ROGER JARDINE :: *chairman*

"Twenty-five years ago people could be excused for not knowing much, or doing much, about climate change. Today we have no excuse. No more can it be dismissed as science fiction; we are already feeling the effects."

Desmond Tutu

chairman's report

There is no doubt climate change is one of the most singularly profound risks facing the world as we know it. The science is compelling. No one can deny the evidence, as polar ice caps and glaciers millions of years old melt before our eyes. Closer to home on the African continent, researchers have found that nine of the 13 oldest baobab trees and five of the six biggest ones have partially or completely died in the past 12 years. These trees, located in Zimbabwe, Namibia, South Africa, Botswana and Zambia, date back to the times of the ancient Greeks.

Since the end of the Second World War, we have seen a rapid rise in global industrialisation and rampant population growth, placing serious pressure on the world's resources. This is starkly demonstrated by the recently published Earth Overshoot Day (the day when humanity has used up nature's resource budget for the year). Published by Global Footprint, an international sustainability organisation, 2019's Earth Overshoot Day occurred on 29 July. In 1973, that date was 31 December. Tellingly, over that same period, the world's population almost doubled from 4 billion to 7.7 billion.

It should therefore not be surprising to any of us, given what I have outlined above, that scientists, environmentalists and NGOs are pushing hard for urgent change.

This topic is not new. So why does it feel like it has only recently become such a big agenda item? Maybe it's because baby boomers are ageing and questioning their legacy, whilst their children and grandchildren are worrying about their futures. Or perhaps more cynically, corporates and politicians are finally waking up to the real risk to their sustainability that global warming represents.

It is certainly the case that shareholders are becoming increasingly focused on the risk that climate change poses to the sustainability of many of their investment holdings. Environmental and social governance has been rapidly adopted in investment decision-making, and corporates in the energy sector have come under particularly severe scrutiny. The United Nations (UN) secretary-general recently announced that the UN pension fund – which manages $68 billion in assets – has publicly committed to divesting from investments in publicly traded companies in the coal energy sector and will not make any new investments in it.

This scrutiny is now rightly moving to financial institutions supporting the energy sector through lending activities. Institutions, such as FirstRand, face increasingly tough questions about our appetite for lending to fossil fuel sectors, however, as in everything, the answers are not simple. Our country's current base-load energy mix is around ninety percent coal. Coal mining accounts for approximately 24% of South Africa's mining industry and employs approximately 85 000 people, with around 200 000 employed in related industries like transport and logistics. In 2018, coal exports totalled R80 billion, which represents 6.4% of total exports, although these are forecast to decline materially in the coming years as countries increasingly scale down coal plants and adopt alternative and more sustainable approaches to the energy mix. This means that as a country, we must develop a detailed transition plan to prepare for the impact of this global shift away from coal and fossil fuels. Our future energy mix objectives must reflect the projected cost and time frame associated with this complex transition, as well as the creation of new jobs in the energy economy of the future.

It is not sensible, given the backdrop described above, to argue for the immediate withdrawal from coal, given how integral it is to the energy fabric of our country, nor is it sensible to argue that banks must be forced to continue funding coal. The reality in South Africa, and many other emerging markets, is that coal capacity is still needed in the short to medium term, particularly when balancing social, economic and environmental considerations. A clear and detailed national transition plan and timetable must be urgently agreed.

The group recently published its policy on lending to the South African thermal coal sector, which required a deep-dive assessment of the economic net impact of transitioning to a low-carbon economy. As the country navigates the journey from coal-centered energy to a more sustainable energy mix, FirstRand will consider thermal coal financing for new capacity (greenfield mining or power generation), subject to international emissions standards and other factors. However, because we consider these projects sensitive and high risk, we will limit that financing to below 0.5% of our total loans and advances. The total coal portfolio, including new coal financing, will, over the next s, be limited to below 2% of total group loans. This means lending to the coal industry is now non- strategic for the group and we are committed to a longer-term thermal coal divestment strategy.

While we have taken a pragmatic position on coal (and we plan to publish a full fossil fuel policy by the end of next year), given the social and economic dynamic that must be managed as part of the transition, we remain deeply cognizant that banks have an important role to play if the commitments of the Paris Agreement are to be met. South Africa is, however, already facing many economic challenges, including an unacceptable level of unemployment and incredibly low growth. These will be key considerations for policy-makers as we navigate the transition.

Which brings me to my second topic: South Africa's fiscal vulnerabilities and the urgent need for structural reform.

It's hard to know where to start when unpacking the myriad of challenges our country faces. We all know the numbers: 29% unemployment, 0.3% GDP growth, a looming budget deficit of 6% and a debt-to-GDP ratio of 58%, and climbing. They all make for grim reading. Yet the response by government and policy-makers is, to be frank, perplexing – particularly its current allocation of the country's scarce resources.

Effective resource allocation matters profoundly to developing countries, especially when there is little to waste. It's obvious that expenditure must be reined in, and each rand spent needs to generate either a social or an economic return (ideally both). Sadly, too much of government's expenditure delivers neither and, if we continue on this road, it will bankrupt the country.

The list of reforms that are necessary has been debated for too long. It includes: policy certainty, increasing competition, reforming state-owned enterprises (SOEs), improving education, improving health care, stabilising the electricity supply, expanding road networks, allocating spectrum, developing the tourism industry, developing the agriculture sector, and the list goes on. We could also add incentives to lift exports and decrease imports, and provide title deeds to more South Africans. More than one plan to deliver on these reforms has been drawn up and debated, only to be replaced by yet another plan.

Perhaps the time has come to acknowledge that a South African developmental state for the twenty-first century must strongly position the private sector as a key partner to the state in the industrial transformation of our country. South Africa's skills and expertise are concentrated in the private sector. It provides 79% of the country's employment and contributes approximately 50% to the fiscal purse through corporate tax (≈19%) and personal income tax paid by its employees (≈31%). FirstRand Bank alone paid R8.5 billion in tax this year. Leveraging private sector balance sheets for infrastructure initiatives can work, as shown by the Renewable Energy Independent Power Producer Procurement programme, where R210 billion was mobilised from the private sector.

To be able to provide a sustainable improvement in living standards for all South Africans, it's time for government to partner with the private sector to drive the developmental agenda. The private sector has the incentive, skills and resources to build businesses that employ people and build the wealth of the country. It cannot, however, do it on its own. It needs a government that creates policy certainty, is not distracted by trying to keep failing SOEs afloat and/or running sectors of the economy that can be done more efficiently by the private sector. Concurrently, deep reform in the public service must also be implemented. The ability of any state to deliver on its agenda is directly determined by the strength of the public bureaucracy. A reform programme that has at its centre a public/private partnership-driven developmental agenda will have a better chance of delivering the economic reforms needed to address the challenges of low growth and high unemployment.

> There is no plausible plan for South Africa to prosper without the private sector playing a strong role in creating sustainable growth.

Government's apparent unwillingness to champion the private sector as a growth engine is mystifying. There are many examples where partnership between the private sector and government is effective. Private-sector skills, technology, capital and innovation can help provide better public services through improved operational efficiency. There is no plausible plan for South Africa to prosper without the private sector playing a strong role in creating sustainable growth.

However, instead of partnering with the private sector, government has demonstrated a desire for state-led solutions, and one example of this is the current proposal for national health insurance (NHI).

I am reasonably confident that it will be very hard to find a South African who does not agree on the desirability of universal access to health care. It is, however, incomprehensible that government can propose new NHI legislation without a detailed grasp of its full financial impact on the country. This is particularly of great concern given the fragility of the country's finances. Important elements of the new policy remain unknown and this creates risk to further investment in the sector. Moreover, the country's public healthcare system is in disarray and the private healthcare industry can play a major role in achieving universal access. A meaningful dialogue between government and the private healthcare sector is required to agree on the mix of policy, regulation and incentives to provide all who live in South Africa access to necessary care without financial or other impediments.

Another policy initiative gaining increasing political currency is the introduction of prescribed assets. We seldom talk about pension fund liabilities (particularly with the emergence of defined-contribution funds), but it's the pension liabilities that are the real issue. The average net replacement ratio in SA pension funds stands at 17% – meaning a pensioner can expect to receive only 17% of their final monthly gross salary when they retire. On this basis alone it is reckless to contemplate prescribed assets (often with misaligned risk and return) when we are under-saved as a country.

Despite the concerns I have expressed above, I do want to acknowledge the President's sustained public commitment to rooting out the corruption that has played its part in the country's fiscal and economic decline. The work of the Zondo Commission should be applauded, as well as the new leadership at key state institutions like SARS and the National Prosecuting Authority, and new boards at SOEs marking a decisive break with the past. However, an anti-corruption strategy is not a growth strategy. Notwithstanding the key interventions made to date, government needs to move swiftly with further and substantial reforms to accelerate growth. These could include:

- Implementing the Eskom restructure plan as proposed in the recent *Economic Strategy Paper* presented by National Treasury.
- Increase competition in the telecommunication and transport sectors (including the ports) by breaking up public sector monopolies and allowing the private sector to provide services (also proposed in the National Treasury paper).
- Design and introduce policies that will incentivise a meaningful lift in domestic savings (so that we can fund infrastructure development).

All the topics I have covered so far are profoundly important to our business. FirstRand is a systemic business as an employer, a taxpayer, a lender and, most critically, a keeper of the country's deposits. Eighty per cent of our earnings are generated from our activities in South Africa, and we need this country to prosper and thrive. However, we also need to work with our fellow Africans, which is why the recent attacks on foreigners are deeply concerning. We have witnessed terrible incidents of violence in communities resulting in several deaths and damage to property.

In our country with so much poverty, inequality and unemployment, deep social tensions invariably arise. Undoubtedly, strong implementable policies that address economic growth and poverty alleviation, as well as an urgent plan to fix our porous borders, are required. However, general criminality and targeted attacks on foreign nationals from the rest of the continent are unacceptable.

Like many other South African companies, FirstRand is growing its presence in several markets in the rest of Africa. We employ 6 085 people on the rest of the continent. South African companies cannot, however, expect to peacefully expand and grow our businesses, creating demand for South African goods and services on the rest of the continent, while fostering a hostile environment for citizens from those markets here at home.

The rule of law is a precondition in any society where its people, citizens and visitors alike, feel that they can live in an environment of peace and security. It is also a precondition in any society where businesses, small and large alike, feel that they operate in an environment in which they can grow and thrive. A free democratic society can never tolerate lawlessness.

It is actually remarkable that, given all the economic pressures we faced as a business in the year under review, and the high earnings base created in the previous financial year by significant private equity realisations, FirstRand's portfolio of businesses produced such resilient and high-quality topline growth. Normalised earnings for the year increased 6% with a normalised ROE of 22.8%. A detailed analysis of the performance can be found in the CFO's report on page 30.

Looking briefly at each of our businesses, FNB generated a very strong operating performance from its domestic franchise, driven by healthy non-interest revenue growth on the back of ongoing customer gains and increased transactional volumes, and high-quality net interest income growth, particularly from deposit generation. The performance of FNB's rest of Africa portfolio improved significantly.

RMB's results were impacted year-on-year by the non-repeat of significant private equity realisations in the second half of the year to June 2018, however, the rest of its portfolio delivered a resilient performance driven by growth in earnings and solid operational leverage. WesBank delivered a subdued performance. The group's performance to June 2019 includes a full 12 months' contribution of post-tax earnings of R1 658 million from Aldermore, which continues to track slightly better than our original expectations when we acquired the business.

Given the group's high return profile and strong capital generation, the board maintained the dividend cover at 1.7x, which remains below its stated long-term cover range of 1.8x to 2.2x. We have, however, indicated that we will revisit the cover range, should capital demand increase to support sustainable balance sheet growth and/or macro risks worsen against the group's current core view.

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This performance is the result of careful and consistent execution of several very specific growth strategies, with the objective to deliver superior value creation for our shareholders. I firmly believe that this group's ability to generate superior NIACC, which is our key performance metric, is testament to a unique business model, a portfolio of stand-out customer franchises, our high-quality talent and absolute discipline in allocating financial resources.

I have always believed that the group's remuneration practices were well aligned to shareholders, in that we ensured that management has never done better than shareholders. The group's remuneration policy did not, however, receive full support from shareholders last year and this gave us cause to undertake some deep introspection.

In this year's remuneration committee report (page 109), which has been completely overhauled, we outline the process we went through to understand the issues, which we saw as partly design and partly disclosure. We engaged with investors and analysed proxy voter services' reports on design and commissioned independent research to benchmark our disclosure relative to local and international peers. We have made significant changes to both, and I hope this better demonstrates that true alignment between management and shareholders does exist.

In closing, I would like to acknowledge our board colleagues Lulu Gwagwa and Ethel Matenge-Sebesho, who will retire as directors at the annual general meeting, and Jannie Durand, who resigns as an alternate director. They have been incredibly valuable members of the group's board and will be sorely missed. I thank them for being wise and hard-working colleagues and wish them well in their future endeavours.

I would also like to thank each and every employee and customer of the group for their commitment, loyalty and trust. We would not be a successful business without you.

ROGER JARDINE
Chairman