cfo's *report*

"The group has been prudent in its provisioning and continues to focus on further strengthening and appropriately tilting its balance sheet to the macro outlook."

Harry Kellan | CFO

The year to June 2020 was extremely challenging for FirstRand, particularly the last quarter. The company's net asset value per share increased 6% to 2 453.1c per share as the group continues to accrete capital, despite the 38% decline in normalised earnings and the drop in the return on equity to 12.9%. From an economic profit generation perspective, this is the first time since the global financial crisis that the group has produced an ROE below the cost of equity (14.0%), resulting in an economic loss (negative NIACC).

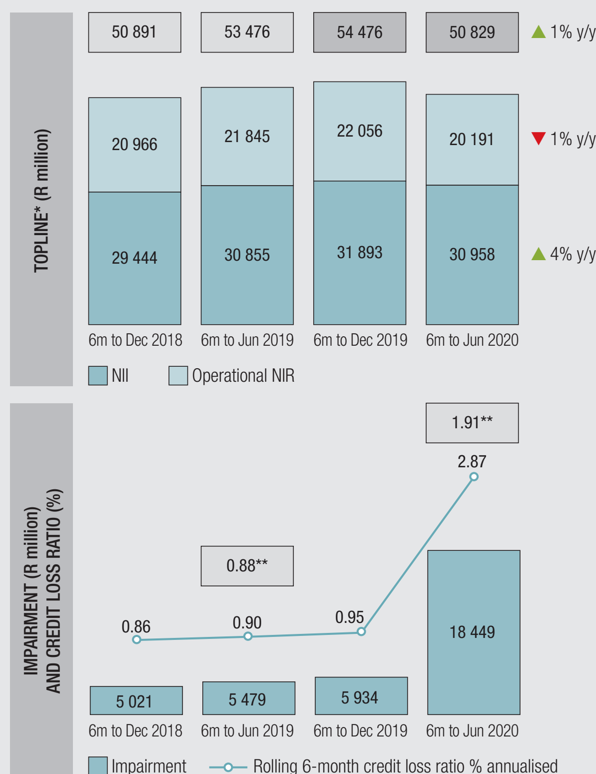
Total revenue increased marginally for the year as gross net interest income (NII) remained resilient, benefiting from growth in deposits and advances. This was offset by a reduction in non-interest revenue, which was impacted significantly by the effects of the COVID-19-related lockdowns.

The impacts of COVID-19 resulted in the group raising higher provisions for bad debts as it adjusted its forward-looking macroeconomic assumptions. This resulted in a substantial increase in the credit impairment charge. Affordability in all segments deteriorated sharply, evidenced by lower levels of underlying transactional and credit turnover and in the amount of debt relief requested by customers. Arrears and non-performing loans (NPLs) both showed material increases.

The net result was an increase in the credit loss ratio from 88 basis points (bps) to 191 bps, which exceeds the levels reached during the global financial crisis. The significant increase in the credit impairment charge was the greatest driver of the decline in normalised earnings.

NORMALISED EARNINGS

R million	2020	2019	% change
Net interest income	**62 851**	60 299	▲ 4
Operational non-interest revenue	**42 247**	42 811	▼ 1
Share of associate income	**207**	1 257	▼ 84
Total revenue	**105 305**	104 367	▲ 1
Operating expenses	**(55 656)**	(53 899)	▲ 3
Indirect tax	**(1 348)**	(1 280)	▲ 5
Pre-provision operating profit	**48 301**	49 188	▼ 2
Impairment charge	**(24 383)**	(10 500)	▲ >100
Income tax expense	**(4 874)**	(9 152)	▼ 47
Profit after tax	**19 044**	29 536	▼ 36
Other equity and non-controlling interest	**(1 779)**	(1 642)	▲ 8
Normalised earnings	**17 265**	27 894	▼ 38



* *Topline total includes share of associate income.*
** *12-month credit loss ratio to June.*

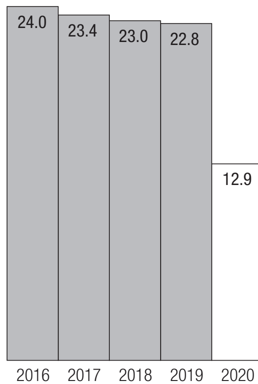
Pre-provision operating profit showed a decrease of 2%, which points to a resilient operating performance, despite margin pressure, subdued non-interest revenue growth due to lower absolute volumes during the lockdown period, and depressed new business origination.

Costs were well contained, increasing just 3%, reflecting focus on cost management and lower variable staff expenditure given the current year performance. The level of cost containment was offset by the degree of pressure on topline, increasing the group's cost-to-income ratio to 52.9%.

The group's capital position remained strong, with a CET1 ratio of 11.5%. Despite this healthy position, the board did not declare a final dividend given the PA's guidance to preserve capital. There is surplus capital to support ongoing regulatory changes, the group's growth initiatives, and the IFRS 9 transition.

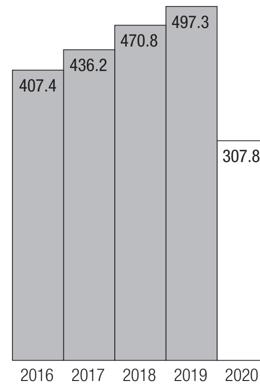
KEY PERFORMANCE METRICS

ROE
%



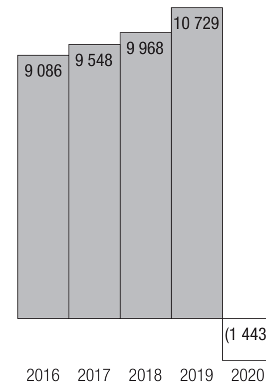
When the group analyses ROE, it also takes into account the relationship between ROA and gearing levels. The group's long-term ROE target range remains at 18% to 22% for normal economic cycles.

DILUTED NORMALISED EPS
cents



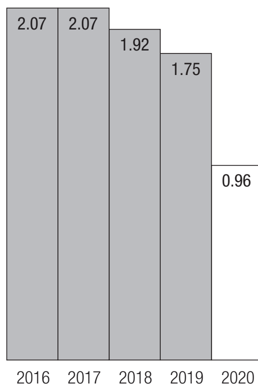
The group targets earnings growth of nominal GDP growth (defined as real GDP growth plus CPI) plus >0% to 3% for normal economic cycles.

NIACC
R million



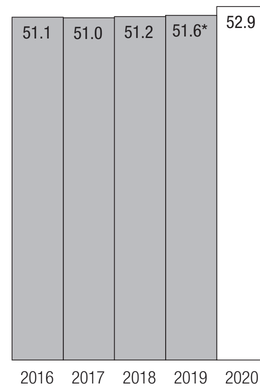
NIACC is the group's internal benchmark for assessing performance.

ROA
%



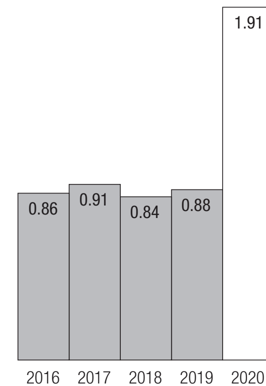
Maximising ROA is a key objective in creating shareholder returns.

COST-TO-INCOME RATIO
%



The group monitors efficiency through the cost-to-income measure. Whilst the group views the cost-to-income ratio as an outcome rather than a target, it recognises that balancing revenue growth and cost growth are key to value creation.

CREDIT LOSS RATIO
%



The group believes that pricing appropriately for credit risk is a key requirement for sustainable returns and targets a through-the-cycle charge range (excluding Aldermore) of 100 to 110 bps. The current year credit loss ratio of 191 bps is a consequence of the COVID-19 economic crisis.

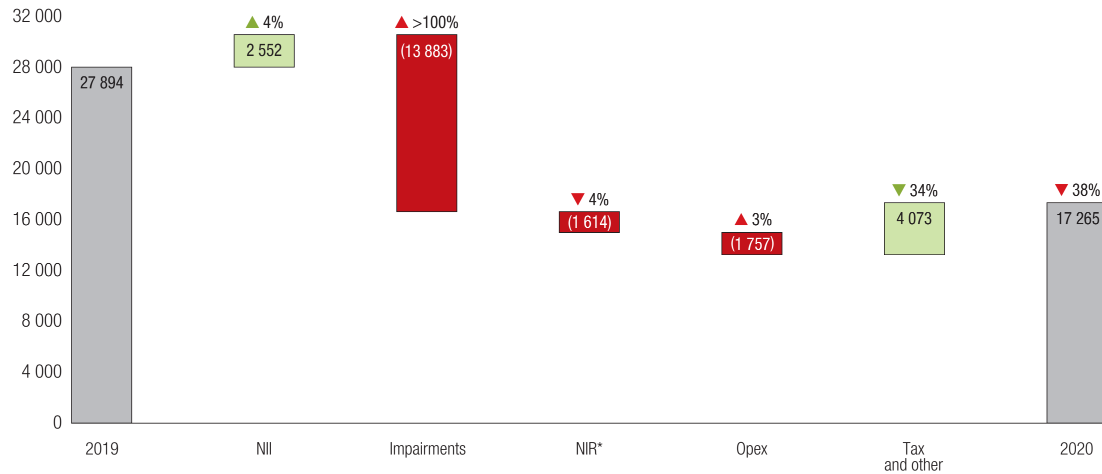
* *Reclassification of R240 million relating to operating expenses incurred on SLOW lounges from operating expenses to fee and commission expenses, so as to better reflect the nature of the expense.*

STRESS ACROSS THE INCOME STATEMENT

The chart below shows a high-level breakdown of movements in the income statement lines for the year under review, with the impairment charge contributing the bulk of the decline in normalised earnings.

NORMALISED EARNINGS

R million



* *Including income from associates and joint ventures.*

REVENUE RESILIENT

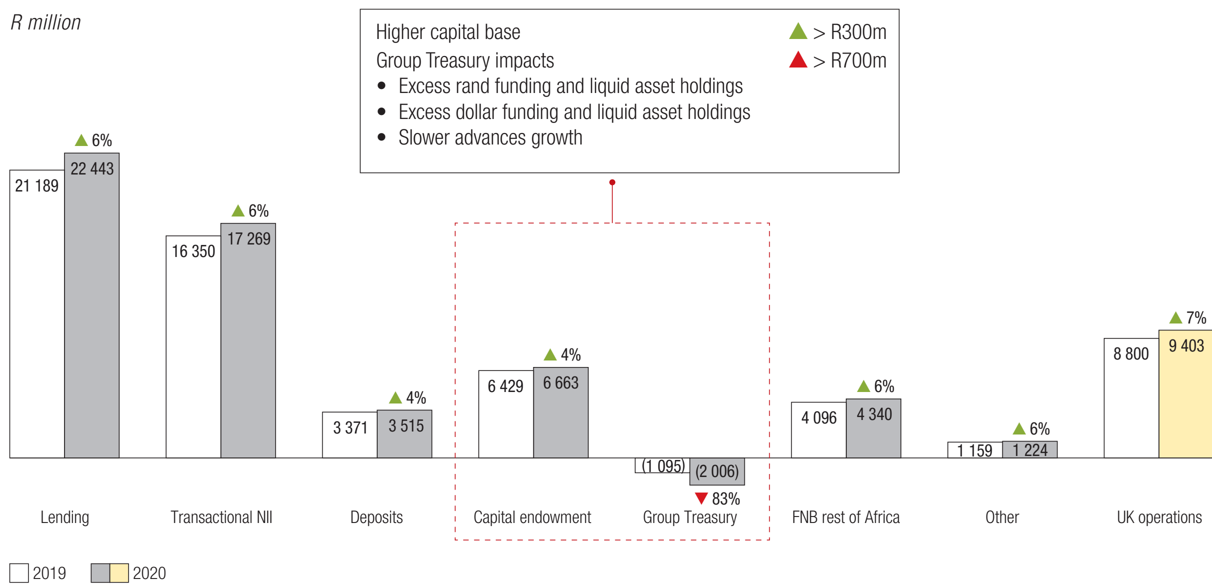
NII increased 4% to R62.9 billion.

Lending income grew 6%, in line with overall growth in advances and matched growth in transactional NII, despite margin pressure across the portfolio.

Capital endowment benefited from a higher capital base, partly offset by lower interest rates. NII was further negatively affected by excess funding and liquid asset holdings (in both rand and dollar) at Group Treasury. The following chart provides a further breakdown of the group's NII.

NET INTEREST INCOME

R million



MARGIN REFLECTS ENDOWMENT AND LIQUIDITY DRAG

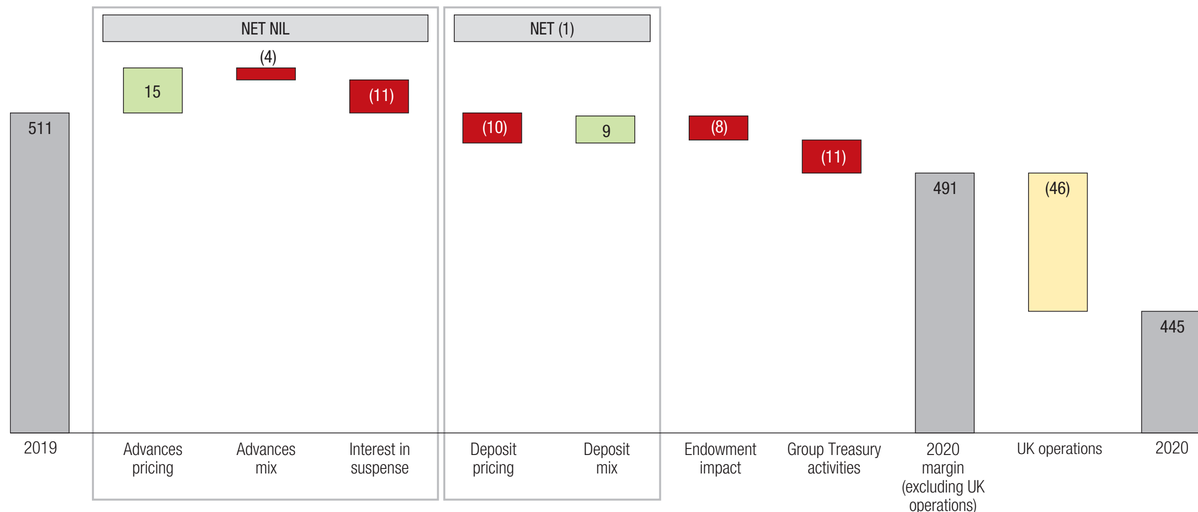
Overall, margins decreased 30 bps to 445 bps. There was a net benefit to the lending margin due to product repricing, but this was offset by a slight shift in mix away from unsecured lending and the impact of interest in suspense due to higher NPLs.

Despite healthy growth in deposits over the year, including during the lockdown period, there was a net reduction of one basis point in deposit margins due to competitive pressures and a change in mix to lower-margin products.

The group entered the COVID-19 crisis in a strong liquidity position as it had increased both local and foreign liquid asset holdings to proactively manage its liquidity coverage ratio (LCR) requirements (particularly in rand) during the first quarter of the calendar year. This, together with the group's strong deposit growth, allowed Group Treasury to successfully navigate tightening liquidity conditions following the onset of the COVID-19 crisis. The negative endowment impact and treasury activities reduced margins by 19 bps.

NORMALISED MARGIN

Bps



DEPOSITS BENEFITED FROM FOCUS ON CUSTOMER ACQUISITION AND PRODUCT OFFERINGS

The benefit of the group's longer-term strategy to gather deposits on the back of growing its strong transactional franchise was clear over the lockdown period, with digital channels leveraged appropriately, whilst maintaining competitive pricing and products.

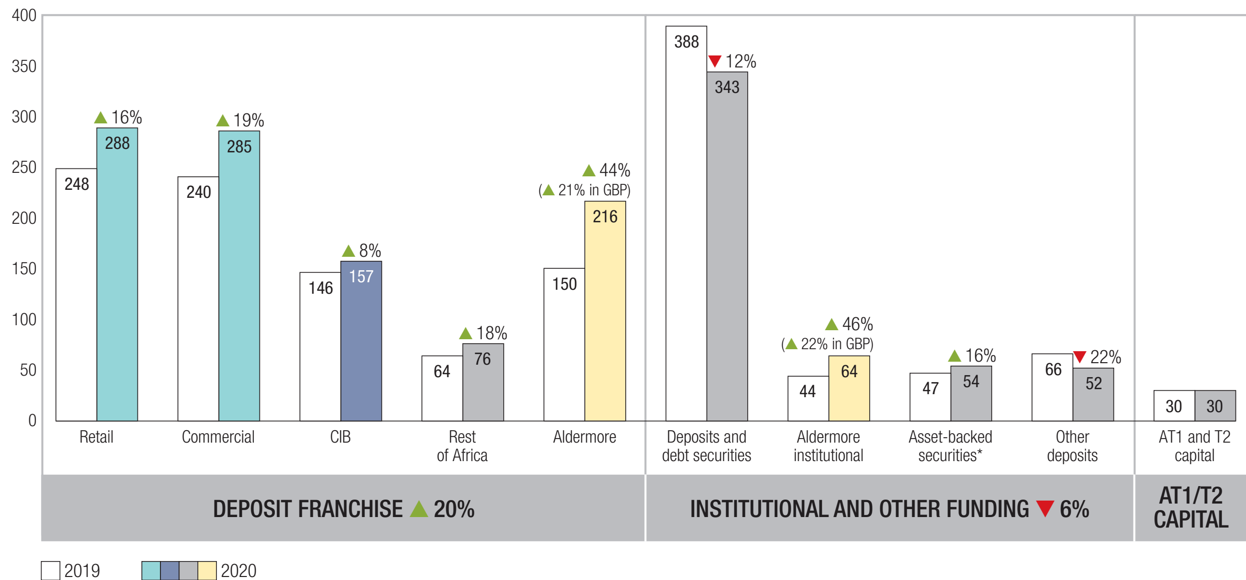
Early in lockdown there were significant drawdowns on irrevocable facilities, coupled with an increase in deposits at RMB. This was expected, given the level of uncertainty, and corporates have been conservatively managing cash flows by holding excess liquidity.

Commercial deposits increased 19%, driven by proactive client engagement, digitisation and innovative deposit solutions. The COVID-19 crisis also led to growth during the second half of the financial year as clients increased bank deposits.

Retail deposits grew 16%, supported by ongoing customer acquisition and simplified product offerings to support savings outcomes. Reduced spending and lower withdrawals from notice products during lockdown contributed and growth in the second half of the financial year. FNB held the largest market share in household deposits in South Africa as at June 2020.

LIABILITIES

R billion



* *Asset-backed securities include Aldermore's securitisations.*

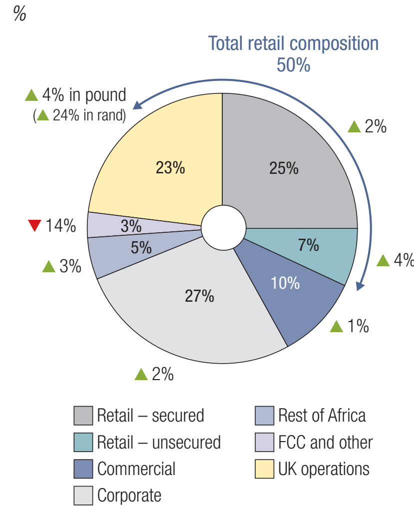
Note: Percentage growth is based on actual, not rounded numbers shown in bar graphs.

Group Treasury's excess liquidity, combined with the strong deposit growth mentioned above, resulted in a 6% decline in overall institutional funding. Institutional funding represented c. 32% of total funding at 30 June 2020 – the lowest level in over a decade.

MUTED ADVANCES GROWTH

Overall advances grew 6% to R1 311 billion (1% excluding the currency depreciation benefit on RMB's cross-border book and the UK operations' advances).

The following chart provides a breakdown of total advances.



Advances growth of 3% in FNB occurred mainly in the premium and commercial segments, with the consumer segment sharply down, reflecting the lack of capacity in lower-income households to take on credit.

Total residential mortgages increased 3%, driven by growth of 9% in premium mortgages due to customer growth and successful cross- and up-sell initiatives. Affordable housing advances declined 36% as a result of lower demand.

Card advances growth of 7% was slower than previous years, reflecting reduced risk appetite given risk cuts, together with significant lower spending during the lockdown period.

Personal loans (excluding the impact of relief loans) were flat after several years of strong growth, reflecting risk cuts on the weaker macro environment pre-pandemic and the impact of the pandemic on customers.

DirectAxis advances grew 1% due to slowing demand and reduced risk appetite.

Advances in the subsidiaries in the rest of Africa grew 3% as Botswana's total advances gained 4% and the group purchased GHL Bank in Ghana, which added R1.6 billion in advances. This was partly offset by a 0.3% decline in Namibia's advances, and the decision to exit Tanzania, which resulted in R435 million in net advances being reclassified to assets held for sale.

At FNB commercial, advances growth of 3% was driven by targeted new client acquisition in the business segment, resulting in 4% growth in core lending, 3% in agriculture, 6% in commercial property finance, and 8% in asset-based finance, offset by a 5% decline in specialised finance.

RMB corporate and investment banking (CIB) core advances growth was 8%, led by the cross-border book, which grew 12% in dollar terms and reflected new credit extension. The SA core advances book grew 3% due to higher working capital facility utilisation.

At WesBank, the 2% decline in advances reflects the material drop in applications during the first two months of lockdown in the SA retail vehicle asset finance (VAF) business, where new business contracted 12%. This added to the lengthening of vehicle replacement cycles, further risk cuts, increased competitive pressures and the challenging economic environment prior to COVID-19.

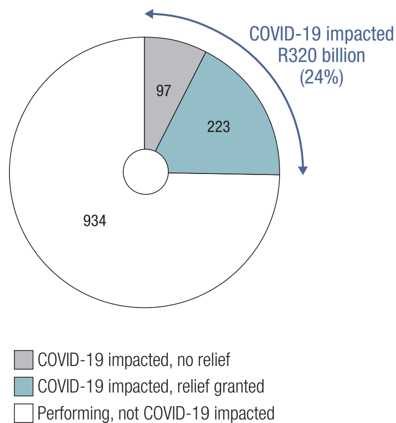
The UK operations produced advances growth of 4% in pound terms. Prior to the lockdown, there was strong new business origination in owner-occupied mortgages and targeted invoice and asset finance origination at Aldermore. New business volumes at MotoNovo benefited from more competitive funding rates from the Aldermore funding platform and relatively benign forward-funding rates given Brexit uncertainty.

DEBT RELIEF

As mentioned in the *CEO's report*, the unprecedented economic stress created by the pandemic required the group to offer payment relief solutions for customers. The group provided debt relief on 18% of performing (stage 1 and stage 2) advances, approximately 70% of the COVID-19 impacted advances (representing 24% of total book) as illustrated in the chart below.

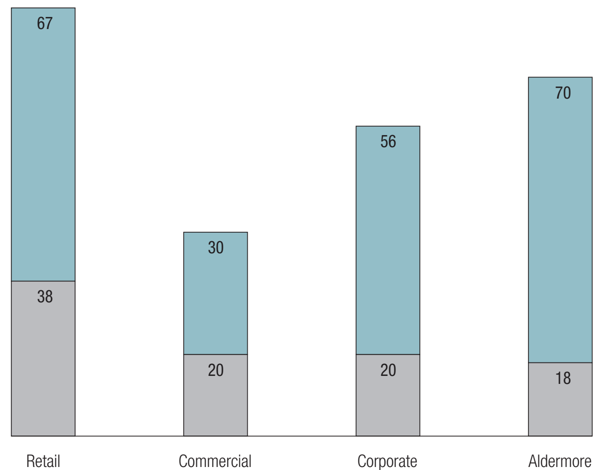
TOTAL GROUP (PERFORMING BOOK)

R billion



COVID-19 IMPACTED PERFORMING ADVANCES PER SEGMENT

R billion



The debt relief provided also impacted the staging of advances, provisioning and the overall credit impairment charge.

CREDIT PERFORMANCE REFLECTS PRUDENT PROVISIONING

FirstRand has revised its macroeconomic outlook for 2020/21, with material downward revisions to key economic variables affecting the group's activities, including a sharp contraction in real GDP of 8%, a significant increase in unemployment and weakness in property markets. These revisions have been incorporated into the group's credit provision models in line with IFRS 9 requirements, with all segments and portfolios experiencing notable incremental impacts from forward-looking adjustments.

This, together with arrears (up 42%), resulted in performing provisions increasing R9 billion, mainly driven by conservative coverage ratios. Group NPLs increased 39% to 4.37% of advances (2019: 3.33%). This required further provision of R6.2 billion, however, coverage has been largely maintained.

All of this combined resulted in a R15.2 billion (45%) increase in provisions (2019: R5.1 billion increase) held against loans and advances across all stages, products and portfolios. The following table unpacks these movements and operational credit losses, and explains the group's materially higher credit impairment charge of R24.4 billion, and the credit loss ratio increase to 191 bps (2019: 88 bps).

ANALYSIS OF IMPAIRMENT CHARGE

R million	**2020**	2019	% change
Performing book provisions	**9 040**	945	
NPL provision	**6 178**	4 152	
Credit provision increase	**15 218**	5 097	>100
Modification	**1 007**	633	59
Write-off and other	**10 532**	7 318	44
Post write-off recoveries	**(2 374)**	(2 548)	(7)
Total impairment charge	**24 383**	10 500	>100

All provisions raised reflect the group's best estimates against available data and scenario analysis (see pages 225 to 230 for detailed macro forecasts) and are considered appropriately prudent given the prevailing risk in the system. In addition, the group has conservatively provided for a sharp increase in credit life retrenchment claims, taking account of the latest economic outlook together with write-downs on non-private equity investments – these are reflected under NIR.

Retail NPLs as a percentage of advances increased to 8.44% from 6.33% in the comparative period, driven by:

- increases in NPL balances across all retail portfolios, mainly due to the impact of COVID-19, despite relief granted; and
- the pronounced absolute increase in residential mortgage NPLs where NPL formation has historically been benign.

Other factors included new business strain from strong unsecured book growth in previous years, which had resulted in risk cutbacks in the second and third quarters of the financial year. Certain operational issues already disclosed in the first half, mainly relating to scorecards and collections in the unsecured portfolios, continued to impact NPLs in the second half.

Commercial NPLs as a percentage of advances increased to 6.51% from 4.33% in the prior year, also driven by COVID-19, the residual impact of the drought in previous years in the agriculture portfolio, and strong book growth in prior years, especially in overdraft advances. RMB corporate and investment banking (CIB) NPLs as a percentage of advances increased to 0.87% from 0.82%.

In the UK operations, NPLs as a percentage of advances increased to 2.18% from 1.38%, mainly driven by the impact of lockdown and normalisation of the book following strong advances growth in prior periods.

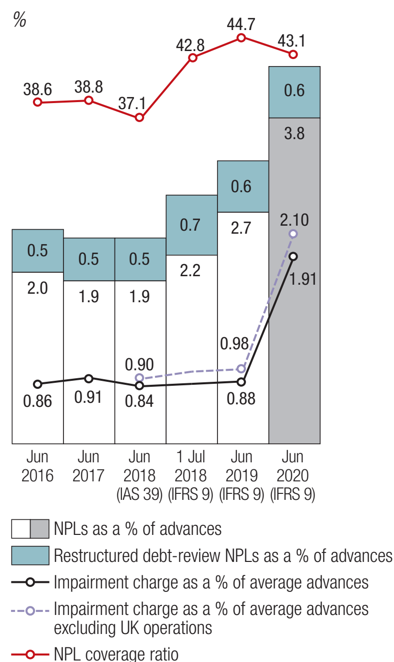
The table below unpacks all movements in NPLs.

TOTAL GROUP NPLs

	R million	% change	Percentage point contribution to overall NPL increase
Operational NPLs	10 393	39	25
Loans under COVID-19 relief	1 910	–	5
Restructured debt review	280	8	1
Definition of rehabilitation (technical cures)	(622)	(15)	(2)
Lengthening of write-off period	696	19	2
NPLs (excluding UK operations)	**12 657**	**33**	**31**
UK operations	3 275	96	8
Total group NPLs	**15 932**	**39**	**39**

The increase in balance sheet provisions coupled with R10.5 billion (excluding modification) in write-offs and other charges – mainly in the unsecured book – offset by bad debts recovered, resulted in a R24.4 billion credit impairment charge on the income statement. This was 2.3 times higher than the previous year and resulted in a credit loss ratio of 191 basis points, as illustrated in the chart below. The table beside the chart provides a breakdown of the impairment charge and credit loss ratio by product.

NPL AND IMPAIRMENT HISTORY



IMPAIRMENT CHARGE AND CREDIT LOSS RATIO

	Impairment charge (R million)		Credit loss ratio (%)	
	2020	2019	**2020**	2019
Retail – secured	**4 185**	2 135	**1.28**	0.67
Residential mortgages	**1 411**	232	**0.64**	0.11
WesBank VAF	**2 774**	1 903	**2.64**	1.80
Retail – unsecured	**8 562**	4 904	**9.83**	6.28
FNB card	**1 997**	937	**6.85**	3.68
Personal loans	**4 899**	2 682	**12.06**	7.50
– FNB	**2 447**	1 296	**10.46**	6.39
– DirectAxis loans	**2 068**	1 386	**12.87**	8.94
– COVID-19 relief	**384**	–	**32.99**	–
Retail other	**1 666**	1 285	**9.62**	7.60
Total retail	**12 747**	7 039	**3.09**	1.78
Commercial	**3 198**	832	**2.39**	0.64
Corporate	**3 293**	400	**0.95**	0.12
Rest of Africa	**1 630**	890	**2.49**	1.41
FCC (including GTSY)	**114**	156	**0.28**	0.37
Total excluding UK operations	**20 982**	9 317	**2.10**	0.98
UK operations	**3 401**	1 183	**1.23**	0.50
Total including UK operations	**24 383**	10 500	**1.91**	0.88

Coverage appropriate given portfolio mix and book growth

In WesBank, portfolio coverage was impacted by increased arrears in stage 2 and higher provisions held before the pandemic given prior stress in the book, which necessitated risk cutbacks.

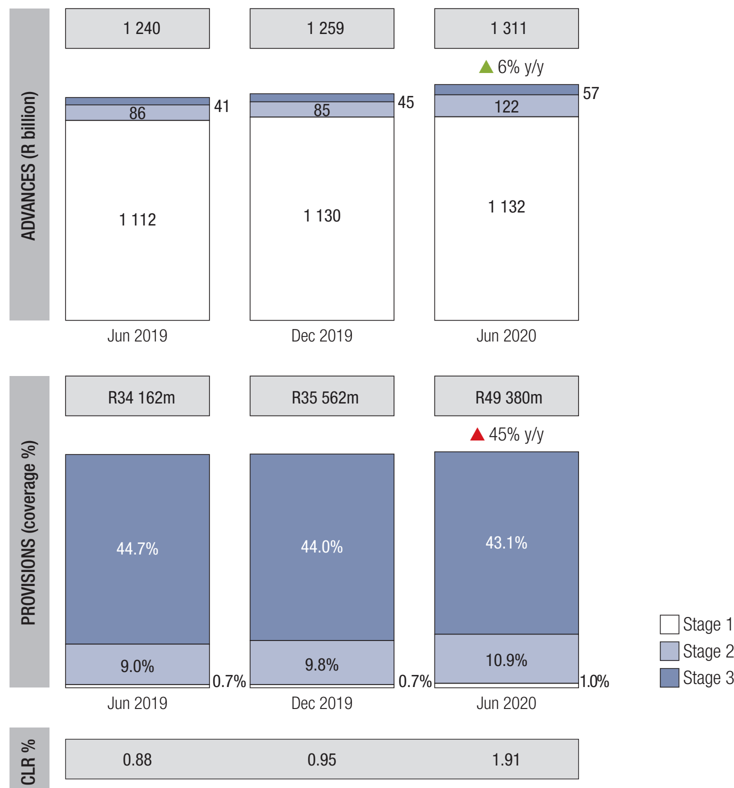
FNB card portfolio coverage increased marginally in line with higher arrears.

Personal loan stage 1 coverage increased due to FLI assumptions, while stage 2 coverage decreased given previous overlays held in the portfolio.

In CIB, a significant portion of performing advances were classified to stage 2 to reflect the higher risk of certain vulnerable sectors, thereby increasing coverage. Commercial had a similar experience, with FLI provisions leading to higher portfolio coverage.

Altogether, both specific and portfolio balance sheet provisions increased 45%, or R15.2 billion, to R49.4 billion year-on-year.

The following graphic provides a breakdown of total advances and provisions, as well as the credit loss ratio.



OPERATIONAL NIR RESILIENT

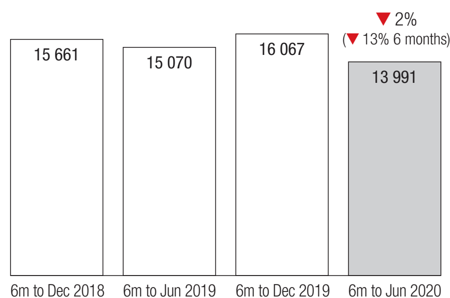
NIR has been fairly resilient. Fee and commission income declined 2%, affected by lower volumes experienced throughout the lockdown, together with R561 million in concessions granted to clients.

The 5% decline in insurance income was driven by increased credit life and death claims and forward-looking claims provisions. Pleasingly, in-force annual premium equivalent (APE) grew 7% (non-credit life APE increased 14%). The number of new policies declined 2%, notwithstanding strong growth in underwritten life products.

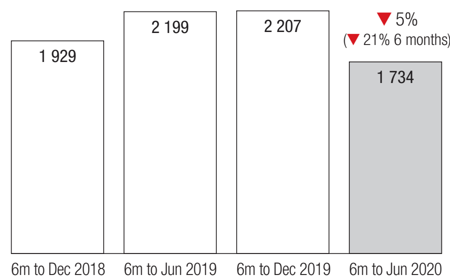
Despite the tough operating environment, markets and client activities delivered a strong performance, mainly due to foreign exchange activities which were bolstered by a robust performance in Nigeria and a recovery in domestic flow activities following increased market activity on the back of COVID-19.

Investment income was negatively affected by around R1 billion in impairments and write-downs against non-private equity investments. This was a result of the performance of certain investee companies specifically impacted by lockdown. This offset a modest uptick in realisation and annuity income. The quality and diversification of the private equity portfolio are reflected in its unrealised value of R3.3 billion (2019: R3.5 billion). The business remains in an investment cycle and additional investments of R1.8 billion were made by June 2020.

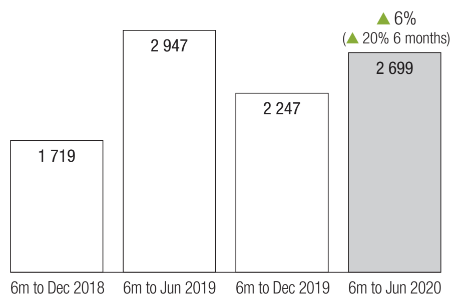
FEE AND COMMISSION INCOME



INSURANCE INCOME

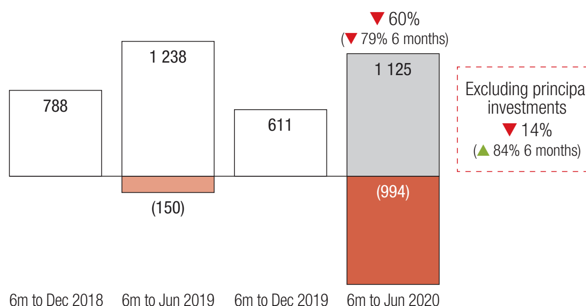


MARKETS, CLIENT AND OTHER FAIR VALUE*



* *Excluding Aldermore fair value hedge.*

INVESTMENT INCOME



Investment income
Principal investments impairment

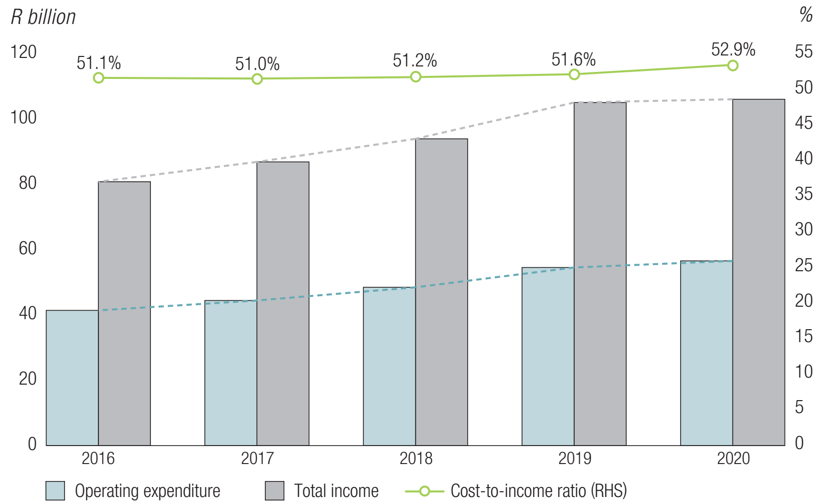
OPERATING COSTS CONTAINED AS GROUP CONTINUES INVESTING FOR GROWTH

Cost growth was contained at just 3%, reflecting the focus on cost management and lower variable staff expenditure given current year performance, and was achieved despite continued investment in:

- insurance and asset management growth strategies;
- platforms to extract further efficiencies;
- the build-out of the group's footprint in the rest of Africa; and
- the process and system modernisation of the UK business.

Additional costs incurred were associated with managing employee and customer wellbeing on premises and in branches, and the rapid facilitation of remote working for a significant proportion of staff when lockdown commenced.

Despite the level of cost containment, given the degree of pressure on the topline, the cost-to-income ratio deteriorated to 52.9%.



Staff costs represent approximately 59% of the group's cost base. Direct staff costs increased 10%, incorporating the employee union increase of 7% in the prior year and staff headcount growth, including the acquisition of GHL Bank. Overall staff costs were up 1%, benefiting from the reduction in variable remuneration, along with the cost benefit due to the non-vesting of the 2017 long-term incentives.

The group expenses the majority of its technology and platform spend, which contributed to the 11% increase in overall IT costs.

Many costs are structurally sticky, but the group continues to make progress in extracting efficiencies.

THE GROUP CONTINUES TO PROTECT AND STRENGTHEN ITS BALANCE SHEET

The structure of the group's balance sheet reflects FirstRand's long-term strategy to increase balance sheet resilience, diversify credit exposures across sectors and segments, increase market liquidity, and reduce reliance on institutional funding.

Group internal capital targets have not been adjusted for the COVID-19 temporary relief measures and are aligned to the minimum requirements, including a fully phased-in Pillar 2A requirement. The group's CET1 ratio remained strong at 11.5% (2019: 12.1%), which is within its internal target range of 11.0% to 12.0%. The year-on-year decrease in the CET1 ratio was largely a function of:

- the COVID-19 impact on earnings;
- an increase in risk weighted assets (RWA) mainly from credit, counterparty credit and market risk driven by rand depreciation; and
- the transitional impact of IFRS 9 on 1 July 2019.

The overall decrease in the CET1 ratio was partly offset by the increase in the foreign currency translation reserve (net of goodwill and intangibles) and the successful financial resource optimisation strategies mentioned above.

The group manages liquidity risk by optimising its funding composition within structural and regulatory constraints to enable business to operate in an efficient and sustainable manner. The group entered the COVID-19 crisis in a strong liquidity position, well in excess of the regulatory minimum LCR of 80%, which the PA has reduced from 100% for this stress period. The net stable funding ratio of 117% exceeded the regulatory minimum of 100%.

FirstRand remains well funded with adequate liquidity buffers to meet both prudential liquidity requirements and internal targets.

CONCLUSION

From an economic profit generation perspective, this is the first time since the global financial crisis that the group has produced an ROE below the cost of equity, resulting in negative NIACC, which represents an economic loss. However, FirstRand still delivered normalised earnings of R17.3 billion and grew shareholder NAV, so the business is in resilient shape despite the challenging environment.

The group has also been prudent in its provisioning and continues to focus on further strengthening and appropriately tilting the balance sheet to the macro outlook to enable FirstRand to effectively weather the prevailing environment, and emerge in a position to fully capitalise on the recovery.

HARRY KELLAN
CFO