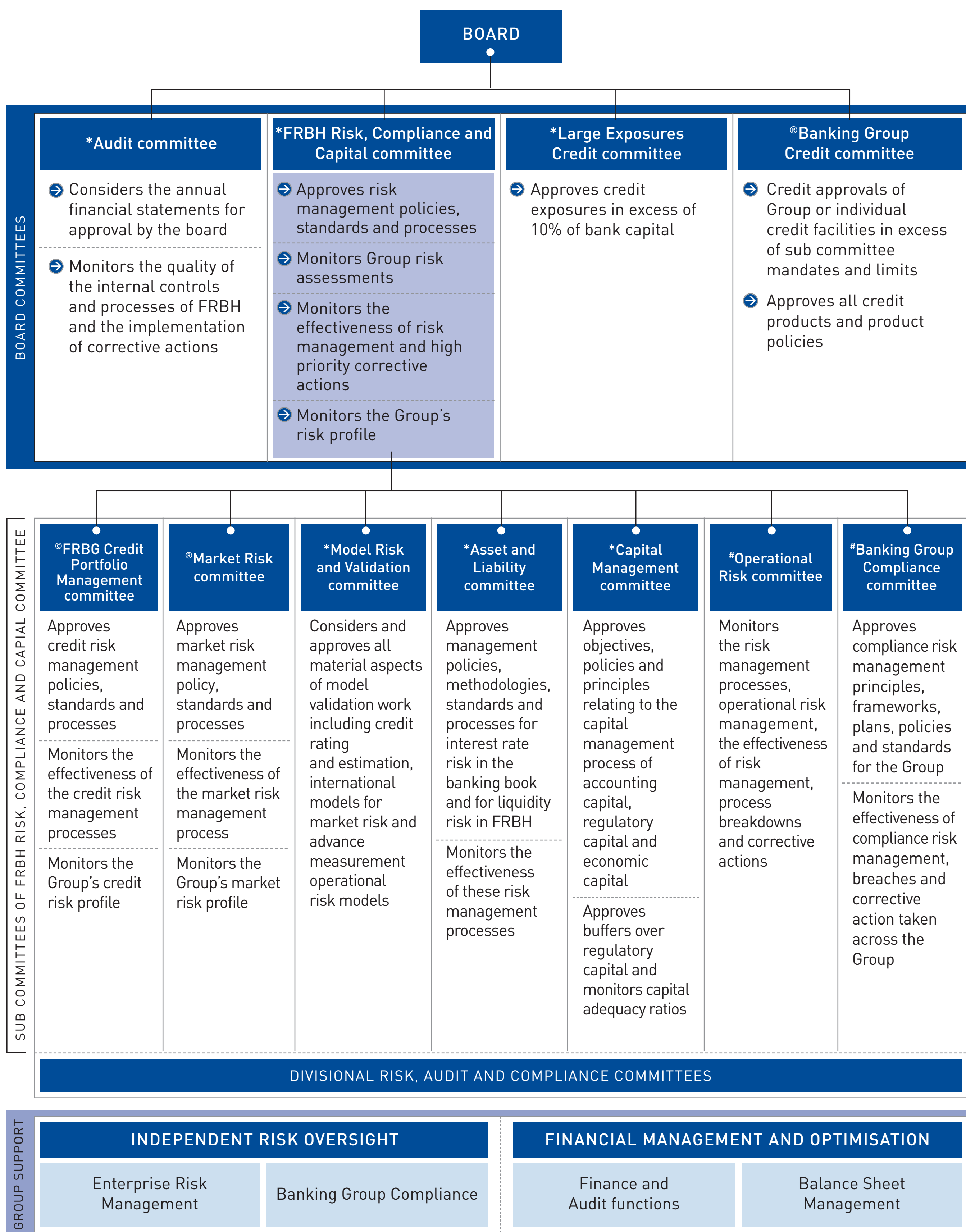
The Board of FirstRand through the FirstRand Audit, Risk and Compliance committee, in line with its Board Charter, is responsible for oversight of the business performance and risk management activities of the Group. The board is supported in these tasks by the boards of the major subsidiaries, board committees and their sub committees; independent and deployed risk management functions as well as internal auditors and compliance. These committees and functions monitor the Group's risks and provide assurance that risk management processes operate effectively throughout the organisation.

The FirstRand Audit, Risk and Compliance committee reviews the findings and reports of the subsidiary boards (including FRBH) and Audit, Risk and Compliance committees. The subsidiary Audit, Risk and Compliance committees review the findings and reports of its sub committees and the independent risk management functions. The independent risk management functions are responsible to ensure that appropriate, effective and efficient business performance and risk management processes, controls and compliance are in place and integrated in the day to day activities.

FRBH adopts the following approach to risk management:



FRBH's governance structure is illustrated in the diagram below:



* Denotes chairperson is a non executive board member.
# Denotes chairperson is a non executive non board member.
© Denotes chairperson is an executive board member.
® Denotes chairperson is executive management. The Banking Group Credit Committee has non executive board representation.

FRBH's risk management governance structures cascade down from the board to the subsidiaries and main divisions and their business units. Divisional and risk sub committees oversee the risk management processes of FRBH.

The ERM function provides independent risk oversight and the FRBH Compliance ("BGC") function provides independent compliance oversight. These independent oversight functions report directly to the CEO and are responsible for coordinating and monitoring the risk governance functions and oversight of FRBH, as well as establishing and driving implementation of risk management standards, methodology and processes.

BSM is responsible for balance sheet optimisation and portfolio management of credit risk, interest rate risk, liquidity risk and capital and funding requirements. The Finance and Audit function manages financial reporting, tax risk and legal risk. BSM and the Financial function report to the CFO.

Deployed risk managers in the various divisions and business units are responsible for supporting the implementation of the Risk Management Framework at business unit level. All the business units report on the effectiveness of their risk management processes to their relevant risk management functions and risk committees via a bottom up process. The risk reporting process is designed to provide an appropriate representation of the risk profile. The risk reports for each of the main business divisions are submitted quarterly for review by the FRBH Risk, Compliance and Capital committee ("RCC committee"). The FRBH RCC committee reports on a quarterly basis to the board.

FRBH has aligned the responsibilities and tasks of the various board committees and sub committees with the recommendations of Basel II.

All FRBH's subsidiaries, divisions and major business units have their own risk and audit committees. All audit committees and the FRBH RCC committee have non executive representation. FRBH RCC committee and all audit committee meetings are attended by representatives from the external and internal auditors and the independent risk management functions. The independent and deployed risk managers attend all risk committees as appropriate.

These mechanisms ensure the integrity of reports presented to the board committees through external and independent oversight observers at all levels of governance.

RISK MANAGEMENT FRAMEWORK

FRBH has adopted its own Risk Management Framework. This framework, a policy of the board, governs the risk management process and provides a matrix of business, strategic, financial and non financial risks that FRBH will monitor. In terms of this Risk Management Framework, risk management is vested as an integral part of management's functions at all levels of FRBH and includes the management of governance, strategy, business performance, competitiveness, human resources, external factors, processes, information technology, and operational, financial and tax risk.

The risk management framework is based on the experience that:

- top performing organisations of long standing excel at good governance, strategic and competitive positioning, the management of key risks and the implementation of world class processes and systems;
- entrepreneurs add value to an organisation through innovation, management of risk and the identification of profitable opportunities which will yield superior and sustainable returns and minimise negative impacts on all stakeholders;
- successful businesses are those that manage their business performance and risks better than their competitors; and
- a business has to get many things right to be successful, whilst a single factor could cause it to fail.

The FRBH risk management framework aims to incorporate risk management processes into the overall management process. Management drives strategy, products, services and processes to generate profits and growth in a sustainable manner. The risk management processes support management by providing checks and balances to ensure sustainability, performance, the achievement of desired objectives and avoidance of adverse outcomes and reputational damage through risk quantification, qualitative assessments, monitoring and the initiation of corrective measures.

The risk management framework comply with statutory and regulatory requirements and are in line with King II and the Committee of Sponsoring Organisations (COSO) requirements. The framework has been reviewed and benchmarked against international best practice and have proved to be thorough, effective and robust in fully supporting enterprise risk management principles.

RISK REWARD APPETITE

FRBH aims to maintain a mix of businesses, business activities, income streams and risk exposures which will ensure that the group will not pierce minimum regulatory capital levels under conditions of severe stress. In addition FRBH aims to maintain its desired credit rating and counterparty status. This is achieved by means of approved strategic and business plans and budgets, risk quantification and risk and capital management processes in accordance with board policies.

Not only does the board aim to preserve capital by means of the aforementioned processes, but also to limit earnings volatility within acceptable levels under all economic and market conditions to avoid loss of confidence or adverse reputational impacts.

Establishing risk appetite and finding an adequate balance between risk and reward is a dynamic process that is built on a blend of qualitative and quantitative, principles, processes and guidelines to set acceptable thresholds for risk appetite.

The principles include, but are not limited to the following:

- the balance sheet of FRB and FRBH must not be excessively geared (economic risk should be backed with core Tier 1 capital);

- sources of income must be widely diversified across business entities, products, market segments, investments, financial and commodity markets and regions;
- off balance sheet exposures should be limited relative to own capital and funding base;
- risk transfer should be about true risk transfer and not accounting/regulatory arbitrage;
- the potential impact of severe downturn and stress conditions must be identified, measured, quantified, understood and contained in accordance with capital preservation and earnings volatility parameters;
- concentration in risky asset classes must be avoided;
- sources of funding must be diversified; and
- sufficient buffers must be held for capital and liquidity purposes.

PROTECTION OF FRBH'S REPUTATION

Safeguarding FRBH's reputation is of paramount importance to its continued prosperity and is the responsibility of every staff member. Reputational risks can arise from environmental, social and governance issues or as a consequence of financial or operational risk events. FRBH's good reputation depends on the way in which it conducts business and protects its reputation by managing and controlling risks incurred in the course of business. This means avoiding large concentrations or exposures and limiting potential stress losses from credit, market, liquidity and operational risk, and taking account of reputational risk to its business.

RISK CATEGORIES

The financial and operational risks for FRBH are discussed in this report. Financial risks include credit risk, market risk, liquidity risk, and interest rate risk. The key non financial and business risks and opportunities for FRBH are identified and discussed in the operational report included in FirstRand's annual report. The non financial business risks and opportunities include issues such as reputation, regulation, transformation, customer relationships and the impact of HIV/AIDS on the customer base. Managing sustainability and reputational risk is a key component of the risk governance process at FRBH. The principal risks to which FRBH is exposed and which it manages are defined as follows:

Strategic and business risk – Strategic risk is the risk to current or prospective earnings and capital, arising from adverse business decisions or the improper implementation of decisions. Business risk describes the risk FRBH assumes due to potential changes in general business conditions, such as FRBH's market environment, client behaviour and technological progress. This can affect FRBH's earnings if it fails to adjust quickly or respond to changes in the business environment.

Credit risk – The risk of loss due to non performance of a counterparty in respect of any financial or performance obligation due to deterioration in the financial status of the counterparty.

Counterparty credit risk – Counterparty credit risk is defined as the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.

Market risk – The risk of revaluation of any financial instrument as a consequence of adverse changes in the market prices or rates. It exists in all trading, banking and investment portfolios. For the purpose of these financial statements market risk is considered to be fully contained within the trading portfolios.

Liquidity risk – The risk that the bank will not meet all payment obligations as liabilities fall due. It also represents the risk associated with not being able to realise assets to meet depositor repayment obligations in a stress scenario.

Interest rate risk in the banking book – Interest rate risk in the banking book is defined as the sensitivity of the balance sheet and income statement to unexpected, adverse movements in interest rates and can be an important source of profitability and shareholder value. Excessive interest rate risk could potentially pose a significant threat to a bank's earnings and capital base, therefore, effective risk management that maintains the risk within prudent levels is essential to the safety and soundness of banks.

Operational risk – Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk but excludes strategic, business and reputational risk.

Compliance risk – Compliance risk is defined as the risk of legal or regulatory sanction, material loss or loss of reputation suffered by a bank as a result of its failure to comply with laws, regulations, rules, related self regulatory organization standards and codes of conduct applicable to its banking activities.

CAPITAL MANAGEMENT

Management aims to produce solid returns to the Group's shareholders while maintaining sound capital ratios and a strong credit rating – all against the backdrop of an efficient capital structure with limited excesses.

The implementation of Basel II by FRBH in January 2008 has had little impact on the Bank's capital ratios. Under Basel II banks are expected to hold capital commensurate with the underlying risks assumed, with focus on:

- Pillar 1 – minimum capital requirement;
- Pillar 2 – supervisory review; and
- Pillar 3 – market discipline.

Both FRBH and FRB are well capitalised and within the targeted range for core equity and total capital adequacy. Despite the deteriorating credit conditions and the pro-cyclicality of capital introduced by Basel II, FRBH and FRB exceed the targeted minimum levels. In the next financial year demand for capital is likely to decline as asset growth, which has already started to slow, is expected to decline further and de-risking has taken place. FRBH has set aside capital for international expansion

initiatives, but will only allocate capital to these initiatives if they meet or exceed targeted hurdle rates.

During the year, FRB issued R1 billion of upper Tier 2 instruments and R1.5 billion of lower Tier 2 instruments. Depending on market conditions, FRB will continue to issue various capital instruments to further enhance and optimise its capital base.

	AT JUNE	
	2008	2007
Capital adequacy		
Capital adequacy ratio:		
FRBH	13.8	13.6
	Basel II	Basel I
Breakdown of capital		
Core equity (%)	73.7	77.2
Non cumulative non redeemable preference shares (%)	6.4	7.5
Debt instruments (%)	19.9	15.3
	100.0	100.0

Dividends

The total capital plan includes dividend policies, which are set in order to ensure sustainable dividend cover. Dividends paid are impacted by the following: sustainable dividend cover based on sustainable normalised earnings, after taking into account volatile earnings brought on by fair value accounting, anticipated earnings yield on capital employed, organic growth requirements and a safety margin for unexpected fluctuations in business plans.

Capital supply and demand

Capital serves as a foundation for a bank's future growth and acts as a buffer against unexpected losses.

The most optimal level of capital is achieved after taking into account business units' organic growth requirements, future business plans – provided financial targets are met – as well as expectations of investors, considerations of rating agencies, and targeted capital ratios. In addition, capital planning ensures that the total capital adequacy and Tier 1 ratios remain within the approved range during different economic and business cycles. The targeted and actual Total capital adequacy ratios are set out on page 10.

The focus remains on core capital, or normalised net asset value, which it believes is the core of measuring strength, performance and capital requirements. Total capital in the broader sense is further enhanced with the issuance of mezzanine debt capital such as preference shares and subordinated debt, while the Basel II environment allows for the use of hybrid and other innovative instruments.

The approved capital plan for FRBH is reviewed as part of its Internal Capital Adequacy Assessment Process ("ICAAP") and incorporates the expected capital utilisation, capital needs, planned issuance of capital instruments, appropriation of profits and dividend payments, desired level of capital (inclusive of a buffer), international expansion and general contingency planning for dealing with divergences, unexpected events and stress scenarios. It is concluded that FRBH is appropriately capitalised under a range of normal and severe scenarios and stress events.

The year under review

Credit growth has slowed offering some respite after a sustained period of intensive capital consumption; while the de-risking of FRBH's international businesses resulted in a lower capital requirement. Given the deterioration in the credit environment over the past 12 months, FRBH remains vigilant to the effects of pro-cyclicality introduced by Basel II and continues to focus on the level of core equity.

Management has driven a number of capital initiatives during year under review to improve FRB's strong capital position, and to ensure that FRBH's sound Tier 1 and Total capital adequacy ratios are maintained.

- In August 2007, FRB concluded Fresco II. This partially funded synthetic securitisation of a portfolio of South African and international corporate credit exposures, relieved R700 million of regulatory capital.
- The inaugural issue of Upper Tier 2 instruments
  - → On 22 April 2008, R628 million fixed rate bonds were issued with no maturity date.
  - → On 22 April 2008, R440 million variable rate bonds were issued with no maturity date.
- The following subordinated bonds (Lower Tier 2) were issued
  - → On 5 November 2007, R1 billion variable rate bonds were issued with a maturity date of 5 November 2017.
  - → On 5 December 2007, R300 million variable rate bonds were issued with a maturity date of 5 December 2017.
  - → On 10 December 2007, R200 million variable rate bonds were issued with a maturity date of 10 June 2021.

Basel II

FRBH implemented the International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version (June 2006), referred to as Basel II, at the start of January 2008. The framework aims to align regulatory capital requirements with the Bank's underlying risk profile and risk management processes. Under Basel II, banks are expected to hold capital commensurate with these risks assumed, with focus on

- Pillar 1 – minimum capital requirement
- Pillar 2 – supervisory review
- Pillar 3 – market discipline

Pillar 1

FRB has received approval from the SARB to use the AIRB approach for credit risk and the Standardised Approach for operational risk under Basel II. An internal model, as approved by the SARB, is used for market risk. FRB has applied for the

AMA for operational risk with targeted implementation during 2009, subject to regulatory approval.

TSA for calculating operational risk is used in the other regulated bank subsidiaries.

Pillar 2

FRBH has also finalised its ICAAP as part of Pillar 2. In Pillar 2, risks are identified and risk management assessed from a wider perspective to supplement the capital requirements calculated within the scope of Pillar 1. The ICAAP framework was submitted to the SARB in June 2008, and has been approved by the FRBH RCC committee. Going forward, the ICAAP will be subject to development and annual review.

The stress testing performed as part of the ICAAP estimates the impact of adverse events and formulates the management action required in response to these stress scenarios. The impact of four different economic scenarios – as well as four bespoke scenarios – on the level of earnings and risk weighted assets have been reviewed. FRBH remains well capitalised given the range of normal and severe scenarios and stress events.

Capital adequacy ratios

The registered banks in FRBH must comply with the SARB regulations and those of their home regulators. Capital adequacy is measured via three risk based ratios: Core Tier 1 capital, Tier 1 capital, and Total capital.

The Banks Act requires FRBH to maintain a minimum level of capital based on risk weighted assets. These minimum requirements are a Tier 1 capital ratio of 7.0% and a Total capital ratio of 9.5% (excluding the bank specific (Pillar 2b) add on). FRBH has always held Tier 1 capital and Total capital well in excess of these required ratios.

Composition of regulatory capital

The next table shows the composition of regulatory capital for FRBH at the end of June 2008.

R MILLION	FRBH
Tier 1	
Ordinary share capital and share premium	5 236
Minority interest	1 771
Non redeemable non cumulative preference shares	3 100
Reserves	33 748
Less: Total impairments	(2 289)
Excess of expected loss over allowable provisions (50%)	(379)
First loss credit enhancements in respect of securitisation structures (50%)	(283)
Other impairments	(1 627)
Total Tier 1 capital	**41 566**
Tier 2	
Upper Tier 2 instruments	1 188
Tier 2 subordinated debt instruments	9 004
Other reserves	286
Less: Total impairments	(662)
Excess of expected loss over allowable provisions (50%)	(379)
First loss credit enhancement provided in respect of securitisation scheme (50%)	(283)
Total Tier 2 Capital	**9 816**
Total qualifying capital and reserves	**51 382**

Risk weighted assets by risk type

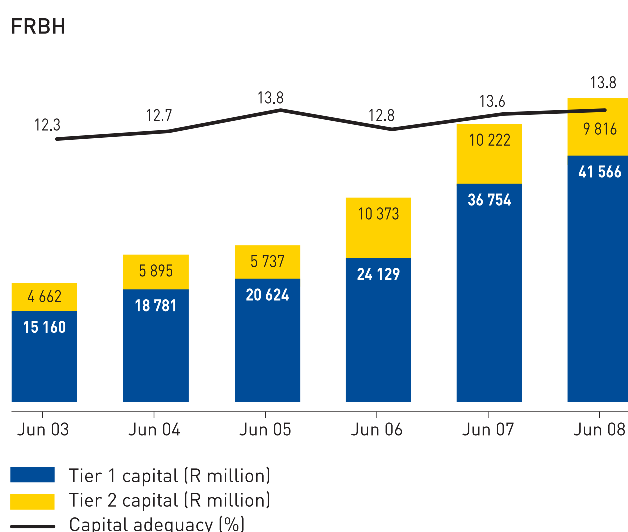
R MILLION	FRBH
Credit risk	256 567
Operational risk	56 472
Market risk	17 710
Equity investment risk	25 653
Other risk	17 182
Total risk weighted assets	**373 584**

The capital adequacy position of FRBH and its subsidiaries is set out below:

R MILLION	AT 30 JUNE 2008 Risk weighted assets	Capital adequacy %*
Basel II		
FRBH	373 584	13.75
FRB (solo)	289 654	12.28
FirstRand (Ireland) plc	18 625	16.97
RMB Australia Holdings Limited	7 917	15.71
Basel I		
FNB (Botswana) Limited	5 468	15.28
FNB (Namibia) Limited	7 518	20.73
FNB (Swaziland) Limited	888	21.04
FNB (Moçambique) S.A.	454	15.12

** Entities operating under Basel II are subject to a minimum capital requirement of 9.5% (excludes the bank specific (pillar 2b) add on). All the banking operations under Basel I are subject to a 10% minimum capital requirement in terms of local rules, except for FNB (Botswana) Limited, where the minimum capital requirement is 15%. These entities also report under Basel II and are included on this basis for the consolidated position of FRBH.*

The graph below depicts the regulatory capital position over the last six years*:



** June 2007 and prior years reflect Basel I, while June 2008 is based on Basel II.*

Targeted ratios

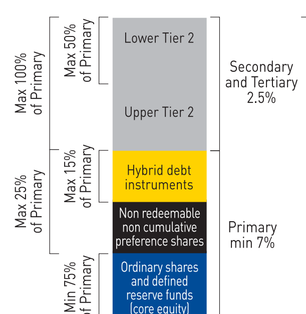
The total capital adequacy ratio for FRBH is within the target range as shown below. The Core Tier 1 ratio exceeded its target. FRBH aims to remain within the targeted range during upturns and downturns.

	FRBH Actual	FRBH Target	Regulatory minimum
Capital adequacy ratio (%)	13.75	12.0 – 13.5	9.50*
Tier 1 ratio (%)	11.13	10.00	7.00
Core Tier 1 ratio (%)	10.30	8.25	5.25
Perpetual preference shares as a % of Tier 1 (%)	7.46		< 25
Tier 2 subordinated debt as % of Tier 1 (%)	21.66		< 50

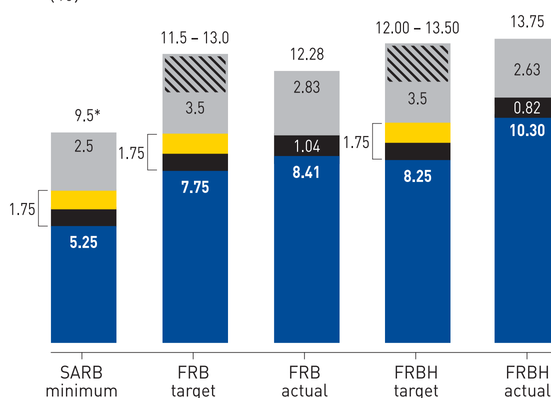
** The regulatory minimum excludes the bank specific (pillar 2b) add on.*

The graph below depicts the capital adequacy position as at June 2008.

Minimum capital adequacy



Capital adequacy
(%)



** Excludes Pillar 2b add on.*

Economic capital

Economic capital is defined as the capital which FRBH must hold, commensurate with its risk profile under severe stress conditions, to give comfort to third party stakeholders – shareholders, counterparties and depositors, rating agencies and regulators – that it will be able to discharge its obligations to third parties in accordance with an indicated degree of certainty even under stress conditions, and would continue to operate as a going concern entity. The adequacy of the capital base is assessed via economic capital review. FRBH remains well capitalised with current levels of qualifying capital exceeding the economic capital required.

Capital is allocated to business units at the higher of:

- regulatory capital; and
- economic capital

Both measures include an appropriate buffer.

The ICAAP framework assists in the attribution of capital to business units in proportion to the risks inherent in their respective businesses, which also drives the optimisation of returns in terms of risk and reward.

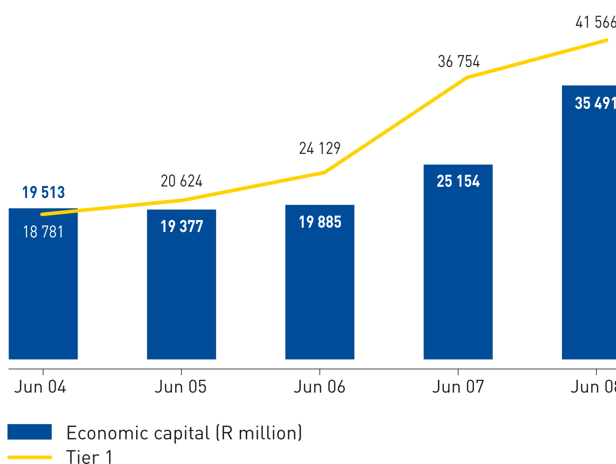
The framework also serves to consistently measure and align economic capital with the underlying risks associated with the activities of each business unit. The capital attribution methodologies involve a number of assumptions and estimates that are revised periodically. Any changes to these factors directly impact other measures such as business units return on average equity and economic profit, or net income after capital charge ("NIACC").

The economic capital allocation methodology is broadly based on the advanced approaches followed under Basel II and takes into account the following risk types (Pillar 1 and Pillar 2):

- Credit risk – the risk of loss due to non performance of a counterparty in respect of any financial or performance obligation due to a deterioration in the financial status of the counterparty;
- Traded market risk – the risk of loss on trading instruments and portfolios due to changes in market prices and rates;
- Equity investment risk – the risk associated with the buying and holding of unlisted and listed shares;
- Operational risk – the risk of loss resulting from inadequate or failed internal processes, people,and systems or from external events;
- Interest rate risk in the banking book – the risk of changes in the economic value of assets and liabilities due to changes in interest rates; and
- Business and other residual risks – the risk of loss due to variances in volumes, prices and costs caused by competitive forces, regulatory changes, reputation and strategic risks.

FRBH has consistently backed all economic risk with Tier 1 capital (core equity and innovative primary capital instruments). During 2007 the level of core equity was increased to prepare for the implementation of Basel II and the initial uncertainties introduced by the new accord.

Economic capital



ACHIEVEMENTS AND FOCUS

2008 ACHIEVEMENTS

ENTERPRISE RISK MANAGEMENT

→ Successful implementation of phase II of the Integrated Risk Reporting project.

→ Implementation of IFRS 7 risk reporting and disclosure.

Credit risk:

→ Formal approval from the SARB to use the AIRB approach for credit risk regulatory capital calculations in FRB.

→ Successful implementation of Banks' Act reporting systems for reporting of credit risk exposure and capital to the SARB.

→ Successful implementation of the Basel II Pillar III and IFRS 7 credit risk reporting requirements.

→ Enhancement on internal economic capital model implementation including enhancement of stress tests for credit risk and assessment of volatility of credit risk under different scenarios.

→ Successful implementation of the revised FRBH risk management functions including the creation of the FRBH Credit Risk control function in ERM and the revised focus in BSM on credit portfolio management.

2008 ACHIEVEMENTS *continued*

Market risk:

- Adoption and implementation of the internal model approach to measure regulatory market risk capital.
- Accurate performance of the internal distressed expected tail loss risk measure.

Liquidity risk:

- Successful implementation of Basel II requirements regarding liquidity risk funding and management.
- Successful implementation of a new Basel II approach to measure, manage and monitor liquidity risk.
- Successful management of liquidity risk and funding during the credit turmoil and sub prime credit crisis in the US and its consequential liquidity concerns.
- Research and case studies of recent bank failures during the credit turmoil were applied to test the conservativeness in the new approach to measure and manage liquidity risk and the results were satisfactory.
- Enhancement of the approach to measure liquidity risk with numerous new Key Risk Indicators in place to depict possible liquidity stresses and risks.

Interest rate risk in the banking book:

- Positioned the book to take advantage of interest rate hikes.
- Transition to Basel II / Basel II progress – in compliance with SARB/Basel II, requirements, the BA330 regulatory return went live in January 2008, replacing the previous DI410 submission. The BA330 return is used to disclose the interest rate risk of the domestic banking book to the SARB. The relevant assumptions and methodologies were approved by a technical committee (mandated by the FRBH's Model Risk and Validation ("MRV") committee) and presented and ratified by the FRBH Asset and Liability Management Committee ("ALCO").

Operational risk:

- Approval from the SARB to use TSA for operational risk.
- Submitted the application to the SARB for AMA for operational risk.

FOCUS AREAS FOR 2009

ENTERPRISE RISK MANAGEMENT:

- Refinement of risk appetite.

Credit Risk:

- Roll out of the enhanced credit risk appetite and portfolio management processes across FRBH.
- Enhance the dynamic loss forecasting and stress testing process.
- Ongoing enhancement of the credit risk economic capital models.
- Further alignment of the international businesses' credit processes, systems and models with the domestic business.

Market risk:

- Defining and implementing a process of determining stop loss limits at entity level to align with the capital allocation process and market risk limit framework.

Liquidity risk:

- Expand on the dynamic management of liquidity risk through the economic and interest rate cycle to sustain profitability without compromising liquidity risk.

Interest Rate risk in the Banking Book:

- Implementation of new integrated risk software, improvement in the integration of economic value and earnings at risk methodologies in determining economic capital charges.

Operational risk:

- Further refinement of quantification for operational risk capital.
- Further refinement of risk scorecards for risk sensitive operational risk capital.
- Risk optimisation process focusing on convergence of risk tools.

STRATEGIC AND BUSINESS RISK

STRATEGIC RISK IS THE RISK TO CURRENT OR PROSPECTIVE EARNINGS AND CAPITAL, ARISING FROM ADVERSE BUSINESS DECISIONS OR THE IMPROPER IMPLEMENTATION OF DECISIONS. BUSINESS RISK DESCRIBES THE RISK FRBH ASSUMES DUE TO POTENTIAL CHANGES IN GENERAL BUSINESS CONDITIONS, SUCH AS OUR MARKET ENVIRONMENT, CLIENT BEHAVIOUR AND TECHNOLOGICAL PROGRESS.

This can affect our earnings if we fail to adjust quickly or lack in our responsiveness to change in the business environment. In essence it is any risk that can result in FRBH not meeting its business performance objectives.

Accountability for strategic risk

The risk is primarily addressed through the development and implementation of an effective strategic plan. The FRBH board is responsible for approving FRBH's objectives and the strategies and plans for achieving those objectives. The FRBH board approves any subsequent material changes in strategic direction, as well as significant acquisitions, mergers, take overs, equity investments and new strategic alliances by the company or its subsidiaries. The CEO is responsible for the development and implementation of the strategic plan.

Risk identification

FRBH's executive management continually reviews FRBH's strategy, taking into account the business, legal and regulatory environments in which it operates. Executive management identifies and assesses strategic and business opportunities and addresses the associated risks throughout the strategic planning process.

Risk management

Executive management and business unit management monitor the external business environment (industry trends, regulatory changes, customer behaviour, competitors) and report on risks and opportunities through FRBH's risk reporting structure. The board reviews the performance of FRBH every quarter and ensures that management takes corrective action to address potential strategic and business risks.

CREDIT RISK

CREDIT RISK IS THE RISK OF LOSS DUE TO NON PERFORMANCE OF A COUNTERPARTY IN RESPECT OF ANY FINANCIAL OR PERFORMANCE OBLIGATION DUE TO DETERIORATION IN THE FINANCIAL STATUS OF THE COUNTERPARTY.

Credit risk arises from advances to customers, lending commitments, contingent products (e.g. letters of credit) and traded products such as investments in debt securities and derivative instruments. It could also arise from the reduction in value of an asset subsequent to the downgrading of the counterparty.

Country risk relates to the likelihood that changes in the business environment will occur that would reduce the profitability of doing business in a country and ultimately might result in credit losses arising from cross border transactions.

Credit risk is the most significant risk type FRBH is exposed to. The contribution of credit risk to the total regulatory and economic capital requirement of FRBH is also the highest of all risk types.

Credit risk governance

Credit risk in FRBH is managed in terms of the Credit Risk Management Framework. This framework is a sub framework of FRBH's Risk Management Framework. Through the establishment of formal credit risk management and governance structures, policies, procedures and methodologies, FRBH aims to achieve effective management of credit risk to provide an adequate return on risk adjusted capital in line with FRBH's risk reward appetite.

The overall responsibility for the effectiveness of credit risk management vests with the board. Through its establishment of formal credit risk management governance structures, the board has delegated the oversight responsibility for credit risk management to FRBH's RCC committee and its sub committees, the credit approval committees, and boards of subsidiary companies. Operational responsibility is delegated to executive management and risk functions both at group and business unit level.

The approval of credit vests with FRBH's Credit committee (a sub committee of the board) and its committee structures. The approval committee approves credit facilities according to delegated mandates. The Large Exposures Credit committee, which is also a sub committee of the board, approves the credit facilities in excess of 10% of capital. For the African subsidiaries, each subsidiary company has its own set of delegated authorities approved by the subsidiary's board and the FRBH Credit committee.

FRBH's RCC committee (a sub committee of the board) approves the Credit Risk Management Framework. It receives and reviews reports that demonstrate the effectiveness of credit risk management and information on the credit risk profile of FRBH. Operational breakdowns or significant weaknesses in the credit risk management process are reported to the committee. It is supported by a sub committee structure which includes the FRBH Credit Portfolio Management committee ("Credit Exco"), as well as the MRV committee.

The Credit Exco is responsible for the strategic management of credit risk and the oversight of the credit risk profile of the Group. Its responsibilities include the review of the following:

- macro economic and credit conditions outlook;
- credit risk profile;
- credit portfolio performance, including the appropriateness of loss impairments;
- new business origination including credit risk reward appetite, and adjustments thereto based on the macro cycle;

- sensitivity and scenario analyses, credit economic capital and stress testing; and
- credit concentrations.

The MRV committee is responsible for the oversight of credit risk measurement systems such as the credit rating systems. Reports on the design and operation of the rating systems are submitted to the MRV committee for challenge and approval. All model development and validation frameworks are set by the MRV committee.

The operational roles and functions for credit risk management are fulfilled by both centralised group functions as well as decentralised functions within the business units. During the year under review, FRBH implemented a two tiered structure in the centralised group functions. The new structure provides for a Group Credit Risk Control unit within the ERM division as well as a Credit Portfolio Management function that resides within the BSM division. ERM reports to the CEO, whilst BSM reports to the CFO.

The Group Credit Risk Control function is responsible for the independent oversight of credit segments in the business units and credit portfolio management in BSM. It owns the credit risk management framework and policies and monitors the implementation of the frameworks. Its role also includes the following:

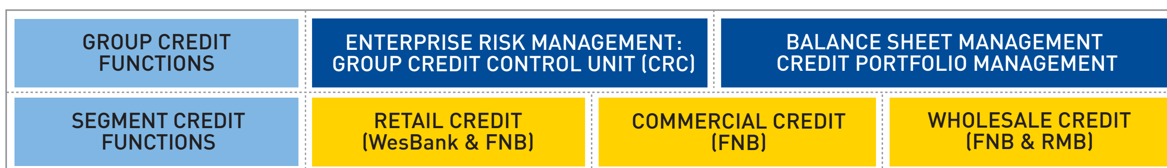
- oversight of the risk reward appetite framework for credit risk;
- monitoring of the credit risk profile of the group;
- review of all credit rating systems as well as independent revalidation of material credit rating systems;
- management of the interaction of third party stakeholders such as the Regulator;
- oversight of the aggregate credit impairment process;
- regulatory reporting; and
- risk profile reporting.

The Group Credit Portfolio Management function is responsible for the balance sheet management aspects of credit risk, including the following:

- formulation of macro economic and credit outlook;
- quantification and allocation of credit economic risk and capital including the credit risk assessment used for the internal capital adequacy assessment process and assessment of capital buffer requirements;
- active participation in the credit strategy and origination activities;
- management of the risk appetite implementation across business units;
- credit risk stress testing, scenario analysis and portfolio modelling;
- management of impairments including the impairment reporting, analysis and assessment;
- initiation of structured credit transactions to optimise the balance sheet;
- coordination of the group securitisation process; and
- credit portfolio reporting and analysis for Credit Exco and other stakeholders.

The diagram below shows the group and segment credit functions. The credit segment heads are supported by teams within the business units and subsidiaries. These functions are responsible for the operational implementation of credit risk policies. This includes the implementation of sufficient credit risk structures, processes and infrastructure to manage the credit process effectively. These functions are responsible for the operational credit business management including the following:

- formulation of credit strategy and determination of credit appetite;
- provision of strategic support to business unit heads to ensure appropriate origination and effectiveness of returns on risk adjusted capital;
- formulation and implementation of risk policies, procedures, methodologies and standards for credit risk management in each segment;
- development of credit rating systems, processes and other decision support tools and pricing approaches;
- monitoring of the quality of new business origination and the existing portfolio;
- implementation of structures for ongoing risk management including management of collateral and facilities;
- reporting on credit risk profile, pricing trends and other key measures; and
- ongoing management of the credit risk processes and infrastructure.



Credit risk management

Credit risk is managed through comprehensive policies and processes that ensure adequate identification, measurement, monitoring and control as well as reporting of credit risk exposure. The objectives of the policies and processes are to ensure a sound credit risk management environment with appropriate credit granting, administration, measurement and monitoring through the implementation of adequate risk management controls.

Based on FRBH's risk reward appetite for credit risk, the risk is managed with reference to such principles including appropriate levels of capital and pricing for risk on an individual and portfolio basis.

The credit value chain incorporates credit risk management at every level in the organisation. Upon application, creditworthiness of the counterparty is assessed and measured in terms of the risk appetite. The counterparty's credit risk is measured using internally developed and validated risk models as described in the credit risk measurement section below. The credit exposure is approved at appropriate levels as prescribed per the delegated mandates.

Processes are in place for the wide range of product and counterparty types in FRBH. Based on product/counterparty characteristics, the credit processes are aligned to manage the specific risk at business unit level. Subsequent to credit approval, all facilities are continually measured, managed and monitored as part of the ongoing credit risk management processes designed at credit segment level. This includes the following:

- quantification of exposure and risk as well as management of facility utilisation within the predetermined and approved credit limits;
- ongoing monitoring of creditworthiness of the counterparty to ensure early identification of high risk exposures;
- reviewing facilities at appropriate intervals;
- collateral and covenant management;
- management of high risk exposures ("watch list exposures");
- collections and work out processes for defaulted assets; and
- credit risk reporting.

Credit defaults are monitored relative to expected losses. Impairments are created against the portfolio and against non performing loans as described in the section below on impairments.

Credit risk mitigation

Although, in principle, the credit assessment focuses on the counterparty's ability to repay the debt, credit mitigation instruments are used where appropriate to reduce FRBH's lending risk resulting in security against the majority of exposures. These include financial or other collateral, netting agreements, guarantees or credit derivatives. The collateral types are driven by segment, product or counterparty type:

- mortgage and instalment sale finance portfolios in FNB Home Loans, Wealth and WesBank are secured by the underlying assets financed;
- personal loans, overdrafts and credit card exposures are generally unsecured or secured via guarantees and suretyships;
- FNB Commercial credit counterparties are mostly secured by the assets of the SME counterparties and commercial property finance deals are secured by the underlying property and the cash flows received from the use thereof; and
- working capital facilities in FNB Corporate Banking are unsecured whereas the structured facilities in RMB are mostly secured as part of the structure through financial or other collateral including guarantees or credit derivative instruments and assets. The credit risk in RMB's treasury environment is mitigated through the use of netting agreements and financial collateral.

Policies and processes for collateral valuation and collateral management

Collateral is valued at inception of the credit agreement and subsequently where necessary through physical inspection or index valuation methods. For wholesale and commercial counterparties, collateral is reassessed during the annual review of the counterparty's creditworthiness. For mortgage portfolios, collateral is revalued using an index model on an ongoing basis. For all the retail portfolios, including the mortgage portfolio, collateral is again valued through physical inspection at the time the exposure enters the workout process.

Collateral is managed internally to ensure the Bank's title to the collateral is maintained on an ongoing basis.

The concentrations within credit risk mitigation types, such as property, are monitored and managed within the credit segments' portfolios. FNB Home Loans and the Wealth segment monitor their exposure to a number of geographical areas, as well as within loan to value bands.

For FRB, collateral is taken into account for capital calculation purposes through the determination of the loss given default ("LGD"). The existence of collateral results in a reduced LGD, and the level of the LGD are determined through statistical modelling techniques based on the historical experience of the recovery processes.

Use of netting agreements

FRBH uses International Swaps and Derivative Association ("ISDA") agreements to govern the netting of derivative transactions. All transactions are valued on a daily basis and the appropriate netting of exposures is applied. The master agreement contains internationally accepted valuation and default covenants. For accounting purposes, netting is only applied where there is legal right of setoff and there is the intention to settle on a netted basis.

Credit concentration risk management

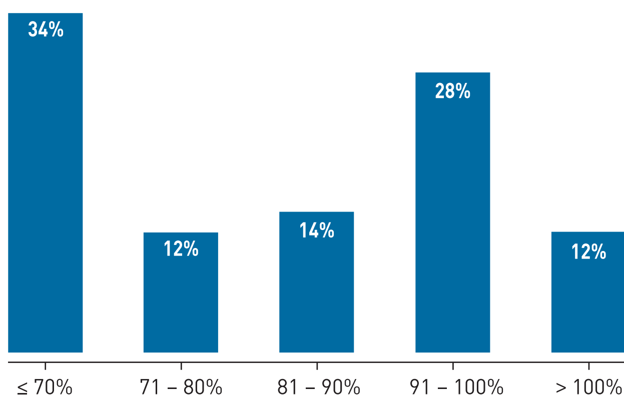
Concentration risk is managed in the credit portfolios, based on the nature of the credit concentration within each segment:

- Wholesale credit portfolio:
  - concentration risk management is based on individual name limits for large exposures (which are reported to and approved by the Large Exposures Credit committee) and the monitoring of industry and country concentrations. A sophisticated simulation portfolio model has been implemented to quantify concentration risk and the potential impact thereof on the credit portfolio. FRBH also uses securitisation structures and the purchase of credit derivatives as a credit mitigation tool to address credit concentration risk management;
- Commercial credit portfolio:
  - for the Commercial (SME level) exposures, the emphasis of concentration risk measurement is on industry distribution; and
- Retail credit portfolios:
  - due to the inherent diversification in the retail portfolios, concentrations are managed with reference to collateral concentrations.

Residential mortgages balance to value

The following graph provides the balance to value distribution for the residential mortgages. The graph presents the balance to property value (at application date or physical valuation date) and excludes any non performing loans:

Residential mortgages balance to value



Credit risk measurement

The credit risk measurement models developed internally in FRBH provide the basis for credit risk management in all segments. The models are widely used in the determination of capital levels, pricing, impairment calculations and scenario and stress testing.

Through the implementation of the Basel II requirements for the AIRB approach, FRB has developed a number of rating systems and risk quantification models. The SARB provided FRB with approval to use its internal rating models for the assessment of regulatory capital under Basel II. The remaining FRBH subsidiaries are using the Standardised Approach for Basel II.

The FNB Africa subsidiaries have implemented the Standardised Approach of Basel II for regulatory reporting to the SARB. However, for internal purposes, the credit measurement models are being aligned to those used in FRB as far as possible. Currently, similar processes have been implemented to a large extent in most of these subsidiaries using similar models and principles.

Where possible, the remaining subsidiaries of FRBH use similar credit measurement systems to those implemented in FRB. Although the Standardised Approach is used for regulatory capital purposes, internally, the credit measurement systems are being used to assign ratings and estimate the probability of default and loss given default.

The risk parameters measured are described below:

i. Probability of default ("PD") and credit ratings

The probability of default is the probability that a counterparty will default within the next year and considers the ability and willingness of the counterparty to repay. The definition of default is dependent on the earlier of the following two drivers:

- a time driven element where an exposure is more than 90 days in arrears; or
- an event driven element when there is reason to believe that the exposure will not be recovered in full.

The definition of default is used in the modelling of credit rating systems described below. The definition of default used for the recognition of non performing loans is similar to the above definition. For some portfolios, the definition used in the credit modelling is slightly more conservative than the definition described above due to the different conventions of day count to determine the time driven component.

Cumulative default probabilities over a multi year cycle are established for internal purposes.

The FirstRand master rating scale, the FR ratings, range from FR 1 to FR 100, with FR 1 being the best rating with the lowest probability of default. The FR rating has been mapped to default probabilities as well as external rating agency national and international rating scales. The granular 100 point scale is summarised for internal purposes into 18 buckets and for reporting purposes into 9 performing buckets as described below.

The ratings and associated PDs reflect two different conventions. The Point In Time ("PIT") PD reflects the default expectations under the current economic cycle whereas the Through The Cycle ("TTC") PDs reflect a longer term average over the economic cycle. These PDs are applied in different circumstances as appropriate to the business and regulatory requirements under Basel II. Typically, the PIT estimates are

used for the calculation of impairments, whereas the TTC estimates are used for regulatory and economic capital calculations.

The FR scale is summarised in the following table, together with a mapping to international scale ratings from external rating agencies:

FR Rating	Midpoint PD	International scale mapping*
FR 1 – 12	0.04%	AAA, AA, A
FR 13 – 25	0.27%	BBB
FR 26 – 32	0.77%	BB+, BB
FR 33 – 37	1.34%	BB-
FR 38 – 48	2.15%	B+
FR 49 – 60	3.53%	B+
FR 61 – 83	6.74%	B
FR 84 – 91	15.02%	B-
Above FR 92		Below B-
FR 100	100%	D (defaulted)

* *Indicative mapping to international rating scale of Fitch and Standard & Poor's.*

The rating assignment process depends on the type of counterparty. The processes vary from an automated score card process in the retail areas to an extensive analysis on an individual basis for corporate counterparties. The retail portfolio is segmented into homogeneous pools through an automated scoring process using statistical models of customer behaviour and application data, delinquency status and other client or product specific parameters. Based on internal product level history associated with the homogeneous pools, the probabilities of default are estimated for each pool. For the Commercial portfolios, counterparties are scored using the Moody's RiskCalc model which output has been calibrated to internal historical default experience. The corporate counterparties are rated through a combination of a detailed individual assessment of the counterparty's creditworthiness and an internally developed statistical rating model. The assessment of the counterparty's creditworthiness is performed through a qualitative analysis of the business and financial risks of the counterparty. The quantitative rating model was developed using internal and external data of more than 10 years.

ii. Loss given default ("LGD")

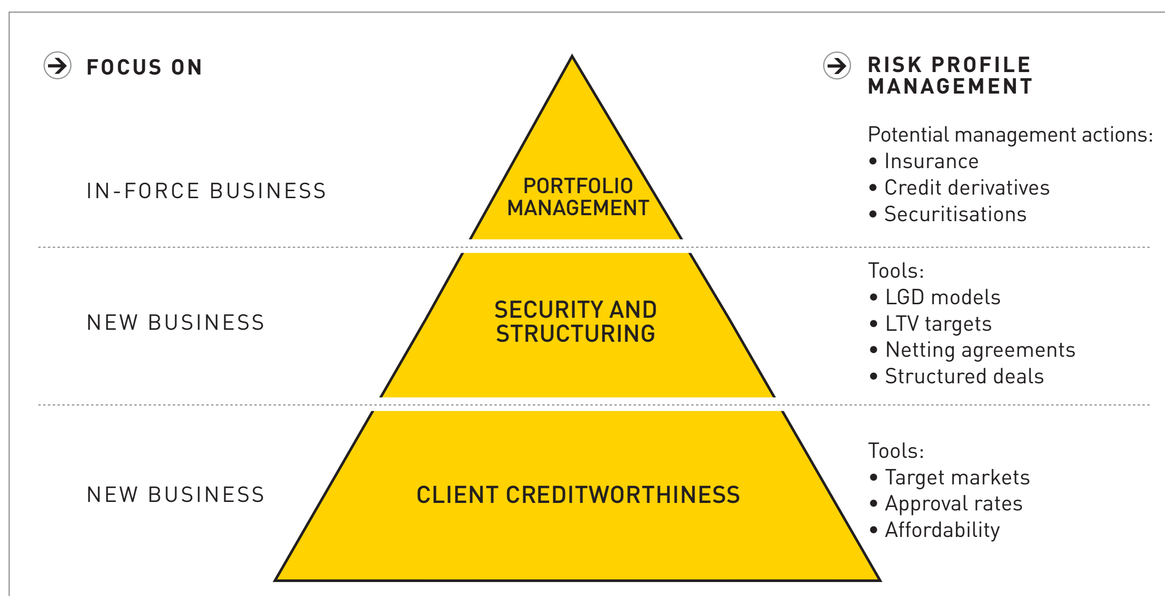
The loss given default is defined as the economic loss that will be suffered on an exposure following default of the counterparty, expressed relative to the amount outstanding at the time of default as a percentage. The recoveries are significantly impacted by the types and levels of collateral held against the exposure, the level of subordination, the effectiveness of the recovery processes and the timing of the recovered cash flows. The estimation of LGD is determined through the use of internal data as well as benchmarking to external data. A long run and a downturn LGD is determined where applicable. The downturn LGD reflects increased LGDs relative to long run average LGD estimates during periods of high defaults (i.e. where a positive correlation exists between the PD and LGD). For the calculation of capital, "downturn" LGDs are used.

iii. Exposure at default ("EAD")

Exposure at default is defined as the gross exposure of a facility upon default of a counterparty. This measurement reflects potential credit exposure for off balance sheet exposures such as the probability of further drawdown under a committed facility and the potential future exposure of derivative exposures.

Use of credit risk measures

The credit risk measures are used extensively in FRBH's processes for pricing and credit impairments. The assigned ratings are also used in the setting of credit risk appetite. Credit ratings and loss parameters also provide input into the capital assigned and are used to determine the return on risk adjusted capital. The following diagram provides an overview of the elements of the risk appetite and how they interact:



Expected loss

Expected loss is calculated as PD x LGD x EAD. This measurement is a forward looking measure of risk through the cycle. For internal purposes, such as inputs into pricing and impairment processes, the PIT probability of default is used in the determination of a PIT expected loss.

The PD, LGD and EAD estimates are used as inputs into the credit approval process, pricing process, provisioning, reporting and regulatory and economic capital estimates where appropriate.

More information on the credit risk measurement for the current portfolio position is provided in the Risk parameters and Basel II sections below.

Credit portfolio management

The PD, LGD and EAD estimates provide input into the portfolio level credit exposure assessment of FRBH. In addition to these metrics, the correlations between counterparties and industries are assessed as well as the potential diversification benefits. Portfolio management includes monitoring of the following:

- credit concentrations to single counterparties and industry sectors relative to capital levels;
- economic capital (unexpected loss) measurement using internally developed macro economic models and simulations for the retail credit portfolios and a sophisticated simulation portfolio model for wholesale credit portfolios;
- assessment of economic risk with reference to potential downturn and severe downturn scenarios, together with the earnings and capital impact thereof and the link to the internal capital adequacy assessment process;
- portfolio stress tests on expected losses, including the assessment of the impact of macro economic factors on the credit portfolio, for example the impact of interest rate changes, property downturns, and general recession conditions; and
- consideration of the need for macro credit hedges given the potential scenarios determined, including the identification of structured transactions such as securitisations and credit insurance.

Policy for impairment of financial assets

General

A financial asset is impaired if its carrying amount is greater than its estimated recoverable amount.

Assets carried at amortised cost

FRBH assesses at each balance sheet date whether there is objective evidence that a financial asset or group of financial assets is impaired. A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a "loss event") and that loss event(s) has an adverse impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the Group about the following events:

i. Significant difficulty of the issuer or debtor;

ii. A breach of contract, such as a default or delinquency in payments;

iii. It becoming probable that the issuer or debtor will enter bankruptcy or other financial reorganisation;

iv. The disappearance of an active market for that financial asset because of financial difficulties; or

v. Observable data indicating that there is a measurable decrease in the estimated future cash flow from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet allocated to the individual financial assets in the Group, including:

   - Adverse changes in the payment status of issuers or debtors in the Group; or
   - National or local economic conditions that correlate with defaults on the assets in the Group.

The FRBH first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If FRBH determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and performs a collective assessment for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

If there is objective evidence that an impairment loss has been incurred, the amount of the loss is measured as the difference between the financial assets' carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account, and the amount of the loss is recognised in the income statement. If a financial asset has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract. As a practical expedient, FRBH may measure impairment on the basis of an instrument's fair value using an observable market price.

The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics (i.e. on the basis of FRBH's grading process that considers asset type, industry, geographical location, collateral

type, past due status and other relevant factors).Those characteristics are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets in FRBH and historical loss experience for assets with similar credit risk characteristics. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently.

Estimates of changes in future cash flows for groups of assets reflect and are directionally consistent with changes in related observable data from period to period (for example, changes in unemployment rates, property prices, payment status, or other factors indicative of changes in the probability of losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly by FRBH to reduce any differences between loss estimates and actual loss experience.

When a loan is uncollectible, it is written off against the related allowance account. Such loans are written off after all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of the provision for loan impairment in the income statement.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss is reversed by adjusting the allowance account. The amount of the reversal is recognised in the income statement.

Past due advances

Advances are considered past due in the following circumstances:

- loans with a specific expiry date (e.g. term loans etc) are treated as overdue where the principal or interest is overdue and remains unpaid as at the reporting date;
- consumer loans repayable by regular instalments (e.g. mortgage loans, personal loans) are treated as overdue when an instalment payment is overdue and remains unpaid as at the reporting date; and
- a loan payable on demand is treated as overdue where a demand for repayment has been served on the borrower but repayment has not been made in accordance with the instruction.

In these instances, the full outstanding amount is considered overdue even if part of it is not yet due. The days past due are referenced to the earliest due date of the loan.

The past due analysis is only performed for advances with specific expiry dates or instalment repayment dates or demand loans that have been demanded. The analysis is not applicable to overdraft products or products where no specific due date are be determined. The level of riskiness on these types of products is done with reference to the counterparty ratings of the exposures and reported as such.

Exposures to credit risk

FRBH implemented the AIRB approach for the exposures of FRB and the Standardised Approach for all other legal entities in FRBH. These approaches have been approved by the SARB. Due to the data scarcity in some markets and materiality levels of subsidiaries within the context of the group, FRBH envisages the Standardised Approach to be used in the subsidiaries for the foreseeable future. Basel II was implemented over the past number of years and has been used in FRBH's regulatory capital calculations since 1 January 2008.

The table below provides the credit exposure of FRBH:

Maximum exposure to credit risk (after interest in suspense)

R MILLION	2008
Cash and short term funds	24 562
– Money at call and short notice	2 211
– Balances with central banks and guaranteed by central banks	11 762
– Balances with other banks	10 589
Gross advances	456 338
FNB	207 658
– FNB Retail	162 841
– FNB Corporate	20 708
– FNB Commercial	24 109
WesBank	99 926
RMB	130 320
FNB Africa	15 755
Other	2 679
Derivatives	49 104
Investment securities (excluding non-recourse investments)	58 482
– Listed debt investment securities	24 310
– Unlisted debt investment securities	34 172
Accounts receivable	5 051
Loans to Insurance Group	2 133
Credit risk not recognised on the balance sheet	66 917
Guarantees	19 713
Acceptances	1 992
Letters of credit	4 843
Irrevocable commitments	40 143
Underwriting exposures	226
Total	662 587

The table below provides the geographic distribution of FRBH's material credit exposures:

Concentration risk of significant credit exposures:

	2008								
R MILLION	South Africa	Other Africa	United Kingdom	Ireland	Other Europe	North America	South America	Other	Total
Advances	411 690	18 847	14 594	1 764	5 700	454	1 512	1 777	456 338
Derivatives	20 754	812	10 052	10 006	4 675	2 655	–	150	49 104
Debt securities	48 461	8 392	465	–	–	789	–	375	58 482
Off balance sheet exposures									
Guarantees, acceptances and letters of credit	25 102	1 345	–	–	–	–	–	101	26 548
Irrevocable commitments	37 801	2 072	60	–	–	76	–	134	40 143

The table below provides the industry distribution of advances:

R MILLION	Total
Advances	
Sector analysis	
Agriculture	9 000
Banks and financial services	64 363
Building and property development	15 246
Government, Land Bank and public authorities	20 503
Individuals	251 867
Manufacturing and commerce	46 527
Mining	12 829
Transport and communication	11 061
Other services	26 117
Notional value of advances	457 513
Contractual interest suspended	(1 175)
Gross advances	456 338
Impairment of advances (note 9)	(7 383)
Net advances	448 955

The table below provides the term to maturity of advances:

	2008			
		Term to maturity		
R MILLION	Carrying amount	Call – 3 months	3 – 12 months	Over 12 months
Maturity analysis of assets and liabilities				
ASSETS				
Advances (net of impairments)	448 955	140 401	37 651	270 903

The table below provides the analysis of the movement in impairment of advances:

Analysis of movement in impairment of advances per class of advance

	2008									
	FNB									
R MILLION	Retail	Corporate	Commercial	WesBank	RMB	FNB Africa	Other	Total impairment	Specific impairment	Portfolio impairment
Opening balance	2 155	233	325	1 072	475	289	1	4 550	2 749	1 801
Exchange rate difference	–	–	–	21	24	8	–	53	45	8
Amounts written off	(1 166)	(24)	(50)	(1 509)	(117)	(56)	33	(2 889)	(2 864)	(25)
Unwinding of discounted present value on non performing loans	(95)	–	(36)	–	–	(18)	(62)	(211)	(209)	(2)
Reclassifications	–	–	–	–	–	–	–	–	129	(129)
Net new impairments created	2 929	100	207	2 248	182	114	33	5 813	5 019	794
– impairments created	3 461	100	207	2 239	231	107	34	6 379	5 526	853
– impairments released	(532)	–	–	9	(49)	7	(1)	(566)	(507)	(59)
Acquisitions/Disposals of subsidiaries	26	–	–	–	–	40	1	67	49	18
Transfers from/(to) other divisions	(2)	(17)	15	(2)	(1)	–	7	–	–	–
Closing balance	3 847	292	461	1 830	563	377	13	7 383	4 918	2 465

The table below provides an analysis of past due advances:

R MILLION	2008						
	Neither past due nor impaired	Re-negotiated but current	Past due but not impaired				
Age analysis of advances			1 – 30 days	31 – 60 days	>60 days	Impaired*	Total
FNB Retail	131 035	876	14 735	4 611	3 606	7 978	162 841
FNB Corporate	20 526	–	25	17	–	140	20 708
FNB Commercial	23 393	–	107	51	46	512	24 109
FNB	174 954	876	14 867	4 679	3 652	8 630	207 658
WesBank	93 486	–	2 195	808	257	3 180	99 926
RMB	129 171	126	133	23	10	857	130 320
FNB Africa	14 533	–	590	106	137	389	15 755
Other	2 631	–	–	–	–	48	2 679
Total	414 775	1 002	17 785	5 616	4 056	13 104	456 338

Advances considered past due is defined in the accounting policies. For internal risk reporting, a distinction is drawn between technical past due or arrear accounts (i.e. accounts in arrears by less than one payment) which typically arise from small short payments e.g. debit orders not yet updated for recent interest rate increases or other technical factors, and normal arrears (i.e. accounts in arrears by 1 – 3 full payments). The past due advances in the tables above includes both technical arrears as well as normal arrears. Total technical arrears included in the past due analysis (mostly relating to retail exposures) amounted to R6.6bn.

Renegotiated advances are advances where, due to deterioration in the counterparty's financial condition, FRBH granted a concession where original terms and conditions of the facility were amended. The objective of such amendment is to mitigate the risks where the current situation could result in the counterparty no longer being able to meet the terms and conditions originally agreed. Renegotiated advances include only those that have been reclassified as *neither past due nor impaired*. In most business units, it is the practice to continue recognition of the renegotiated advances as past due and therefore it is not included above as renegotiated but rather as past due in the table above. Where the advances were reclassified as *neither past due nor impaired*, the adherence to the new terms and conditions are closely monitored. The renegotiated advances exclude any advances where the facility terms were extended or renewed as part of the ordinary course of business on terms and conditions equivalent to the current terms or conditions for new debt with similar risk.

The table below provides the analysis of the non performing loans:

	2008			
R MILLION	Total value including interest in suspense	Security held	Specific impairment	Contractual interest suspended
Non performing lendings by sector				
Agriculture	121	75	37	17
Banks and financial services	66	29	31	6
Building and property development	592	62	216	141
Government, landbank and public authorities	281	8	13	3
Individuals	11 688	5 374	3 890	854
Manufacturing and commerce	646	129	381	97
Mining	33	3	9	3
Transport and commuication	163	44	29	7
Other	689	146	312	47
Total non perfroming lendings	14 279	5 870	4 918	1 175
Non performing lendings by category				
Overdrafts and managed accounts	803	180	677	131
Card loans	1 658	–	1 102	154
Instalment sales	2 053	365	766	105
Lease payments receivable	1 066	165	395	54
Property finance	6 774	4 993	1 235	511
– Home loans	6 655	4 904	1 204	487
– Commercial property finance	119	89	31	24
Personal loans	928	161	532	94
Other	997	6	211	126
Total non perfroming lendings	14 279	5 870	4 918	1 175
Non performing lendings by class				
FNB Retail	8 663	4 679	2 700	685
FNB Coporate	140	–	121	–
FNB Commercial	625	349	291	113
Total FNB	9 428	5 028	3 112	798
WesBank	3 345	523	1 288	165
RMB	980	16	170	123
FNB Africa	478	217	198	89
Other (Capital Centre, other subsidiaries)	48	86	150	–
Total non performing lendings	14 279	5 870	4 918	1 175
Non performing lendings by geographical area				
South Africa	13 151	5 629	4 435	965
Other Africa	513	217	205	90
UK	52	24	40	–
Other	563	–	238	120
Europe	78	–	–	–
Australasia	485	–	238	120
	14 279	5 870	4 918	1 175

Net recoverable amount on non performing loans is R8 186 million.

For asset finance the total security value reflected represents only the realisation value estimates of the vehicles repossessed at the date of repossession. Where the respossessions has not occurred yet the realisation value of the vehicle is estimated using internal models and is included as part of the recoveries in total.

The credit exposures in the table below are classified into the Basel II approaches followed by FRBH. The exposures below are the IFRS accounting exposures and not those used for regulatory capital calculations. The exposures used in the regulatory capital calculations are after recognition of regulatory netting and other capital related impacts:

Exposure to credit risk – Basel II approaches

			Standardised Approach subsidiaries	
R MILLION	2008	FirstRand Bank (AIRB*)	Regulated bank entities within FNB Africa	Other subsidiaries
Cash and short term funds	**24 562**	19 088	1 114	4 360
– Money at call and short notice	**2 211**	828	23	1 360
– Balances with central banks and guaranteed by central banks	**11 762**	10 390	506	866
– Balances with other banks	**10 589**	7 870	585	2 134
Gross advances	**456 338**	407 196	15 724	33 418
FNB	**207 658**	197 838	–	9 820
– FNB Retail	**162 841**	153 021	–	9 820
– FNB Corporate	**20 708**	20 708	–	–
– FNB Commercial	**24 109**	24 109	–	–
WesBank	**99 926**	87 773	–	12 153
RMB	**130 320**	120 282	–	10 038
FNB Africa	**15 755**	78	15 724	(47)
Other	**2 679**	1 225	–	1 454
Derivatives	**49 104**	48 257	5	842
Debt Investment securities	**58 482**	42 495	7 206	8 781
Accounts receivable	**5 051**	3 186	364	1 501
Loans to Insurance Group	**2 133**	1 841	–	292
Credit risk not recognised on the balance sheet	**66 917**	61 283	3 336	2 298
Guarantees	**19 713**	18 340	1 168	205
Acceptances	**1 992**	1 992	–	–
Letters of credit	**4 843**	4 668	175	–
Irrevocable commitments	**40 143**	36 057	1 993	2 093
Underwriting	**226**	226	–	–
Total	**662 587**	583 346	27 749	51 492

– the table above exclude any intergroup balances with FRBH entities.

** AIRB: Advanced Internal Ratings Based approach*

For the portfolios using the Standardised Approach, the following rating agencies are used; however, exposures in the relevant jurisdictions are mostly unrated:

- Fitch Ratings
- Moody's
- Standard & Poor's

The ratings are mostly used for corporate, bank and sovereign counterparties in the portfolios where available. Where applicable, FRBH uses the internally developed rating mapping between the rating agencies and the risk weightings.

The following table provides the regulated bank entities (mostly FNB Africa) exposures after risk mitigation in each risk bucket:

R MILLION	AT 30 JUNE 2008 Exposure
0%	23
10%	–
20%	1 996
35%	5 668
50%	760
75%	7 572
100%	11 730
Deducted	–
Total risk weighted	**27 749**

Portfolio and type of exposures	Description of rating system
1. Large corporate portfolios (Wholesale: FNB Corporate Banking and RMB) Exposures to private sector counterparties including corporates, securities firms and public sector counterparties. A wide range of products gives rise to the credit exposures, including loan facilities, structured finance facilities, contingent products and derivative instruments.	The default definitions applied in the rating systems are aligned to the requirements of Basel II. ***Rating process:*** → The rating assignment to corporate credit counterparties is based on a detailed individual assessment of the counterparty's creditworthiness. → This assessment is performed through a qualitative analysis of the business and financial risks of the counterparty and is supplemented by internally developed statistical rating models. → The rating models were developed using internal and external data of more than ten years. The qualitative analysis is based on the methodology followed by international rating agencies. → The rating assessment is reviewed by the FRBG Credit committee and the rating (and associated PD) is approved by this committee. → After approval by the FRBG Credit committee, no overrides of the rating or probability of default is possible. → LGD and EAD estimates are based on modelling of a combination of internal and suitable adjusted international data. ***Validation methodology:*** Annual validations are performed where ranking and calibrations are assessed using statistical tests as well as expert comparisons. Independent validation is also conducted internally using similar statistical tests which may include full re-estimation of model parameters.

Portfolio and type of exposures	Description of rating system
2. Low default portfolios: Sovereign and bank rating systems (Wholesale: FNB Corporate Banking and RMB) Exposures to sovereign and bank counterparties.	The default definitions applied in the rating systems are aligned to the requirements of Basel II. *Rating process:* → Expert judgement models are used with external rating agencies and structured peer group analyses forming key inputs in the ratings process. The analysis is supplemented by internally developed statistical models. → Calibrations of PD and LGD are done using mappings to external default history and calibrations based on credit spread market data. → The rating assessment is reviewed by the FRBG Credit committee and the rating (and associated PD) is approved by this committee. → After approval by the FRBG Credit committee, no overrides of the rating or probability of default is possible. *Validation methodology:* Annual validations are performed where ranking and calibrations are assessed using statistical tests as well as expert comparisons. Independent validation is also conducted internally using similar statistical tests which may include full re-estimation of model parameters.
3. Specialised lending rating systems (Wholesale: FNB Corporate Banking, RMB and FNB Commercial) Exposures to private sector counterparties for the financing of income producing real estate.	The default definitions applied in the rating systems are aligned to the requirements of Basel II. → The rating system is based on hybrid models using a combination of statistical cash flow simulation models and qualitative scorecards calibrated to a combination of internal and benchmark data. → The rating assessment is reviewed by the FRBG Credit committee and the rating (and associated PD) is approved by this committee. → After approval by the FRBG Credit committee, no overrides of the rating or probability of default is possible. *Validation methodology:* Annual validations are performed where ranking and calibrations are assessed using statistical tests as well as expert comparisons. Independent validation is also conducted internally using similar statistical tests which may include full re-estimation of model parameters.

<table>
<tr><th>Portfolio and type of exposures</th><th>Description of rating system</th></tr>
<tr><td>4. Commercial portfolio (SME Corporate and SME retail counterparties in FNB Commercial and WesBank)

Exposures to SME clients.
A wide range of products gives rise to the credit exposures including loan facilities, contingent products, and term lending products.</td><td>The default definitions applied in the rating systems are aligned to the requirements of Basel II.

SME Retail
Rating process:
→ The retail portfolio is segmented into homogeneous pools and sub pools through an automated scoring process using statistical models that incorporate product type, customer behaviour and delinquency status.
→ Based on internal product level history associated with the homogeneous pools and sub pools, probabilities of default are estimated for each sub pool.
→ LGD and EAD estimates are applied on portfolio level, estimated from internal historical default and recovery experience.

SME Corporate
Rating process:
→ PD: Counterparties scored using Moody's RiskCalc, of which the output was calibrated to internal historical experience.
→ LGD: Collateral type determines recovery rate. Recovery rates set with reference to internal historical experience, external data (Fitch) and Basel II guidelines.
→ EAD: Portfolio level credit conversion factor ("CCF") estimated from internal historical experience and benchmarked against international studies.

Validation methodology:
Annual validations are performed where ranking and calibrations are assessed using statistical tests as well as expert comparisons. Independent validation is also conducted internally using similar statistical tests which may include full re-estimation of model parameters.</td></tr>
<tr><td>5. Residential mortgages (Retail exposure rating systems for FNB HomeLoans, RMB Private Bank exposures and mortgages exposures in the Mass segment)

Exposures to individuals for the financing of residential mortgages.</td><td>The default definition applied in the rating systems is aligned to the requirements of Basel II.

Rating process and approach:
→ The retail portfolio is segmented into homogeneous pools and sub pools through an automated scoring process using statistical models that incorporate product type, loan characteristics, customer behaviour, application data and delinquency status.
→ Based on internal product level history associated with the homogeneous pools and sub pools, probabilities of default are estimated for each sub pool.
→ No overrides of the probability of default are possible. The only potential override is not that of the PD, but rather of the automated decision to lend or not. Such overrides are done judgementally by credit managers in the segments and are supported by business reasons.
→ LGD and EAD estimates are based on sub segmentation based on the collateral or product type, and associated modelling of internal data history. The loan to value data is used as an input into the rating system.

Validation methodology:
Annual validations are performed where ranking and calibrations are assessed using statistical tests as well as expert comparisons. Independent validation is also conducted internally using similar statistical tests which may include full re-estimation of model parameters.</td></tr>
</table>

Portfolio and type of exposures	Description of rating system
6. *Qualifying revolving retail exposures (Retail exposure rating systems for FNB Card and FNB Consumer overdrafts and RMB Private Bank)* Exposures to individuals providing a revolving limit through a credit card or overdraft facility.	The default definitions applied in the rating systems are aligned to the requirements of Basel II. *Rating process and approach:* → The retail portfolio is segmented into homogeneous pools and sub pools through an automated scoring process using statistical models that incorporate product type, bureau data, internal customer behaviour, application data and delinquency status. → Based on internal product level history associated with the homogeneous pools and sub pools, probabilities of default are estimated for each sub pool. → No overrides of the probability of default are possible. The only potential override is not that of the PD, but rather of the automated decision to lend or not. Such overrides are done judgementally by credit managers in the segments and are supported by business reasons. → LGD and EAD estimates are based on sub segmentation and the respective collateral or product type, and associated modelling of internal data history. In general, the revolving credit exposures are unsecured and therefore only the efficiency of the recovery processes impacts on the level of LGD. The EAD measurement plays a significant role due to the high level of undrawn limits inherent in these product types. The EAD estimate is based on actual historic EAD and is segmented depending on whether the facility is straight or budget (credit card) and utilisation size. *Validation methodology:* Annual validations are performed where ranking and calibrations are assessed using statistical tests as well as expert comparisons. Independent validation is also conducted internally using similar statistical tests which may include full re-estimation of model parameters.
7. *Other retail exposures (Retail rating systems for FNB Personal Loans, Smart Products and WesBank retail auto finance and personal loans)*	The default definitions applied in the rating systems are aligned to the requirements of Basel II. *Rating process and approach:* → The retail portfolio is segmented into homogeneous pools and sub pools through an automated scoring process using statistical models that incorporate product type, customer behaviour, application data and delinquency status. → Based on internal product level history associated with the homogeneous pools and sub pools, probabilities of default are estimated for each sub pool. → No overrides of the probability of default are possible. The only potential override is not that of the probability of default, but rather of the automated decision to lend or not. Such overrides are done judgementally by credit managers in the segments and are supported by business reasons. → LGD and EAD estimates are based on sub segmentation and the respective collateral or product type, and associated modelling of internal data history. *Validation methodology:* Annual validations are performed where ranking and calibrations are assessed using statistical tests as well as expert comparisons. Independent validation is also conducted internally using similar statistical tests which may include full re-estimation of model parameters.

Control mechanisms implemented for credit risk measurement

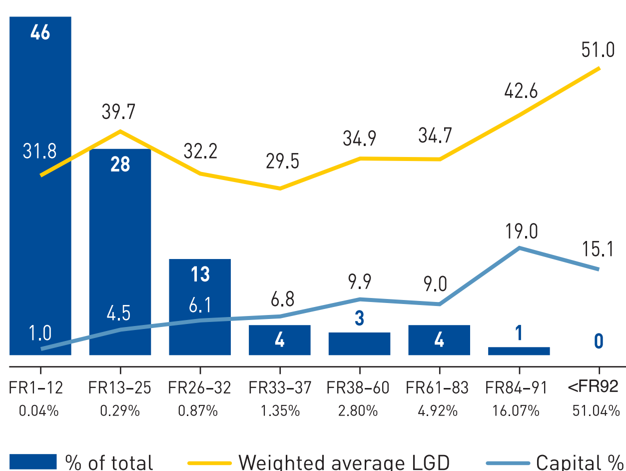
Rating systems are recalibrated and validated independently on an annual basis to ensure their validity and accuracy. The focus remains on the predictive power of the underlying models. The models are appropriately conservative and incorporate data of downturn periods such as 2001 and 2007. The independent validation of the rating systems are conducted by the Group Credit Risk control function in the ERM division. The function is responsible for the review of all rating systems and a comprehensive revalidation of all material rating systems. The rating systems are also reviewed by an actuarial auditing team within Internal Audit, and sampled revalidation is also carried out. The MRV committee, being the board sub committee responsible for the independent oversight and approval of the rating systems, review the results of the independent validations.

The table below provides the Basel II asset classes and the relevant FRB portfolio.

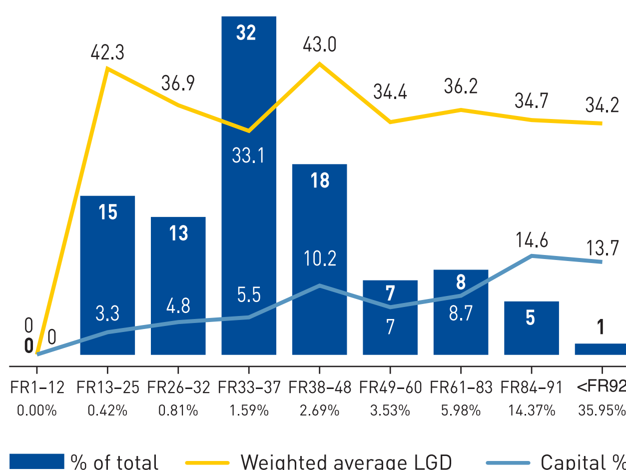
Basel II asset class	FRB portfolio
Corporate, Bank and Sovereign	RMB FNB Corporate Banking Balance Sheet Management
SME corporate and retail	FNB Commercial
Residential mortgages	FNB HomeLoans RMB Private Bank and FNB Private Clients Mortgages in FNB Mass
Qualifying revolving retail	FNB Card FNB Personal Banking (Overdrafts) RMB Private Bank and FNB Private Clients
Other Retail	FNB Mass (secured and unsecured Smart Products) FNB Personal Banking (Personal loans, student loans)
Other Retail SME Corporate	WesBank

The section below provides the exposure distribution per EAD as well as the exposure weighted average TTC PD, LGD and indicative capital ratio for each Basel II asset class. The TTC PD is lower than the PIT PD in the current cycle. The credit conversion factor for FRB is estimated at 79% for off balance sheet products.

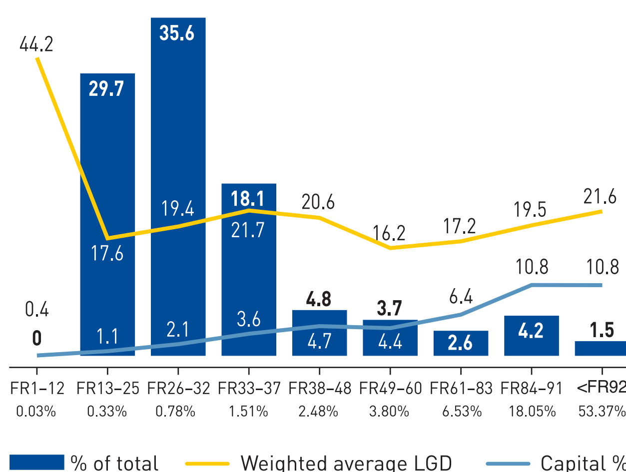
Corporate, bank and sovereign (unaudited)
(%)



SME exposures (FNB Commercial) (unaudited)
(%)

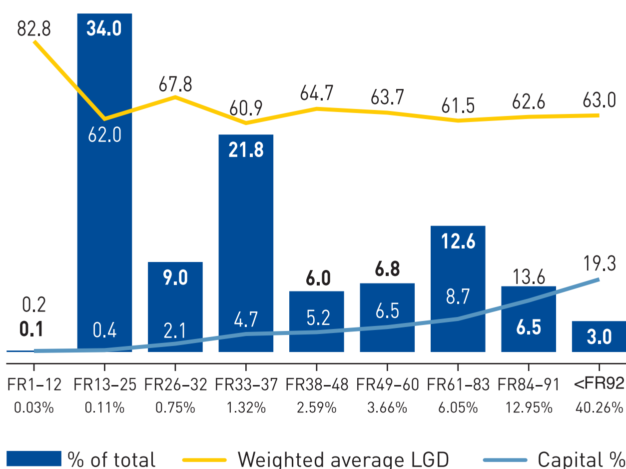


Residential mortgages (unaudited)
(%)



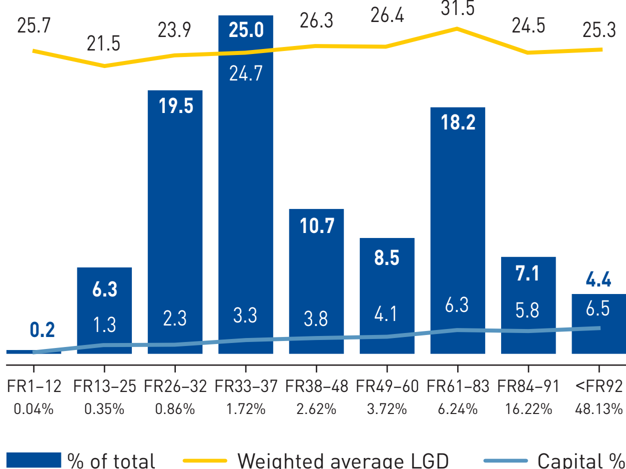
Qualifying revolving retail (unaudited)

(%)



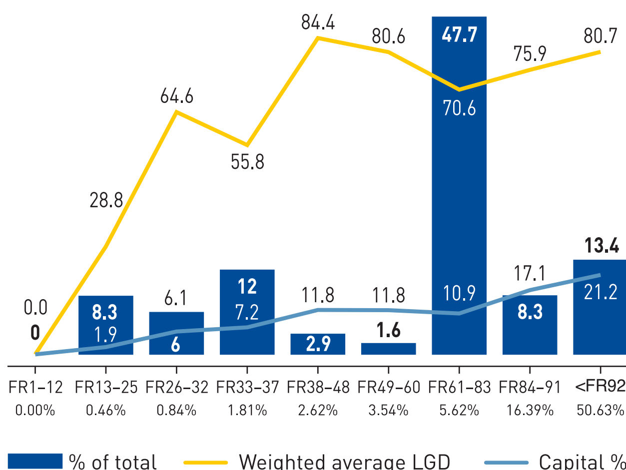
WesBank

(%)



Other retail (unaudited)

(%)



Securitisations

FRBH uses securitisations as a tool to achieve a combination of some or all of the following results:

- Enhanced liquidity position through the diversification of funding source;
- Matching of cash flow profile of assets and liabilities;
- Reduction of balance sheet risk;
- Reduction of capital requirements; and
- Management of credit concentration risk.

During the year under review, FRB concluded the FirstRand Enhanced Synthetic Credit Obligation II (Fresco II) securitisation transaction. This was a R 20 billion collateralised loan obligation of corporate exposures, structured to enable FRB to manage the economic and regulatory capital held against its large corporate credit portfolio.

FRB has in place a number of traditional and synthetic securitisation structures. From an accounting perspective, the traditional securitisation transactions are treated as sales transactions. At inception, the assets are sold by FRB to the special purpose vehicle at carrying value and no gains or losses are recognised. For the synthetic securitisations, the credit derivative is recognised at fair value, with any fair value adjustments reported in profit or loss. The securitisation entities are consolidated into FRBH.

The two tables below show the exposures arising from securitisation activities split between on balance sheet and off balance sheet:

On Balance Sheet Securitisation Exposures – own transactions

				AT 30 JUNE 2008		
Transaction	Year initiated	Rating agency	Asset type	Assets securitised (R MILLION)	Assets outstanding (R MILLION)	Exposure (R MILLION)
Traditional securitisations						
Nitro 1	2006	Moody's	Retail instalment sales	**2 000**	**534**	**15**
Nitro 2	2006	Moody's	and leasing	**5 000**	**1 897**	**49**
Nitro 3	2007	Moody's and Fitch		**5 000**	**3 088**	**125**
Ikhaya 1	2007	Fitch	Retail mortgages	**1 900**	**1 608**	**52**
Ikhaya 2	2007	Fitch		**2 884**	**2 320**	**133**
Total Traditional securitisations				**16 784**	**9 447**	**374**
Synthetic securitisations			Retail instalment sales			
Procul	2002	Fitch	and leasing	**2 000**	**2 000**	**1 015**
Fresco II	2007	Fitch	Corporate receivables	**20 000**	**20 000**	**18 259**
Total Synthetic securitisations				**22 000**	**22 000**	**19 274**
Total securitisation				**38 784**	**31 447**	**19 648**

In each of the securitisations mentioned above, FRBH played the role of originator, investor, servicer and swap counterparty. All the above transactions continue to perform in line with expectations as detailed in each of the respective offering circulars.

Off Balance Sheet Exposures[1]

Off Balance Sheet Securitisation Exposures

			AT 30 JUNE 2008
Transaction	Transaction type	Exposure type	Exposure (R MILLION)
Own transactions			
iNdwa	Conduit	Liquidity facility	**9 126**
iVuzi	Conduit	Credit enhancement	**680**
Third party transactions			
Freestone	Securitisation	Liquidity facility	**200**
Freestone	Securitisation	Liquidity facility	**260**
ABSA CARS	Securitisation	Liquidity facility	**298**
ABSA HOMES	Securitisation	Liquidity facility	**233**
PROPS	Securitisation	Liquidity facility	**625**
Total			**11 422**
of which:			
Own transactions			**9 806**
Third party transactions			**1 616**

1 *It is important to note that from an accounting perspective, upon consolidation, the underlying assets in the off balance sheet entities are consolidated back onto the FRBH balance sheet.*

All the liquidity facilities in the transactions above will rank senior in the priority of payments in the event of a drawdown. As such the inferred rating on the liquidity facility to iNdwa is F1+(zaf), while the inferred ratings on the other liquidity facilities are AAA on a national scale level. Economic capital is allocated to the liquidity facility extended to iVuzi as if the underlying assets are on balance sheet to reflect the risk that these assets may come on balance sheet in a stress scenario.

The tables below show the conduit programmes that have been facilitated by FRBH, in place as at 30 June 2008:

Conduits

Transaction	Underlying assets	Year initiated	Rating agency	Programme size (R MILLION)	Current size of non recourse investments (R MILLION)
iNdwa	Corporate term loans	2003	Fitch	15 000	9 329
iVuzi	Corporate term loans	2007	Fitch	15 000	4 362
Total				30 000	13 691

Other

Transaction	Underlying assets	Year initiated	Rating agency	Programme size (R MILLION)	Current size of non recourse investments (R MILLION)
iNkotha	Call loan bond fund	2006	Fitch	10 000	4 327
Total				10 000	4 327

The table below shows the roles played by FRBH in each of the above conduit programmes:

Transaction	Originator	Investor	Servicer	Liquidity provider	Credit enhancement provider	Swap counterpart
iNdwa	–	–	√	√	–	√
iNkotha	–	–	√	–	–	–
iVuzi	–	–	√	√	√	√

All the above conduit programs continue to perform in line with the expectations as detailed in each of the respective offering circulars.

FRB has neither securitised any exposures that were impaired or past due at the time of securitisation nor has it suffered any losses during the current period on the assets that remained on its balance sheet. All the securitisation transactions were subject to the regulatory securitisation framework.

The table below shows the securitisation exposures retained or purchased and the associated internal ratings based capital charge per risk band:

	AT 30 JUNE 2008		
Risk weight bands	AIRB Exposure (R MILLION)	Capital (R MILLION)	Deduction (R MILLION)
=<10%	17 840	129	–
>10% =<20%	10 742	133	–
>20% =<50%	230	9	–
>50% =<100%	1 015	41	–
>100% =<650%	827	218	–
Total	30 654	531	–

None of the securitisations transactions are subject to the early amortisation treatment.

COUNTERPARTY CREDIT RISK

COUNTERPARTY CREDIT RISK IS DEFINED AS THE RISK THAT THE COUNTERPARTY TO A TRANSACTION COULD DEFAULT BEFORE THE FINAL SETTLEMENT OF THE TRANSACTION'S CASH FLOWS.

Risk governance and management

Counterparty credit risk is managed in terms of the Credit Risk Management Framework for Wholesale Credit Exposure which is a sub framework of the FRBH Credit Risk Management Framework.

Counterparty credit exposure limits are set at a counterparty level in line with the credit risk appetite of FRBH. To accommodate the business requirement of all operating divisions across FRBH (e.g. WesBank's moveable asset finance division, FNB's transactional banking division and RMB's

Investment Banking, FICC and Equity Trading divisions) the approved credit risk appetite is allocated to the operating divisions taking into account the credit standing of the obligor and credit pricing considerations.

Counterparty credit risk limit applications are assessed and approved individually. In order to determine the appropriate level of such limits the bank requires a comprehensive analysis of the counterparty credit risk, including the extent to which the exposure can increase under distressed conditions. This analysis is done by an independent specialist credit analyst, in conjunction with market risk, who recommends a counterparty limit. All limit recommendations are considered and approved by business unit owners who have co-responsibility for ensuring the counterparty credit risks are acceptable, appropriate processes and procedures are in place to monitor and manage the level of credit risk, and the rewards are commensurate for the proposed risks. These recommendations are then motivated to appropriate credit committees comprising executive and non executive members who are sufficiently independent from the business requesting the credit facility to objectively decide on such a credit facility. All counterparty credit risk limits are reviewed annually and resubmitted to the relevant credit committee for approval. Approved counterparty credit limits may be allocated to various groups of products.

Wherever possible, derivative trading is pursued under ISDA master agreements, International Securities Market Association ("ISMA") contracts, or Credit Support Annexes ("CSA"). These agreements provide for the ability to settle the net exposures due and payable by both counterparties where there are payables and receivables owing by both counterparties respectively. They also provide for margining or collateral arrangements where appropriate.

Risk measurement and economic capital

Limit and exposure management processes are supported by various management information systems as well as manual intervention processes. A credit risk resource within each business unit ("BU") is responsible for ensuring that limits are monitored and adhered to. Credit risk reports are reviewed on a daily basis by the credit operations staff. These reports are created at the desk level and sent to the dealers who use the report to check limit availability before concluding new transactions. The credit operations staff also checks the daily credit risk reports which will identify any dealing excesses that have arisen. Exposures are monitored both at BU level and in aggregate for FRBH.

Any excess exposure over a sub allocated limit has to be reported to the BU head, the head of BU risk management and RMB Risk and Compliance without delay and corrective actions must be agreed by all parties. Such excess exposure is evaluated taking cognisance of the sub allocated limit and of total actual exposure at FRBH level in relation to the total approved counterparty credit limit at FRBH level. Excesses against sub allocated limits require risk management to identify the cause of the excess (e.g. dealer non compliance, unexpected market moves, settlement failure, counterparty credit deterioration, etc.). It is the responsibility of the dealers to remedy the cause of the excess.

Failure to correct a breach as agreed, or recurrence of the same or similar breaches from desk level upwards, are reported to the RMB Finance, Risk and Capital committee, FRBH ERM division and to the next meeting of the FRBH RCC committee. These committees are responsible for raising these issues to appropriate board forums to take corrective action.

Economic capital is assessed in terms of the AIRB approach to credit risk. However, the estimated exposure at default is measured under the Basel II current exposure method for FRB.

Counterparty credit risk arising from derivative and structured finance transactions of FRB:

R MILLION	AT 30 JUNE 2008
Gross positive fair value	111 891
Netting benefits	55 087
Netted current credit exposure before mitigation	56 804
Collateral value	17 746
Exposure at default	54 235

Distribution of credit derivatives of FRB based on nominal values:

R MILLION	Credit default swaps	Total return swaps	Other	Total
Own credit portfolio				
– protection bought	2 102	–	4 118	6 220
– protection sold	152	–	–	152
Intermediation activities				
– protection bought	–	–	250	250
– protection sold	970	420	–	1 390

MARKET RISK

MARKET RISK IS THE RISK OF REVALUATION OF ANY FINANCIAL INSTRUMENT AS A CONSEQUENCE OF ADVERSE CHANGES IN THE MARKET PRICES OR RATES. IT EXISTS IN ALL TRADING, BANKING AND INVESTMENT PORTFOLIOS. FOR THE PURPOSE OF THESE FINANCIAL STATEMENTS MARKET RISK IS CONSIDERED TO BE FULLY CONTAINED WITHIN THE TRADING PORTFOLIOS.

Substantially all market risk within FRBH is taken in RMB as this is the division within FRBH where the market risk taking and management expertise lies.

Market risk governance and management

Market risk is managed in terms of the Market Risk Framework which is a sub framework of FRBH's Risk Management Framework. Trading activities currently include trading in the foreign exchange, interest rate, equities, commodities and credit markets in both physical and derivative instruments.

A two tiered governance structure governs market risk taking activities within FRBH. The first tier consists of determining the appetite of FRBH for market risk taking activities, and the independent prudential oversight attached thereto. The second tier involves the non statutory governance forums that actively oversee the implementation of board policies at the divisional level. Appetite for market risk taking activities is determined by the FRBH board, with primary independent prudential oversight of market risk then vesting with the FRBH RCC committee. At the divisional level, the RMB Proprietary Board (an executive management committee) has the primary task of strategic risk allocation to the transacting units and ensuring the implementation of the prudential aspects of the board mandate. The RMB Finance, Risk and Capital committee is the market risk committee of RMB and is a sub committee of FRBH RCC committee, and is charged with the independent oversight of market risk within RMB and reports all material aspects of market risk to the FRBH RCC committee. Longer term equity investments, both listed and unlisted, are approved by the Investment committee on an individual basis and are managed under the Investment Risk Framework. Market risk limits are reviewed at least annually.

Market risk measurement

Market risk exposures are limited by means of distressed ETL limits, whilst soft VaR triggers indicate that positions need to be reviewed by management. Both sets of limits are approved by the RMB Proprietary Board and ratified by the FRBH RCC committee and the board. Risk concentrations are controlled by means of appropriate sub limits attached to both asset class (interest rate, equity, foreign exchange, commodities and traded credit) and business unit maximum allowable exposures.

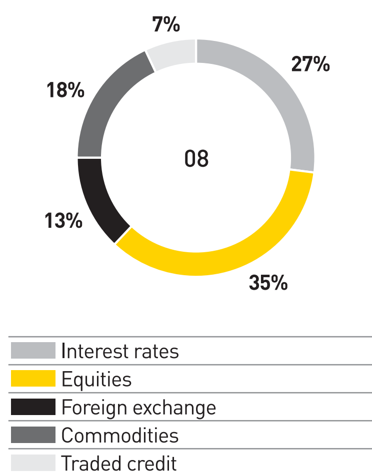
Stress conditions are represented by historic systemic disaster scenarios over which the portfolio is fully revalued. The disaster scenarios have been deliberately set to reflect the illiquid conditions and volatile price movements experienced during a typical systemic breakdown in the markets.

RMB has approval from the SARB to measure regulatory market risk capital under the internal model approach, as stipulated in the Basel II Accord, for the local trading book. For all international legal entities the Standardised Approach is used to calculate regulatory market risk capital although for internal economic capital measurement, the internal model approach is used for all legal entities and is based on distressed ETL.

In addition to the distressed ETL and VaR methodologies, FRBH supplements its measurement techniques with defined stress tests and scenario analyses across all material risk factors. The calibration of the stress tests are reviewed from time to time to ensure that they are indicative of possible market moves under distressed market conditions and they provide additional insight into possible outcomes under stressed market conditions to the RMB Proprietary Board.

The following pie chart shows the distribution of exposures per risk factor across FRBH's trading activities at the end of the financial year based on the distressed ETL methodology.

FRBH's market risk exposure per risk factor



	Interest rates
	Equities
	Foreign exchange
	Commodities
	Traded credit

FRBH market risk exposure per risk factor

Market risk exposures are quantified on a daily basis across all trading activities of RMB and monitored by the business and central risk managers, desk heads, business unit heads, and designated executive management. The business and central risk managers at RMB monitor exposure against limits, the causes of any excesses and the correction thereof. These functions also track the daily profits and losses against risk exposures and monitor the attribution of profits and losses by risk factor to ensure that risk exposures do not go undetected and that profits and losses are explained within the risk measurement framework.

Realised market risk exposures

The market risk management processes are well vested and have functioned effectively for a number of years. Notwithstanding this, risk processes are only really properly tested through times of

market distress and turmoil. The RMB market risk process functioned well through the recent period of distress, displaying a good deal of robustness and flexibility in carrying out its day to day requirements as well as accommodating the addition of bespoke, point in time requirements. The risk measures, which were predicated on distressed markets, proved in the main, to be well calibrated to cope with the distress over the past year. Neither internal audit nor an external independent model valuator nor the SARB internal model process approval team identified significant process deficiencies in the 2008 financial year. Process shortcomings identified are corrected and the progress with corrective actions is monitored by the risk managers and the RMB Finance, Risk and Capital committee as they arise.

Trading book VaR analysis

The VaR exposures below reflect the aggregate market risk exposure per asset class across different trading activities. The VaR risk measure estimates the potential loss over a 10 day holding period at a 99% confidence level. The VaR scenario set comprises the most recent 250 scenarios, as is required for internal model capital regulatory market risk measurement.

The table below reflects the aggregate market risk exposure per asset class across different trading activities:

	30 JUNE 2008				30 JUNE 2007
R MILLION	Min	Max	Ave	Year end	Year end
Risk type					
Equities	192.6	575.3	390.8	233.8	269.0
Interest rates	61.0	214.4	102.8	100.7	93.4
Foreign exchange	19.7	194.6	63.0	69.0	40.5
Commodities	36.1	152.8	82.8	119.8	68.1
Traded credit	23.5	87.8	48.4	46.5	21.4
Diversification				(265.1)	(226.9)
Total				304.7	265.5

In order to validate the VaR calculations, back testing is conducted on a daily basis. This is accomplished by comparing the 1 day VaR at the 99% confidence level to actual and theoretical trading profits or losses for that particular day.

Stress analysis

A revaluation of the portfolio is calculated over 500 scenarios of which 250 scenarios represent a distressed market period. Once the current financial crisis plays itself out the distressed scenario set will be supplemented with data from the current market crisis.

	AT 30 JUNE 2008				AT 30 JUNE 2007
R MILLION	Min	Max	Ave	Year end	Year end
Risk type					
Equities	302.2	910.7	656.3	346.4	504.5
Interest rates	171.6	612.2	319.2	270.1	222.9
Foreign exchange	55.3	333.9	128.2	124.6	92.0
Commodities	70.3	264.8	141.9	180.5	118.5
Traded credit	47.6	217.3	89.4	67.6	251.4
Diversification				(496.2)	(592.1)
Total				493.0	597.2

FirstRand International

FirstRand Ireland PLC represents the most material international subsidiary exposed to market risk. FirstRand Ireland PLC makes use of both the distressed ETL and VaR methodologies as well as additional stress scenario analysis to estimate the potential profit and loss impact of the market risk exposures, based on assumptions for changes in market prices and interest rates. The board sets market risk limits for each business area. The risk exposures are monitored against risk limits on a daily basis for all business units.

FNB Africa subsidiaries

FNB Namibia and FNB Botswana represent the most material FNB Africa subsidiaries. Both of these entities make use of a stress methodology to estimate the market risk positions held and the maximum losses expected.

Equity positions in the banking book

EQUITY INVESTMENT RISK GENERALLY REFERS TO THE RISK ASSOCIATED WITH THE ACQUISITION OF EQUITY/OWNERSHIP OR PARTICIPATION IN A LISTED COMPANY OR AN UNLISTED COMPANY OR A START UP.

Risk governance and management

Equity investments are approved by business unit investment committees, the RMB investment committee or the FRBH Large Exposures Credit committee depending on the value of individual investments. The FRBH Large Exposures Credit committee also approves investments comprising both debt and equity portions, irrespective of the percentage split, should the total exceed approved thresholds.

Risk associated with private equity investments is managed through various means. Prior to investing, a comprehensive due diligence is performed for each investment providing a thorough understanding of a business and comfort around its management team. Management incentives and constraints are structured such that the interests of the buyer and those of management are aligned for the success of the investment. In the majority of cases, RMB seeks a seat(s) on the board of the investee company. Investments are further monitored regularly throughout the life of the deal. Investee company financial statements are received and analysed on a regular basis. Personal contact with portfolio companies' management is maintained regularly and any concerns are raised with management at the time.

RMB conducts a bi-annual review of all private equity portfolio companies. Matters such as the valuation of the companies are peer reviewed, and the outlook for the companies and any upcoming events that are deemed potential risks to the value of a company are discussed.

On a portfolio level, risk in the private equity portfolio is managed through the diversification of investments across geography, industry, stage (i.e. venture capital, leveraged buy out or structured deals) and vintage (annual replacements of realisations).

Risk on listed equities is managed in accordance with the market risk framework. This includes the role of both management and oversight bodies.

Risk measurement and economic capital

Economic capital for equity exposures held for investment purposes is calculated using a stress test approach similar to the Basel II approach for equity investments, i.e. applying a risk weighting of 300% and 400% of exposure value for listed and unlisted investments, respectively. A conservative portfolio offset is allowed for unlisted investments that are equity accounted should the carrying value be less than the risk weighted market value.

Where price discovery permits for liquid listed equity positions, the ETL under distressed market conditions is calculated on a standalone basis (per the trading book methodology and scenarios). This measure is used as the economic capital, subject to a floor of 20% of market value on the capital calculation.

Where price discovery into the underlying assets of hedge funds permits for a look though to those underlying assets, the modelling of economic capital is based on such a look through approach as opposed to the simplistic 300% (risk weight) stress tests. The underlying assets are modelled onto FRBH's market risk systems and capital is assigned on a market risk basis, with an appropriate scaling to account for the time taken to liquidate the investment. The look though approach is also applied to the underlying assets of companies where those underlying assets consist entirely of investments with adequate pricing discovery.

Those funds where asset prices or values are not available on a frequent basis are treated in the same manner as unlisted equity investments with the assumption that the valuation provided by the fund is correct as this is the value at which the fund is carried on book.

The following table provides information relating to equity investments in the banking book of those entities regulated as banks within FRBH:

	AT 30 JUNE 2008		
R MILLION	Publicly quoted investments	Privately held	Total
Carrying value	2 399	6 703	9 102
Fair value*	2 231	7 484	9 715
Total unrealised gains recognised through equity instead of the income statement**	891	92	983
Latent revaluation gains not recognised in the balance sheet**	(168)	781	613
Economic capital held	483	1 569	2 052

* *Fair values of publicly quoted investments were not considered to be materially different from the quoted prices.*

** *These unrealised gains or losses are not included in Tier 1 or Tier 2 capital.*

LIQUIDITY RISK

LIQUIDITY RISK IS THE RISK THAT THE BANK WILL NOT MEET ALL PAYMENT OBLIGATIONS AS LIABILITIES FALL DUE. IT ALSO REPRESENTS THE RISK ASSOCIATED WITH NOT BEING ABLE TO REALISE ASSETS TO MEET DEPOSITOR REPAYMENT OBLIGATIONS IN A STRESS SCENARIO.

Liquidity risk: a broader definition

Due to rapidly changing markets, technologies, governance, accounting policies, and regulatory monitoring, risk management has become more sophisticated, with liquidity risk being no exception. Understanding what the impacts of these factors are on liquidity is extremely important and it starts by broadening the definition of liquidity risk into market liquidity risk and funding liquidity risk. Funding liquidity risk is the risk that the bank will not be able to effectively meet current and future cash flow and collateral requirements without negatively affecting the normal course of business, the bank's financial position or its reputation. Market liquidity risk is the risk that market disruptions or lack of market liquidity causes the bank to be unable (or able, but with difficulty) to trade in specific markets without affecting market prices significantly. Furthermore we also acknowledge that liquidity risk is a consequential risk and continue to monitor and understand possible impacts of other risks and events on the funding and liquidity risk of our organisation. This also comes into place when stress testing and scenario analysis is performed.

Liquidity risk governance

FRBH's Liquidity Risk Management Framework aims to apply sound principles for managing liquidity risk, based on best practice international standards. It is designed in line with Basel II to identify, measure and manage the liquidity risk position of FRBH. Rapidly changing markets with growing product complexities, changes in the economy, international expansion, the entry of new participants to the market and historical catastrophic consequences due to overexposure to liquidity risk highlight the need for continual reassessment of and improvements to the framework. Hence our obligation to update and review this framework regularly and ensure appropriate liquidity risk management within FRBH. The underlying policies are reviewed regularly by FRBH's BSM division. These policies are also independently approved by FRBH's ERM division, FRBH's ALCO and FRBH's RCC committee.

The liquidity risk management framework covers three broad topics:

- governance and organisational structure for managing liquidity;
- analytical framework for measuring, monitoring, and managing liquidity; and
- stress testing and contingency planning.

FRBH acknowledges that good governance and an effective organisational structure are imperative for the efficient management of liquidity risk.

BSM is responsible for the measurement and management of liquidity risk. The ERM division, with a dedicated Asset and Liability oversight team is responsible for independent oversight of liquidity risk and reports to FRBH ALCO.

Liquidity risk measurement

Liquidity risk for FRBH is measured in a combination of daily and monthly procedures for the purpose of determining the bank's liquidity risk status. As a strategic management tool, this assists dynamically in strategy formulation and tracking of effectiveness. The liquidity risk measurement processes attempt to analyse and depict liquidity risks evident in the material portfolios and legal entities of the banking operations. The risk measurement processes are classified into the following broad categories:

- diversification (term, source, product);
- off balance sheet exposures;
- available funding resources;
- performance measurement;
- reputation (risks & events);
- regulatory requirements;
- asset quality; and
- other risks/events.

Each category has multiple key risk indicators, highlighting the risks and trends on and off balance sheet. Conduits, securitisations, contingent liabilities and undrawn facilities are all included and managed as if on balance sheet. Limits are set on two levels (amber and red) for each key risk indicator. Amber levels indicate a warning signal and possible negative trends and that action required to restore the status to green (depending on tolerance levels). Red levels indicate immediate action required and possibly activating contingency plans. These key risk indicators are monitored regularly (daily and monthly) to enable the BSM division to effectively manage the Banks' liquidity position and are reported monthly to FRBH ALCO and quarterly to the FRBH RCC committee.

Management of liquidity risk

Liquidity risk is managed in terms of the Liquidity Risk Management Framework, which is ancillary to FRBH's Risk Management Framework. Liquidity risk is centrally managed by the BSM division. The liquidity risk management approach firstly includes intraday management (operational liquidity), managing the daily payment queue, forecasting cash flows and factoring in access to central banks. Secondly, tactical liquidity risk management deals with access to unsecured funding sources and the liquidity characteristics of FRBH's asset inventory (asset liquidity). Finally, dynamic liquidity risk measurement and analysis assists in the strategic decision making process, when defining our issuance strategy. The following diagram illustrates the liquidity risk management cycle.

Term funding diversification is considered a very important analysis for liquidity risk. Liquidity risk resides in the short term exposure the bank faces, where most of FRBH's liabilities mature within 1 month and relatively few assets mature in that period. To manage this risk, the steps indicated in the diagram above are followed. Determining the liquidity risk target profile is the key starting point. Comparing the current profile with that of the industry and identifying the target risk profile forms part of the measurement process which filters through the liquidity risk management framework. Stress testing is performed to determine how effectively the current and targeted risk profiles would withstand certain stress events at certain severity levels. Stress testing also plays a key role in the methodology for calculating the size of the liquidity buffers, considering FRBH's risk appetite. These unencumbered liquidity risk buffers are in excess of the statutory requirements and are actively managed in portfolios of high quality liquid assets, maintained at suggested levels for protection against any unexpected disruptions. The current funding profile is strategically adjusted to reach the target risk profile by implementing certain short , medium and long term action plans. The wholesale funding market is utilised to correct any strategic adjustment differences. The costs of these strategic decisions are passed on to the respective business units via the internal matched maturity funds transfer pricing models. Once the cycle is complete, the risk profile is reassessed, considering current market and economic conditions as well as risk appetite, and the cycle would start once again.

The following actions are taken within this process to maintain an adequate liquidity risk profile and status:

- industry benchmarking;
- analyse & decrease concentration of short term funding maturities;
- diversify the range of products offered to financial institutions and maintain an appropriate mix of funding sources;
- maintain and manage a portfolio of available liquid securities;
- perform assumptions based sensitivity analyses to assess potential cash flows at risk in stressed conditions;
- maintain liquidity contingency plans;
- monitor sources of funding for contingency funding needs;
- monitor daily cash flow movements across the Bank's various payment streams;
- actively manage the daily settlements and collateral management processes;
- define, measure and monitor key risk indicators;
- define and monitor liquidity risk limits;
- monitor balance sheet liquidity ratios against internal and regulatory requirements;
- maintain an appropriate term mix of funding;
- consider off balance sheet exposure and contagion risks (for example conduits) and manage within appropriate risk appetite levels;
- consider key risk indicators on reputation risk and performance measurement as an integral part of determining the liquidity risk status for the Bank; and
- assess the liquidity risk position on a daily basis to support decision making on liquidity risk and funding management.

Although FRBH also engages in financial transactions utilising special purpose entities, we are not reliant upon these entities to any material extent in terms of our funding and liquidity capacity. These entities (and FRBH's obligations to them) are fully consolidated in our liquidity risk measurement, stress testing and management processes and are managed conservatively from a liquidity risk perspective.

FRBH is adequately funded and able to meet all its current obligations.

INTEREST RATE RISK IN THE BANKING BOOK

INTEREST RATE RISK IN THE BANKING BOOK IS DEFINED AS THE SENSITIVITY OF THE BALANCE SHEET AND INCOME STATEMENT TO UNEXPECTED, ADVERSE MOVEMENTS IN INTEREST RATES AND CAN BE AN IMPORTANT SOURCE OF PROFITABILITY AND SHAREHOLDER VALUE. EXCESSIVE INTEREST RATE RISK COULD POTENTIALLY POSE A SIGNIFICANT THREAT TO A BANK'S EARNINGS AND CAPITAL BASE, THEREFORE, EFFECTIVE RISK MANAGEMENT THAT MAINTAINS THE RISK WITHIN PRUDENT LEVELS IS ESSENTIAL TO THE SAFETY AND SOUNDNESS OF BANKS.

Banks are typically exposed to the following sources of interest rate risk:

- **repricing risk** (which arises from the differences in timing between repricing of assets, liabilities and off balance sheet positions);
- **yield curve risk** (when unanticipated changes in the shape of the yield curve adversely affects a bank's income or underlying economic value);
- **basis risk** (imperfect correlation in the adjustment of the rates earned and paid on different instruments with similar repricing characteristics); and
- **optionality** (the right that the holder has to alter the cash flow of the underlying position).

Interest rate risk governance

Interest rate risk in the banking book is managed in terms of FRBH's Framework for the Management of Interest Rate Risk in the Banking Book, which is a sub framework of the Risk Management Framework. The framework is reviewed at least annually.

Interest rate risk management is part of FRBH's BSM division. The objective of BSM is to protect and enhance the balance sheet and income statement of FRBH. In line with this objective, interest rate risk in the banking book is managed from an earnings approach over a specified horizon and changes to economic value are monitored and managed within defined risk tolerance levels.

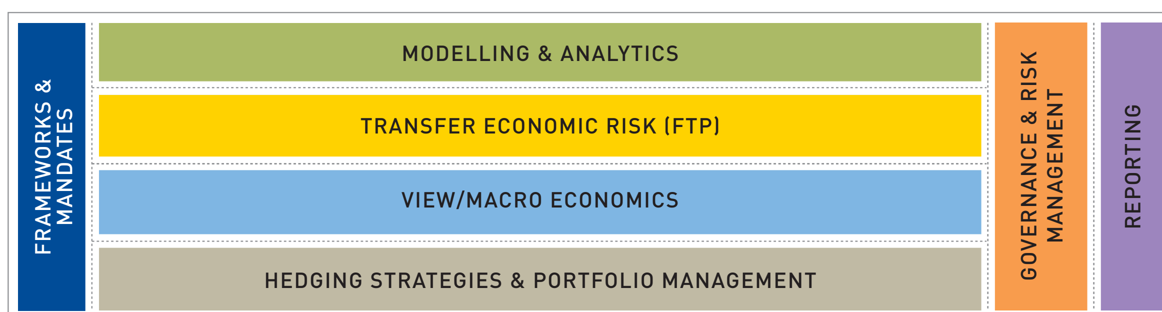
Interest rate risk in the banking book is reported to FRBH ALCO, a sub committee of the board's RCC committee, on a monthly basis. FRBH ALCO is responsible for monitoring the implementation of the interest rate risk management framework and the management of interest rate risk in the banking book across FRBH (i.e. it monitors the risk exposures and the effectiveness of the interest rate risk management). Interest rate risk that arises from trading activities is managed under the Market Risk Framework.

The board (through FRBH RCC committee) approves overall risk limits for the interest rate risk in the banking book. FRBH ALCO approves additional sub limits. In addition to the monthly risk reporting to FRBH ALCO, any limit breaches and proposed remedies are reported immediately to the Chairperson of FRBH ALCO, the Head of ERM, the Risk Officer for Interest rate risk in the banking book and to the next meeting of the FRBH RCC committee (where deemed appropriate).

To ensure that region specific issues are addressed, the effectiveness of interest rate risk management in the banking books of international businesses is monitored by FRBH's International ALCO, which is a sub committee of FRBH ALCO. Each of the FNB Africa subsidiaries has its own ALCO, which monitors interest rate risk associated with the banking book of that subsidiary and reports back to FRBH ALCO on a monthly basis.

Interest rate risk management process

The net interest rate risk profile of the domestic banking book is managed centrally by the Macro Portfolio Management ("MPM") pillar in BSM. The graph below illustrates their portfolio management process. The banking book of RMB is managed separately. It is managed in terms of the Market Risk Framework and limits.



The interest rate profile is adjusted by changing the profile of liquid assets or through transactions in derivative instruments, based on FRBH's interest rate outlook with reference to other risk factors impacting FRBH's balance sheet, most notably credit risk. Risk measurement and hedging is, in general, done at an aggregate level (i.e. the net interest rate risk profile of the bank is hedged). Micro hedging is generally reserved for large and complex once off transactions. The management of the interest rate profile is done within the risk limits approved by FRBH ALCO. An investment committee oversees these activities and challenges the macro economic view and debates proposed investment strategies.

Where possible, cash flow hedge accounting is applied to derivatives that are used to hedge interest rate risk in the banking book. In cases where hedges do not qualify for cash flow hedge accounting, mismatches may arise due to timing differences in the recognition of income between hedges, which are fair valued, and underlying banking book exposures, which are accounted for on an accrual basis or on a fair value basis (depending on the type of instrument).

Interest rate risk measurement

Several measures are used to quantify interest rate risk in the banking book, some of which measure the risk from an earnings perspective and others from an economic value perspective. A selection of earning and economic value measures are reported to FRBH ALCO on a monthly basis.

The table below show the repricing schedules for the FRBH banking book (excl. RMB) at the financial year end. All assets, liabilities and derivative instruments are placed in time buckets based on their repricing characteristics. Instruments which have no explicit contractual repricing or maturity dates are placed in time buckets according to management's judgement and analysis, based on the most likely repricing behaviour.

Repricing schedule for FRBH banking book as at 30 June 2008:

	Term to repricing				
R MILLION	Within 3 months	After 3 months, but within 6 months,	After 6 months but within 12 months	After 12 months	Non rate sensitive
Net repricing gap	32 852	5 066	(10 899)	1 068	(28 087)
Cumulative repricing gap	32 852	37 918	27 019	28 087	–

***Note 1:** This repricing analysis excludes the banking books of RMB as this is managed on an ETL and VAR basis separately. Interest rate risk in the RMB Banking Book is managed as part of Market risk and reported accordingly.*

The natural position of the banking book remains asset sensitive (positively gapped), since interest earning assets reprice sooner than interest paying liabilities. This makes our projected NII vulnerable to a drop in interest rates (as reflected above). The Macro Portfolio Management team positioned the banking book to take advantage of interest rate hikes.

NII is forecast using the current balance sheet position. The NII simulation assumes that there is no management intervention in response to changes in the level of interest rates. The implied forward curve (with spreads where appropriate) is used as the base forecast of rates in the future to facilitate simulation of the base case projected NII for the 12 month forecast horizon. A static balance sheet (based on current position) is used in the modelling of NII to isolate the impact of rate changes on NII by preventing other assumptions relating to volume growth from masking/offsetting the impact of adverse rate movements (that would reduce NII), by increasing NII as a result of growing volumes.

New volume points are assigned to balances as and when they mature to maintain balance sheet size. Derivatives that mature are not replaced as there is no rule based derivative trading strategy which can be used to predict how derivative positions will be replaced. Several assumptions are made with respect to the repricing characteristics of instruments which have no explicit contractual repricing or maturity dates when performing NII simulation:

- non maturity deposits ("NMDs") do not have a specific maturity and individual depositors can freely withdraw or deposit balances. The interest rates associated with these products are administered by the bank, but not indexed to market rates. Examples of NMDs include current, savings and transmission accounts. NMDs are assumed to reprice overnight since the administered rate can change on any day at the bank's discretion; and
- prime linked products are assumed to reprice instantaneously when the repo rate changes.

Several interest rate scenarios are modelled to assess their impact on projected earnings in the banking book. For example, a 200 basis point instantaneous, parallel downward (upward) shift in the yield curve is modelled to determine the potential impact on NII over the next 12 months (assuming no management intervention to mitigate the impact of changes in the level of interest rates).

Sensitivity of FRBH projected NII as at 30 June 2008

	Change in projected 12 month NII as a % of base
Downward 200 bps	–11.39%
Upward 200 bps	+11.52%

Note 2: *This NII sensitivity analysis excludes the banking books of RMB as this is managed separately. Mark to market bonds and hedges are excluded.*

Interest rate risk sensitivity in the RMB banking book is managed as part of Market risk and reported accordingly.

The following represents our sensitivity of available for sale (assets) and cash flow hedges reserves' to interest rate movements (based on a static balance sheet), assessing the expected decrease or increase in valuation due to parallel movements in yield curves.

Sensitivity of FRBH reported reserves to interest rate movements as at 30 June 2008

	As % of total shareholders' equity
Downward 200 bps	–0.48%
Upward 200 bps	+0.60%

Note 3: *This sensitivity analysis excludes the banking books of RMB as this is managed separately.*

OPERATIONAL RISK

OPERATIONAL RISK IS DEFINED AS THE RISK OF LOSS RESULTING FROM INADEQUATE OR FAILED INTERNAL PROCESSES, PEOPLE AND SYSTEMS OR FROM EXTERNAL EVENTS. THIS DEFINITION INCLUDES LEGAL RISK BUT EXCLUDES STRATEGIC, BUSINESS AND REPUTATIONAL RISK.

Operational risk governance

FRBH Operational Risk committee ("ORC") is a sub committee of FRBH RCC committee, and is established to assist the board and the RCC committee in discharging its responsibilities in terms of the management of operational risk across FRBH. Operational risk is managed in terms of the Operational Risk Management Framework ("ORMF"), which is a sub framework of FRBH's Risk Management Framework. The framework covers methodologies and policies that ensure adequate identification, measurement, monitoring, control and reporting of operational risk exposure.

Operational risk management process

Governance and oversight of operational risk is carried out by the ORC. The committee is chaired by an independent non executive member and its membership includes, inter alia, the divisional heads of risk as well as senior members of the ERM division. Independent monitoring of operational risk occurs through a number of ERM functions across FRBH. Examples of these functions include Risk insurance, Legal, Information risk services, Operational risk governance, and Forensic services. Each of the functions has defined roles, responsibilities and performance objectives to ensure that operational risk is effectively managed and reported across FRBH.

The management of operational risk is inherent in the day to day execution of duties by management of business units. Business unit and subsidiary risk managers are responsible for implementing and embedding the operational risk policies, frameworks and methodologies within their business environments. The deployed risk managers and divisional risk committee structures play a key role in monitoring adherence to policies, processes and procedures.

Operational risk management tools

A number of operational risk management tools are used within FRBH to intelligently and proactively deal with the practical implementation of day to day operational risk management. These include:

- internal loss data – loss data reporting and analyses are being used by risk managers to understand the root causes of loss incidents and to understand where corrective action needs to be taken to mitigate against losses;
- external data – subscription to an external database that is a repository of all global publicly known loss events;
- key risk indicators – key risk indicators ("KRI") are being used as an early warning risk management measure to highlight areas of increasing risk exposure. KRI reports are included in management information packs to assist management' in its decision making processes;
- self assessment – Risk Effectiveness Reports ("RER") and Risk and Control Self Assessments ("RCSA") are integrated in the risk management process to assist risk managers to identify key risk areas and to assess the effectiveness of the controls in place;
- incident and issue reporting – a process of reporting and escalating operational risk incidents and issues through the risk committee structures; and
- risk scenario analysis – risk scenarios are used to help management understand where areas of potential severe losses exist.

Operational risk quantification and capital calculation

Operational risk capital is calculated based on the Basel II operational risk Standardised Approach ("TSA") for internal capital allocation as well as for regulatory purposes. FRBH obtained approval from the SARB to use TSA for regulatory capital purposes from 1 January 2008.

A more sophisticated operational risk quantification and capital calculation methodology has been developed and is being implemented using the AMA for operational risk in accordance with Basel II and SARB requirements. An application to use AMA

on a partial use basis for South African operations was submitted to the SARB during the first quarter of 2008. The FNB Africa subsidiaries will remain on TSA for the 2008/2009 period.

Capital charges for operational risk will be calculated using statistical models under the Basel II AMA framework. Risk scenarios and internal loss data are the key inputs in the AMA operational risk capital modelling process, and qualitative risk measures such as the RCSA's, KRI's and audit findings will provide input to internal operational risk capital allocation mechanisms.

Business continuity management

Business continuity management in FRBH focuses on improving the resilience of banking operations in order to withstand unexpected disruptions and disasters.

Business continuity management is an ongoing process of assessing needs, identifying weaknesses and single points of failure, developing strategies and keeping plans current and tested. The approach involves following a well established annual cycle of actions, designed to ensure plans and associated measures are kept relevant and tested.

The status of readiness for disruptions is measured through quarterly reporting reflecting the organisation's compliance with the cyclical requirements, eg full testing of plans annually. These are reported through the governance structure to the FRBH RCC committee and the board.

Legal risk

Legal risk is the risk of loss due to defective contractual arrangements, legal liability (both criminal and civil) incurred during operations by the inability of the organisation to enforce its rights, or by failure to address identified concerns to the appropriate authorities where changes in the law are proposed (implemented changes are dealt with as part of compliance risk).

Legal risk is managed in terms of the Legal Risk Management Framework and through activities such as the monitoring of new legislation, awareness initiatives, identifying significant legal risks and by managing and monitoring the impact of these risks through appropriate processes and procedures, one of which was the establishment of the Legal Risk committee.

There were no significant legal risk breakdowns during the year.

Information risk

Information risk is defined as the possibility of harm being caused to a business as a result of a loss of confidentiality, integrity or availability of information.

The Information Technology Governance and Information Security Framework ("IT Framework") is a customisation of ISACA's Control Objectives for Information and related Technology (COBIT®) framework and the Information Security Forum's Standard of Good Practice for FirstRand. The IT Framework is approved by the TIMCO (Technology and Information Management Risk committee), and applies to FRBH.

The IT Framework:

- defines the objectives for managing IT Governance and Information Security;
- outlines the processes that need to be addressed across FRBH in terms of IT Governance and Security; and
- sets out the measurement framework for IT Governance and Security across FRBH.

Due to the changing nature of information risk and information security, FRBH constantly faces new threats and challenges. The risk management structure for information risk is specifically structured to enable and support the measurement of the status and the resolution of issues.

Fraud and security risks

FRBH is committed to creating an environment that safeguards its customers, staff and assets through policies, frameworks and actions. To this end, FRBH distributes and communicates its Ethics Policy to existing staff members on a quarterly basis. The Ethics Policy reiterates FRBH's commitment to a stance of "zero tolerance" towards crime. Executive management throughout FRBH is committed to living the values of "zero tolerance" and enforce them stringently.

FRBH believes it has appropriate governance structures in place to address fraud and security risks. The risk management structure for fraud and security risks is adequate to address these risks and find solutions to safeguard its people and assets.

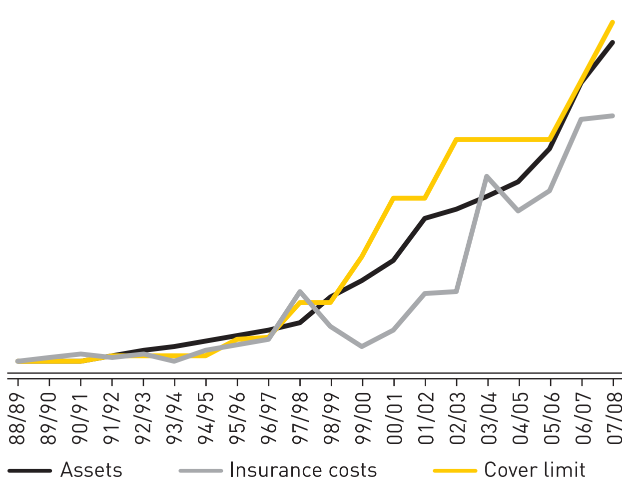
Risk insurance

For many years the Group, which includes all majority owned and management controlled companies, has had a structured approach to insurance risk financing to protect against unexpected material losses arising from non trading risks. These structures are continuously refined and enhanced through the ongoing assessment of changing risk profiles, organisational growth and the monitoring of international insurance markets. The levels and extent of the various covers are also benchmarked annually which is achieved through close working relationships with service providers and association with the ERM division of FRBH.

FirstRand's insurance buying philosophy is to carry as much risk to its own account as is economically viable within the financial resources of the Group, and to only protect itself against catastrophic risks through the use of third party insurance providers. Therefore, considerable self retentions are built into the insurance risk financing structures. The retentions are insured into a dedicated insurance company which enhances the Group's ability to carry risk for its own account.

The financial institutions insurance programme remains the largest of the insurance risk financing structures and, as can be seen from the graph below, the levels of cover have kept pace with FirstRand's growth, whilst total cost is maintained within an acceptable band.

Financial institutions insurance programme – increase in assets, insurance cover limit (base 1988/1989)



Developments within the Group continue to be monitored and the risk insurance team ensures that the insurance financing programme is adapted where appropriate.

COMPLIANCE RISK

COMPLIANCE RISK IS DEFINED AS THE RISK OF LEGAL OR REGULATORY SANCTION, MATERIAL LOSS OR LOSS OF REPUTATION SUFFERED BY A BANK AS A RESULT OF ITS FAILURE TO COMPLY WITH LAWS, REGULATIONS, RULES, RELATED SELF REGULATORY ORGANISATIONAL STANDARDS AND CODES OF CONDUCT APPLICABLE TO ITS BANKING ACTIVITIES.

Compliance risk management is essential to ensure business success and it is nothing more than best practice management in line with regulatory requirements imposed by law. It promotes confidence with all stakeholders by meeting the expectations of customers, the markets and society as a whole, and aligns the business with international best practices and enables global competitiveness.

FRBH is continuously taking action to further embed compliance in FRBH through a four phase process:

- self assessments and reporting;
- monitoring;
- use of internal audit reports; and
- external independent reviews.

The results of all four phases are reviewed through a strong governance process that starts with the FRBH Compliance committee, through to the FRBH RCC committee and finally to the FRBH Audit committee.

The tone is set at the top by strong pronouncements from FRBH board, FRBH RCC committee and FRBH Audit committee and divisional executives on non compliance as stated in the FRBH Risk Management Framework.

The responsibility to ensure that FRBH complies with all relevant laws, regulations and supervisory requirements rests with the board, management boards, business entity heads, senior management, management and employees of FRBH, as stipulated by the Risk Management Framework. Compliance risk management is an integral part of the management process. The Risk Management Framework classifies compliance under its governance component which deals with principles, policies, conduct, values, compliance, oversight and the management of performance and includes the following:

- implementing structured and transparent governance structures;
- ensuring compliance with statutes and regulations;
- identifying and managing all risks and measuring the effectiveness of risk management;
- implementing corrective actions to address deficiencies;
- working with lawmakers and regulators to protect our interests, avoiding reputational damage and preventing or mitigating the potential negative impact of changes in statutes or regulations; and
- ensuring zero tolerance towards non compliance, fraud and criminal activities.

Compliance governance in FRBH is done through a structured and formalised process, which integrates divisional compliance and FRBH structures. Each of FRBH's divisions has its own compliance governance committees, namely a risk and compliance committee and an audit committee. A detailed report of each division's status of compliance is presented to its risk and compliance committee and escalated to its audit committee and divisional board. At FRBH level a report on the status of compliance in all three the operating divisions is tabled at the FRBH RCC committee and escalated to the FRBH Audit committee and board.

Changes in the regulatory environment posed a specific challenge to FRBH during the past year. The implementation of the National Credit Act, No 34 of 2005 and the South African Banks Act, No 94 of 1990, as amended, had a major impact on compliance risk management in FRBH. FRBH, however, successfully implemented both acts. FRBH is actively participating in the formulation of new legislation such as the Consumer Protection Bill and the Protection of Personal Information Bill.

ABBREVIATIONS

AIRB	Advanced Internal Ratings Based
ALCO	Asset and Liability Management committee
AMA	Advanced Measurement Approach
BGC	FRBH Compliance
BSM	Balance Sheet Management
BU	Business unit
CCF	Credit conversion factor
CEO	Chief executive officer
CFO	Chief financial officer
Credit Exco	FRBH Credit Portfolio Management committee
CSA	Credit support annexes
EAD	Exposure at default
ERM	Enterprise Risk Management
ETL	Expected tail loss
FNB	First National Bank
FRB or the Bank	FirstRand Bank Limited
FRBH	FirstRand Bank Holdings Limited
FTP	Funds transfer pricing
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
ISDA	International Swaps and Derivative Association
ISMA	International Securities Market Association
KRI	Key risk indicators
LGD	Loss given default
LTV	Loan to value
MPM	Macro Portfolio Management
MRV committee	Model Risk and Validation committee
NIACC	net income after capital chanrge
NII	net interest income
NMD's	Non maturity deposits
ORC	Operational risk committee
ORMF	Operational risk management framework
PD	Probability of default
PIT	Point in time
RCC committee	Risk, Compliance and Capital committee
RCSA	Risk control self assessment
RER	Risk effectiveness report
RMB	Rand Merchant Bank
SARB	South African Reserve Bank
SME	Small and medium enterprise
the Group	FirstRand Limited
TSA	The Standardised Approach
TTC	Through the cycle
VaR	Value at Risk