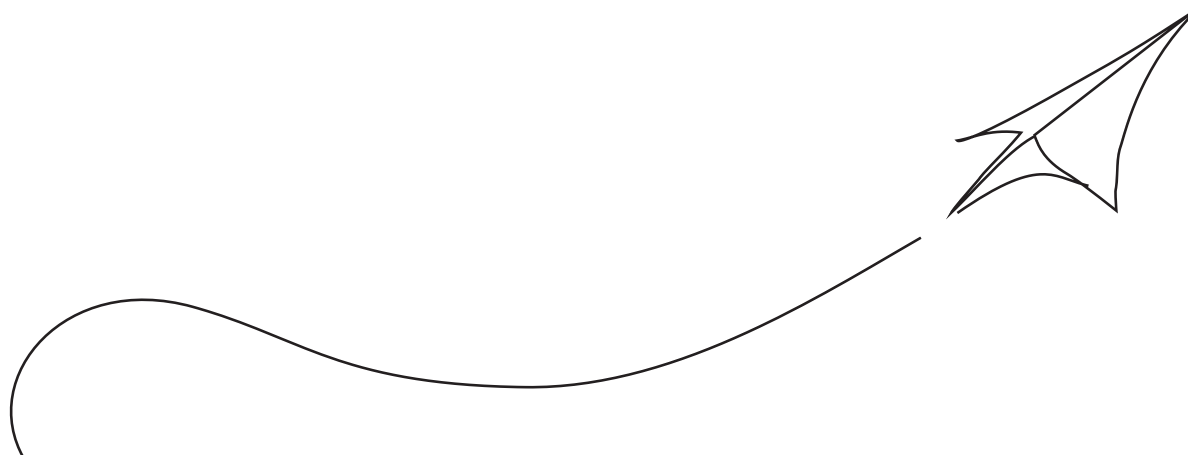


strong strategic framework

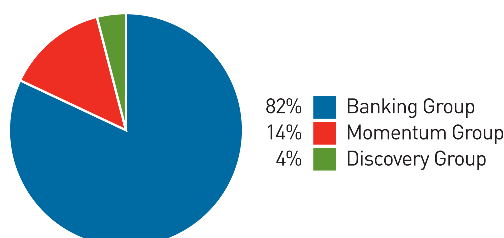
The Group CFO has responsibility for the strategic positioning of the balance sheet, including both the assets and liabilities originated by the individual business units. At the core of our balance sheet management approach is a belief that the balance sheet and its income statement streams can be both protected and enhanced throughout the cycle, through the active management of investment and enterprise value risks.

Johan Burger Chief Financial Officer

Introduction

This report represents a high level overview of FirstRand Limited's performance and balance sheet management strategies, which form a major part of the Group CFO's portfolio.

FirstRand Limited comprises three main operating entities, the FirstRand Banking Group, the Momentum Group and the Discovery Group. The chart below illustrates the relative contribution by each of these entities to the normalised earnings of the Group.



** Based on normalised earnings, excluding the FirstRand centre and NCNR preference shares*

The Group's operational style is to break these legal entities down into a portfolio of autonomous business units, which operate within a broader FirstRand strategic framework. We are therefore structured along "federal" lines with the business units responsible for the daily management of business, financial and operational risks and for the delivery of:

- targeted return on economic capital; and
- growth in net income after cost of capital ("NIACC").

Business unit normalised earnings

	Year ended 30 June		
R million	**2007**	2006	% change
FNB	**4 140**	3 255	27
FNB Africa	**456**	377	21
RMB	**3 910**	2 148	82
WesBank	**918**	1 059	(13)
Group Support	**617**	624	(1)
Banking Group	**10 041**	7 463	35
Momentum Group	**1 716**	1 514	13
Discovery Group	**536**	424	26
FirstRand Limited	**(100)**	(169)	(41)
Dividends to NCNR* preference shareholders	**(348)**	(274)	27
	11 845	8 958	32

** Non cumulative non redeemable*

The CFO's portfolio includes strategies designed to protect and enhance the business unit returns and reduce earnings volatility through the cycle. Below is a review of these strategies in relation to:

- performance management; and
- balance sheet management.

Performance management strategy

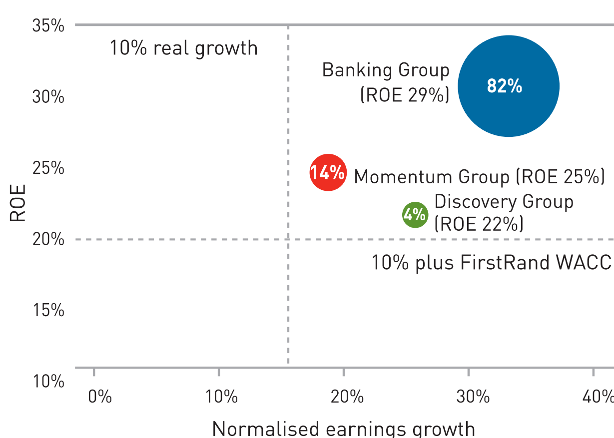
FirstRand's performance management strategy remains a key component of the Group's overall strategy. Its focus is to deliver superior, sustained returns to shareholders.

We continue to monitor the effectiveness of our performance management strategy using two financial targets, namely 10% real growth in normalised earnings and return on equity of 10% plus FirstRand's weighted average cost of capital.

During the year FirstRand produced excellent results, growing normalised earnings 32% or 26% in real terms after adjusting for the effects of inflation. Headline earnings grew 29% or 23% in real terms.

The diagram below indicates that the three legal entities delivered against all relevant financial targets, thus delivering superior value for shareholders.

Financial targets met



** Based on normalised earnings, excluding the FirstRand centre and NCNR preference shares*

We believe normalised earnings most accurately reflect the sustainable operational performance of the business given the non operational and accounting anomalies that impact headline earnings. The table below shows the reconciliation between normalised earnings and headline earnings in the current and prior year.

	Year ended 30 June		
R million	**2007**	2006	% change
Headline earnings – audited	**10 457**	8 115	29
Adjustments	**1 388**	843	
Private equity realisations	**397**	219	
Agreement with National Treasury	**–**	30	
Discovery BEE transaction	**19**	102	
IFRS 2: Share based payments	**401**	168	
Treasury shares	**543**	352	
Listed property adjusted to NAV	**28**	(28)	
Normalised earnings	**11 845**	8 958	32

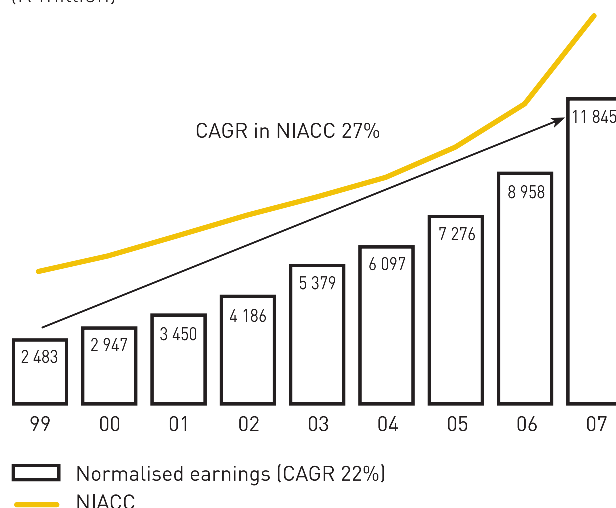
All of the individual franchises within the Banking Group also delivered ahead of targeted return on economic capital as indicated in the chart below.

ROE and earnings contribution

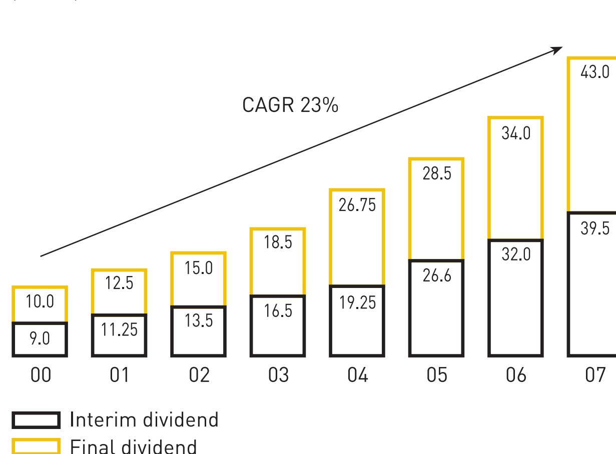
	ROE %	Earnings %
FNB	33	35
FNB Africa	33	4
RMB	43	33
WesBank	18	8
Momentum	25	13
Discovery	22	5
OUTsurance	64	2

During the current year further enhancements were made to the implementation of the performance management strategy to include the following three additional measures, namely growth in NIACC, growth in tangible net asset value ("TNAV") and growth in distributions to shareholders. These performance measures are in the process of being implemented across the Group to generate sustainable profits and add greater economic value to shareholders. The tables below indicate the Group's track record in two of these ratios.

NIACC and normalised earnings
(R million)



Ordinary dividend per share
(cents)



Risk reward management

Risk management disciplines are rigorously applied to provide the business units with appropriate risk frameworks to ensure sustainable performance within a band of acceptable return volatility and to avoid undesired outcomes.

Risk is core to our business and operational risks are an inevitable consequence. Our aim is not, therefore, to eliminate all risks but to achieve an appropriate balance between risk and return. By actively managing the inter relationship between risk management, balance sheet management and capital, we seek to limit the scope for adverse variations in our earnings and ROE, particularly in the context of "stress events" and downward economic cycles.

Balance sheet management

The Group CFO has responsibility for the strategic positioning of the balance sheet, including both the assets and liabilities originated by the individual business units. At the core of our balance sheet management approach is a belief that the balance sheet and its income statement streams can be both protected and enhanced throughout the cycle, through the active management of investment and enterprise value risks, which include:

- interest rate risk;
- credit portfolio risk;
- capital risks; and
- strategic funding risks.

To achieve this objective we have implemented an integrated balance sheet management approach. This approach requires a detailed understanding of the economic cycle and the interplay between the risks created by the cycle and the "levers" that can be used to mitigate those risks. Ultimately, we seek to optimise the natural position of the balance sheet, look for natural hedges or implement appropriate macro hedges in the current structure, and only make the balance sheet available to the origination businesses if the required risk reward return can be met.

Our integrated balance sheet management approach is aligned to the objectives of performance management in that it facilitates optimisation of the spread between ROE and COE.

During the current year the integrated balance sheet management structure was further refined and cross pillar integration was improved. The structure was also enhanced to include a fourth pillar on equity and investment analysis. The updated structure is depicted below and now consists of four key pillars, namely:

- macro portfolio management;
- credit portfolio management;
- capital management and strategic funding; and
- equity and investment analysis.

Below we explain in more detail the high level objectives and activities of the four pillars. These are currently fully implemented in the Banking Group and steps have been taken to introduce them to the Momentum Group.

Macro portfolio management

The macro portfolio management ("MPM") pillar manages the net interest rate position of the Banking Group. It also interacts with the other three pillars to assist them to protect and enhance their portfolios with respect to risk arising from the macro economic environment, specifically as they relate to interest rate and exchange rate risk. Accordingly, the MPM pillar manages the risk free component of the investment of capital as well as macro hedges to protect the balance sheet and more particularly the credit portfolio.

In addition to the regular governance processes, an investment committee – made up of senior management – meets regularly to review the macro economic environment and to oversee the investment strategy of the MPM pillar and all its portfolios.

In the year under review, the repo rate of the South African Reserve Bank increased from 7.5% to 9.5%. The domestic balance sheet was protected by positioning the book as short as possible. The income statement also benefited from the positive endowment effect by closing out the endowment hedges before the start of the hiking cycle.

By aligning the different risk types (capital, credit, funding and interest rates), we were able to pull the desired levers and align our portfolios appropriately during this rising interest rate cycle.

As an example, the MPM team – in conjunction with the credit portfolio management team – implemented a tail risk protection strategy to reduce the adverse impact of large hikes in interest rates on bad debts. These strategies have contributed positively during the year under review.

The MPM pillar also became more involved in the management of the international interest rate position. Most notably, we formalised an investment and risk management process for the UK banking book (Carlyle Finance). The duration of the portfolio was shortened to protect against rate hikes in the UK. As a next step, the interest rate and exchange rate risk of the international capital portfolio will receive more attention and become more actively managed.

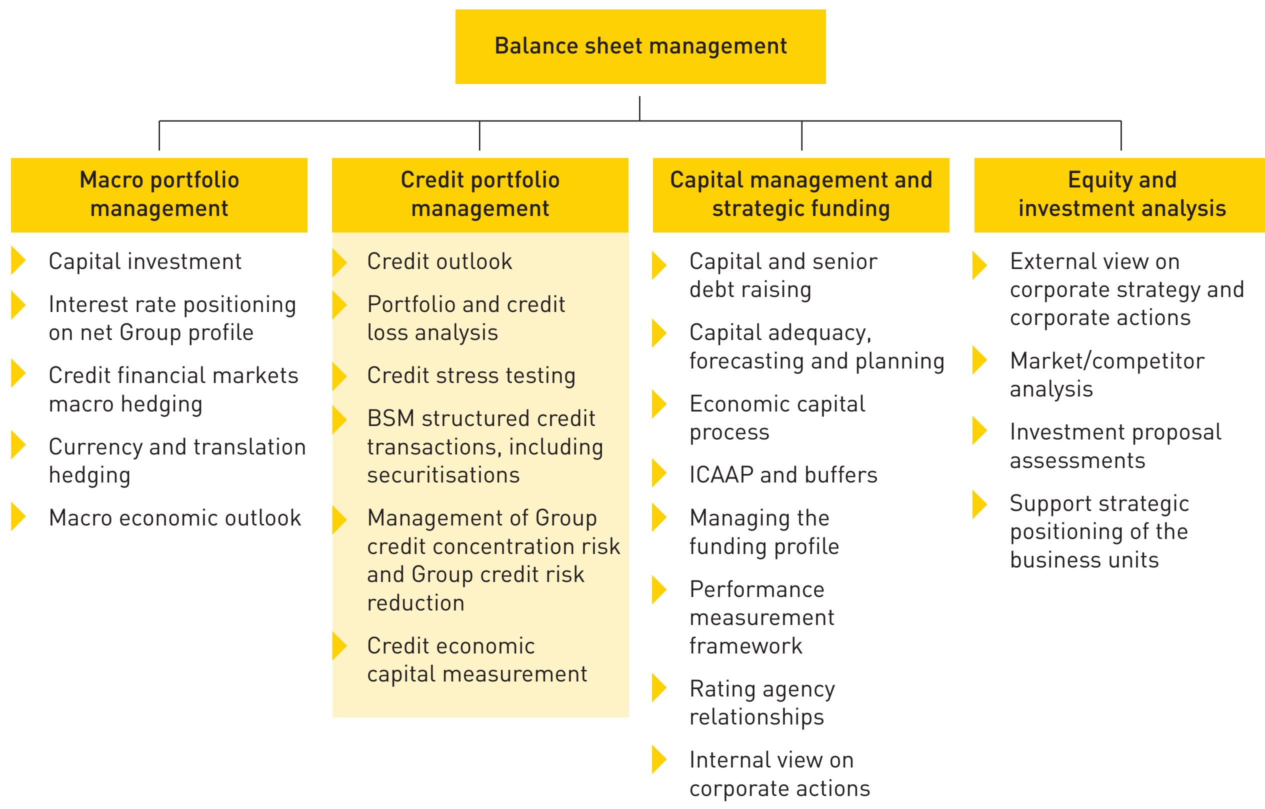
With the creation of balance sheet management last year, one of the objectives was to consolidate all exposures across the banking book, to offset natural hedges and to manage the residual net position consistently across the Banking Group. Good progress has been made in this regard and all key portfolios are now included in the consolidated position.

In the coming year, these activities will also be expanded to include the asset/liability management activities of Momentum Group.

Credit portfolio management

Credit portfolio management ("CPM") is responsible for the management and oversight of the Bank's aggregate credit portfolio risk. The objectives of the function are:

- the management of aggregate credit risk through economic cycles, ie mitigating the impact of procyclical credit business activities on capital and earnings volatility; as well as
- optimisation of credit capital consumption (both regulatory and economic capital).



The function is also concerned with the review of credit risk quantification and pricing models used by business units and, in conjunction with the Enterprise Risk Management teams, provides independent oversight on aspects such as credit rating models and implementation of the credit risk management framework.

CPM plays a portfolio management role for the underlying business units which are focused on:

- formulating the Group's credit outlook (taking into account FRBG's macro economic outlook) for Wholesale, Commercial and Retail businesses;
- supporting the business units in determining their credit risk appetite and pricing strategies;
- reviewing origination strategies through different economic cycles;
- performing scenario analysis, stress testing and long term loss forecasting;
- monitoring portfolio risk information, including various measures of portfolio credit quality, credit impairment trends, arrears and non performing loans;
- assessing the adequacy of credit provisions in the light of the macro economic outlook; and
- determining and executing credit loss protection strategies, in consultation with the macro portfolio management pillar to mitigate earnings volatility and extreme losses, especially in an adverse credit cycle.

CPM also works with business units to ensure disciplined origination, especially with regards to risk adjusted pricing and ensuring that the returns are managed within an acceptable level of volatility.

As credit risk forms the largest component of economic capital, CPM also allocates economic capital and monitors returns. The allocation of economic capital is aligned with Basel II principles and the implementation of Basel II across the Group is the responsibility of CPM.

During the past year the CPM team had the following key successes:

- significant improvements were made in the sophistication of the credit economic conditions and loss forecasting models. On the basis of these forecasts it was determined that credit losses increase at a more rapid pace if interest rates move beyond 200 bps over a short horizon;
- credit hedging strategies (including both interest rate hedges as well as insurance structures) were put in place in consultation with MPM to protect against the impacts of potential movements beyond 200 bps. Over the past 18 months, interest rates moved by 300 bps of which 200 bps were experienced during the 2007 financial year. These strategies have contributed some R150 million to earnings for the current period;
- following the conclusion of a three year Basel II project lead by the Credit Portfolio Management team, FRB obtained in principle approval from the South African Reserve Bank to use the Advanced Internal Ratings Based Approach ("AIRB") for credit under Basel II from 1 January 2008. This means that all 17 rating systems used across the Bank (as described in more detail in the Risk Management report) will be used to quantify probability of default, loss given default, and exposure at default for the individual credit portfolios in order to estimate the regulatory capital requirement under Basel II; and
- adoption of the AIRB approach results in credit capital savings of approximately R2 billion compared to alternative approaches available under Basel II.

Operationally, the focus for 2008 will be further improvements in systems and methodologies to enhance credit portfolio risk quantifications, as well as improvements in economic capital quantification, concentration risk measures and risk appetite quantification measures.

Capital management

The objective of capital management is to maintain the optimal level of capital in the most cost efficient way, given our risk profile and targeted credit counterparty rating. The optimal capital level is achieved through balancing the needs of regulators, rating agencies, depositors and shareholders.

We aim to fulfil the requirements of shareholders and maintain an efficient capital structure with limited excesses, but which supports our short term growth requirements. We do not hold surplus capital for acquisitions and the need for raising additional capital is assessed on a transaction by transaction basis.

The table below indicates our actual and target minimum capital ratios.

R million	Target %	Actual %
Banking Group		
Target capital adequacy	>12.5	13.6
Tier I	>9.0	10.7
– Core Tier I	>7.0	9.8

Our policy is to capitalise the Group at the higher level of economic or regulatory capital. At the same time we seek to provide a capital buffer to give confidence to debt holders, depositors, regulators and rating agencies. We strive to achieve the highest credit rating possible in South Africa, but are currently constrained by the sovereign credit rating. A strong credit rating places us in a strong position to attract debt funding at a lower cost.

MPM invests the capital in low risk assets and the profile of these assets depends on our interest rate view. The benefits of this approach mean that business units are protected from the volatility of the interest rate cycle and therefore can focus on operational and strategic priorities to maximise the return on the risk assumed through their own strategies.

Our capital investment strategy and economic capital allocation approach allows the business units to price correctly for the risk they assume. Our approach also provides the business units with a stable cost of equity.

We strive to create value for shareholders while protecting our strong capitalisation and credit ratings.

The year under review was characterised by increased demand for capital for growth requirements, which was funded by strong capital generation.

In order to ensure that the Group achieves its performance targets, capital management monitors performance to ensure that the capital deployed to the business units meets these targets. If they do not, business models are adapted, changed or terminated.

It is expected that the demand for capital both locally and internationally will continue to remain strong. The Group actively seeks to fund this growth in the most efficient manner. In August 2007, the Group concluded Fresco II, which was a partially funded synthetic securitisation of a portfolio of South African and international credit exposures held on balance sheet. This transaction has provided the group with capital relief of R1 400 million (Basel I) and R700 million (Basel II). The Banking Group will also hold a buffer for international expansion initiatives but will only allocate capital to these if they meet or exceed current hurdle rates.

Basel II, which is applicable from 1 January 2008, will have a neutral impact on the capital requirements of the Banking Group, with the potential for a slight increase due to the current cycle. The minimum capital ratio will be 9.5% going forward and will comprise each of the following three components:

Pillar 1:	8%	minimum capital requirement
Pillar 2a:	1.5%	add on for systemic risk
Pillar 2b:	x%	add on for bank specific risks

The new regulations will also allow for more innovative Tier I and Tier II capital instruments to be issued. The Group is planning to take this opportunity to further strengthen the capital base and to fund the growth requirements of the Group.

The introduction of IFRS, which requires increased fair value accounting will lead to greater earnings volatility going forward, particularly in the investment bank. The Group does not wish to expose the dividend to this volatility and therefore will focus on a sustainable growth rate in dividend. This means that the dividend cover may vary from year to year. In the current year the Group has increased the dividend by 25%.

Strategic funding

The objective of strategic funding is to secure funding at an optimal cost from diversified and sustainable funding sources.

It is highly desirable that we achieve maximum market share in retail, commercial and corporate deposits, which represent the most cost effective source of funding. Extra market share in these deposits will create a competitive advantage for us as it provides a natural liquidity buffer, and our liability strategy is focused on achieving this objective.

In order to be in a position to take full advantage of changes in financial markets, we have embarked on a strategy to liquefy the balance sheet, which will enable us to optimally fund growth across a broad range of sources and through economic cycles. Given the current market conditions and this strategy, our objective is to make use of either our deposit franchise or the capital markets to fund the asset growth.

The ability to differentiate through new and innovative funding mechanisms is one of our hallmarks and we constantly review new proposals regarding funding strategies based on forecast balance sheet structures. This allows us to anticipate and plan for future funding and structural liquidity requirements.

We place great value on the establishment of strong relationships with all our debt investors and we have an active marketing approach underpinning our funding strategy with a strong focus on existing and new relationships. The relationships with the rating agencies, namely Moody's, Fitch, Standard and Poor's, and the maintenance of our credit rating, are central to the funding strategy.

Funding and liquidity management

We maintain a well balanced portfolio of liabilities, with a broad range of funding sources (by market, product and currency) which generates a stable flow of financing and provides protection in the event of market disruptions. Together with our centralised approach to funding management this enables us to pursue a strategy to fund business activities at the lowest possible cost.

Funding and liquidity management determine the medium and long term funding requirements of the Group by assessing the overall funding profile of the balance sheet, the effective maturity of the asset base and the quantity of funding that will need to be replaced. It also reviews the ability of the Group to continue to fund itself on an ongoing basis across all business activities through periods of stress, by actively managing the buffers.

In order to manage liquidity requirements, the Group has built up liquidity buffers within South Africa and international balance sheets and there are plans to increase these in light of the current market uncertainties.

Internationally, in order to further diversify the funding base and lengthen its profile, the Group embarked upon a Euro Medium Term Note Program of US1.5 billion. During the period under review, the Group issued Euro 500 million Floating Rate Notes, five years at an effective coupon of 50 bps over Euribor.

Domestically, the Group approved R50 billion securitisations programme (R25 billion synthetic securitisations, R25 billion physical securitisations), bilateral funding lines and three corporate conduits (iNdwa, iNkotha, iVuzi) and a warehouse facility.

The Group has issued R15 billion in securitisations (homeloans and autoloans) to date to diversify the funding base and provide capital relief.

As originating banks often absorb material expected losses from both on balance sheet and securitised pools, it is our belief that sound underwriting standards and practices remain the best protection against excessive credit exposure. Our approach to securitisation requires that all loans be subject to the same loan policy and approval process to protect against the tendency to loosen underwriting standards for pools that lenders believe may be sold and to ensure that the sold and retained loans are of the same general quality. In our securitisations, the risk of "cherry picking" is mitigated by selecting a general pool of assets to be securitised to ensure that the Bank does not compromise its rating on any of the existing entities. The Banking Group also views securitisation as a broad-based strategic initiative and, as such, has integrated the Bank's risk management systems into all facets of the securitisation process.

Equity and investment analysis

The Equity Pillar in Balance Sheet Management is responsible for ensuring that strategic decisions reflect the requirements of equity shareholders. The interplay between the positioning of the Group and the impact that these decisions have on the Group's valuation underpins the Balance Sheet Management activity. In achieving alignment, we analyse both local and international banks. Current trends, business practices, products and services are identified. This analysis encompasses the evaluation of the business units' strategic positioning and performance relative to local peer group and international benchmarks.

In order to assist the business units in meeting the returns set out in the performance framework, particularly on new capital allocations, this function provides support in formulating expansion plans for greenfields operations or acquisitions. We strive to ensure that new initiatives meet both the strategic and financial expectations of shareholders. During the last year the Group formulated entry strategies for India and Brazil and made a small acquisition in Mozambique.

Macro economic trends and bottom up information is used to develop detailed forecasts for use in the capital and funding planning processes.

To ensure that the Group meets its performance targets we work closely with the other three pillars to design the appropriate performance measurement tools.

Balance sheet management in a changing environment

Balance sheet management is acutely aware of the risks inherent in the current macro economic environment and the threats (and possible opportunities) posed by the volatility in the global financial markets. The Balance Sheet Management team continues to monitor these events and are constantly looking for further ways to protect the balance sheet and income statement streams of the Group.

Some of the key focus areas are the following:

Macro portfolio management

MPM continues to monitor the current macro economic environment and the threats and is constantly looking for further ways to protect the balance sheet and income statement streams of the Group. Although the objective to enhance is never far from the surface, the objective to protect dominates under these uncertain conditions.

Credit portfolio management

The adverse credit cycle resulting from consumer indebtedness and the interest rate hikes experienced in the 2006/2007 financial year, as well as the continued rate hikes after the financial year end is expected to result in further increases in arrears, NPL's and impairment rates over the next year.

It is expected that impairment rates will continue to increase and remain above the stated medium term target of 70 – 90 bps and be in a range of 90 – 110 bps given the current market implied interest rates. The increase is, however, in line with the sensitivity tests conducted as early as June 2006 and the upper boundary expectations for the credit portfolio in an adverse cycle.

CPM continues to actively monitor the outcome of the recent volatility experienced in the international credit markets for any potential spill over into the domestic market. Where required, further mitigating actions will be put in place to protect the Banking Group's earnings, including additional interest rate derivative hedges to protect against the increase in bad debts on the retail books resulting from unexpected interest rate increases, as well as consideration of industry and name specific protection structures for the Wholesale credit area.

Capital management and strategic funding

The strong growth in liquidity in recent years has created an investor appetite for highly leveraged financing arrangements with low credit protection. However, the losses suffered by market participants from sub prime mortgage exposures and changes in credit rating agency views on risk in highly levered transactions have caused investors to re-evaluate their risk appetite and have led to a broad repricing of risk. As a result, debt issues, particularly in the high yield space, have been downsized, restructured, or withdrawn, credit market access has been interrupted, and issuers across the entire credit spectrum have seen a rise in borrowing costs.

The changing market dynamics have meant that the Group will need to carefully monitor the demand and supply for structured credit products in both local and international markets, but most keenly those in the international markets. The current market dynamics are projecting higher cost of credit and liquidity. It has also led to an increase in volatility, which lead to an increase in the cost of capital. The market dynamics have been taken into account in the internal transfer pricing of funding and pricing to business units for new business. The impact of the change in market dynamics on the existing businesses is not expected to be material.

Johan Burger
Chief financial officer