FirstRand

cfo's
report

for the year ended 30 June 2023

HARRY KELLAN *Chief Financial Officer*

Overview of results

The 12% increase in the group's normalised earnings was driven by good topline growth, reflecting continued momentum in new business origination in all large lending portfolios, ongoing growth from the deposit franchise and the performance of the group's transactional franchise (measured by customer growth and volumes).

The relative size and quality of the transactional franchise allows the group to achieve high levels of capital-light earnings growth, translating into superior returns to shareholders. At the same time, FirstRand continues to employ a judicious and tactical approach to lending, supporting its customer franchises whilst protecting the balance sheet and return profile. This is a necessary balancing act given the operating environment, which is currently characterised by high inflation and interest rates, combined with sluggish system growth and competitive behaviour. The credit performance for the year was in line with expectations and is a direct outcome of the group's origination strategy, in particular from mid-2020 to late 2021, as the country emerged from the Covid-19 pandemic. The decision to tilt origination to low- and medium-risk customers has resulted in a credit loss ratio below the group's through-the-cycle (TTC) range, despite a higher interest rate and inflation cycle than initially anticipated. Over the past 18 months, the group has gradually lifted origination back to pre-pandemic appetite.

FirstRand delivered a normalised return on equity (ROE) of 21.2% (2022: 20.6%), which is at the top end of the target range of 18% to 22%, and produced R12.0 billion of economic profit (2022: R10.1 billion), or net income after cost of capital (NIACC), which is its key performance measure.

Despite the record dividend payout for the year ended 30 June 2022, the group grew net asset value (NAV) 10% year-on-year.

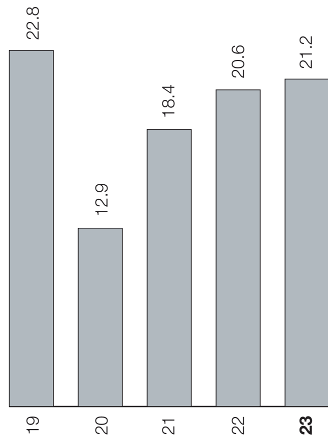
Given the high return profile, the group remained capital generative, with the Common Equity Tier 1 (CET1) ratio at 13.2% (2022: 13.9%) notwithstanding the impact of the special dividend declared in the prior year. Taking into account this strong capital level, the board was comfortable to keep the dividend payout at 58.8% and the dividend cover at 1.7 times unchanged. This translates into an annual ordinary dividend of 384 cents per share, an increase of 12% year-on-year.

FirstRand's performance, in particular the composition and quality of its earnings and high return profile, continues to reflect the consistent and disciplined execution on strategies designed to maximise shareholder value, tightly managed through the group's financial resource management (FRM) process. These are covered in more detail in the *CEO's report* at https://www.firstrand.co.za/investors/integrated-reporting-hub/directors-reports/.

The strength of the customer-facing businesses in the FirstRand portfolio has allowed the group to capitalise on profitable growth opportunities across all markets, sectors and segments – thus delivering resilient operating performances despite the challenging macroeconomic environment.

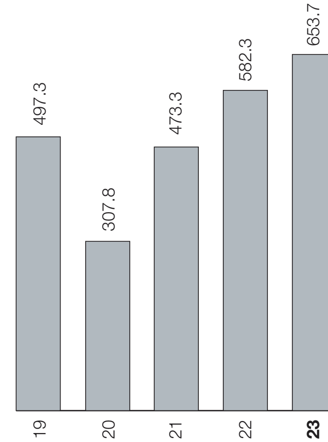
Key performance metrics

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 is 18% to 22% for normal economic cycles.

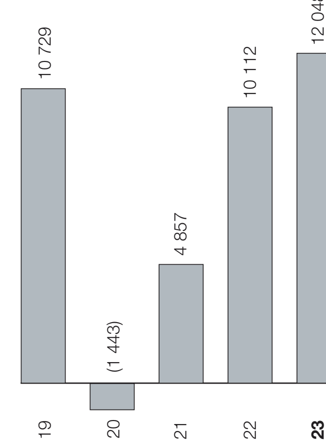
Diluted normalised EPS
(cents)



The group targets earnings growth of nominal GDP* growth plus >0% to 3% for normal economic cycles.

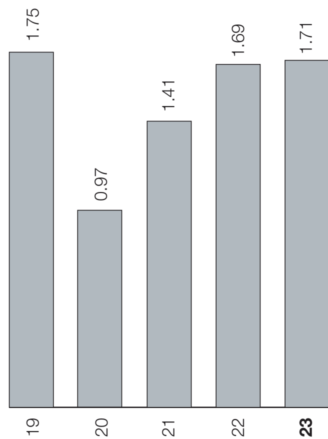
* *Defined as real GDP growth plus CPI.*

Net income after cost of capital
(R million)



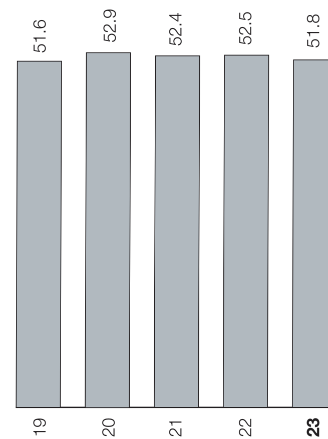
Net income after cost of capital is the group's internal benchmark for assessing performance.

ROA
(%)



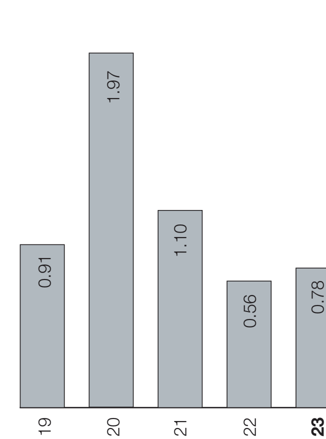
Maximising ROA is a key objective in creating shareholder returns.

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 is key to value creation.

Credit loss ratio
(%)



The group believes that pricing appropriately for credit risk is a key requirement for sustainable returns.

The following table provides an overview of key financial highlights.

KEY PERFORMANCE METRICS (NORMALISED)

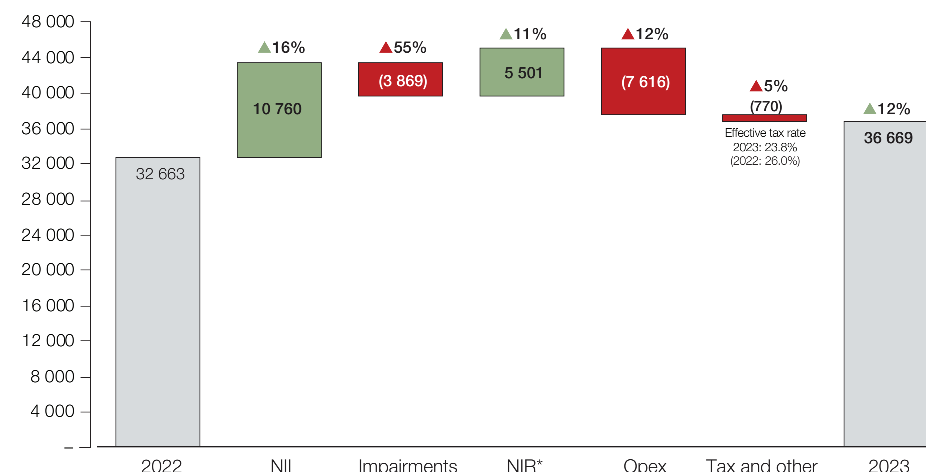
	2023	2022	% change	
Earnings per share (cents)	**653.7**	582.3	12	▲
Dividend per share (cents)	**384**	342	12	▲
Earnings (R million)	**36 669**	32 663	12	▲
NIACC (R million)	**12 048**	10 112	19	▲
Net asset value per share (cents)	**3 221.3**	2 938.9	10	▲
Net interest margin (%)	**4.47**	4.40		▲
Credit loss ratio (%) – core lending advances	**0.78**	0.56		▲
Cost-to-income ratio (%)	**51.8**	52.5		▼
Return on equity (%)	**21.2**	20.6		▲
Return on assets (%)	**1.71**	1.69		▲
CET1 ratio* (%)	**13.2**	13.9		▼
Stage 3/NPL as a % of core lending advances	**3.80**	3.88		▼
Gross advances – core lending advances (R billion)	**1 511**	1 311	15	▲
Deposits (R billion)	**1 923**	1 656	16	▲
Number of employees (excluding FirstJobs)	**49 697**	47 105	6	▲
FirstJob employees	**796**	954	(17)	▼

* *On an IFRS basis including unappropriated profits.*

Above-inflation cost growth and credit normalisation were more than offset by strong topline performance

The following chart provides an unpack of the movements in the various income statement lines, reflecting strong topline growth and an expected increase in the impairment charge. The impact of inflation and an increase in headcount pushed costs up. The group benefited from a lower effective tax rate, reflecting a 1% reduction in South Africa's corporate tax rate.

Normalised earnings
(R million)

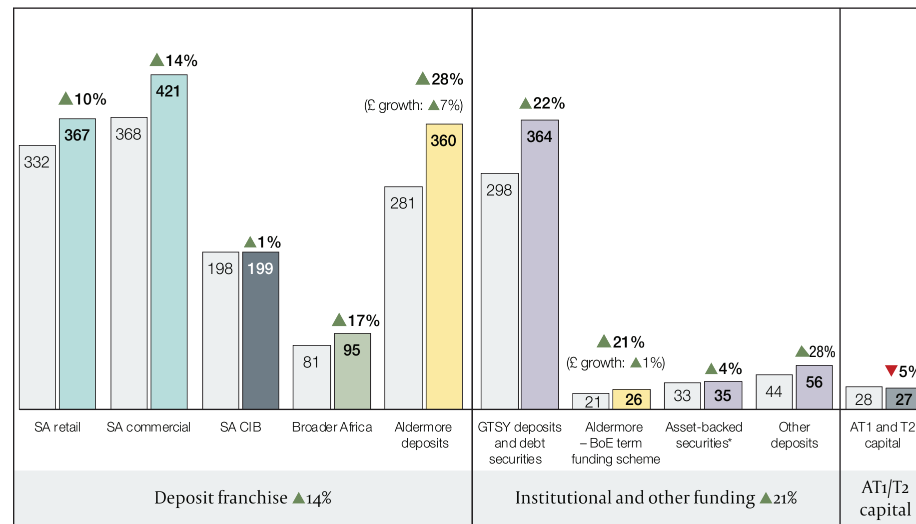


* *Includes share of profit from associates and joint ventures after tax.*

Deposit franchise outperformance continued

As shown in the chart below, the deposit franchise grew strongly, up 14% year-on-year, representing an increase of c. R180 billion. Excluding the impact of the rand's depreciation against the pound sterling, the increase was R120 billion, with R90 billion growth from the South African franchise. FNB continued to actively encourage customers to move funds into more rate-sensitive deposits, resulting in strong growth in variable-rate investment products. Active customer growth also underpinned the deposit performance as customers started dipping into their savings, as expected, given the strain consumers are under due to the high-inflation and high interest rate environment.

Aldermore deposits grew to £15 billion, which supported advances growth and enhanced Aldermore's liquidity profile in an uncertain environment.



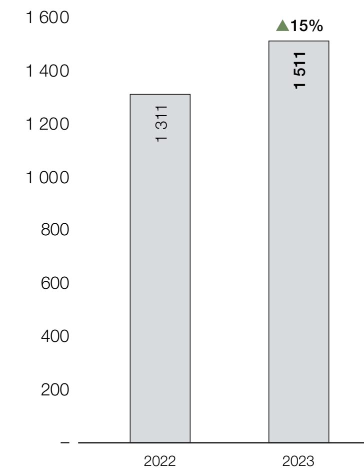
* *Include Aldermore securitisations.*

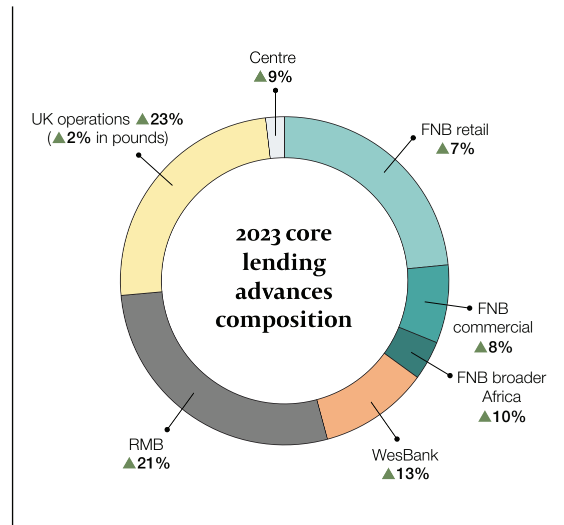
Note: Percentage growth is based on actual rather than rounded numbers shown in the bar graphs.

Institutional funding increased in order to fund advances growth, however, the contribution to overall funding remains relatively low at 19%. The weighted average remaining term profile of institutional funding declined from 39 months to 29 months, given the issuance of shorter-dated negotiable certificates of deposit (NCDs).

Growth across lending portfolios

Overall core lending advances grew 15% to R1 511 billion, with the depreciation of the rand contributing five percentage points to growth, i.e. core lending advances increased 10% on a constant currency basis.





Growth in certain retail advances slowed in the second half of the year given customer affordability pressures, but on a year-on-year basis still delivered healthy increases with retail advances up 7% for FNB and 9% for WesBank.

In the commercial segment, advances growth of 8% reflects FNB's consistent strategy to originate tactically in those sectors showing above-cycle growth, and which are expected to perform well even in an inflationary and high interest rate environment. WesBank's corporate book delivered 20% growth in advances.

The FNB broader Africa portfolio also delivered good growth in advances across most jurisdictions, up 10%.

RMB's core advances growth continued (+21%), with origination also leaning towards lower-volatility sectors and better-rated counterparties.

Advances growth in the UK operations was resilient (+2% in pounds, +23% in rand) despite the challenging inflationary and interest rate environment, underpinned by the focus on specialist buy-to-let.

Net interest income growth driven by transactional franchise, endowment and advances growth

Overall group net interest income (NII) increased 16%, driven by core lending advances growth (+15%), continued deposit gathering (+14%) and the endowment benefit.

ACTIVITY ANALYSIS OF NET INTEREST INCOME

R million	Year ended 30 June		
Net interest income	**2023**	2022*	% change
Lending	**25 825**	24 473	6
Transactional**	**20 022**	16 749	20
Investment deposits	**4 234**	3 558	19
Capital endowment (including ALM strategies)	**9 891**	8 926	11
Group Treasury, Centre and other#	**286**	(678)	(>100)
FNB broader Africa	**5 139**	3 969	29
NII excluding UK operations	**65 397**	56 997	15
UK operations' NII	**13 219**	10 859	22
Total NII	**78 616**	67 856	16

* *Comparative information has been represented in order to provide better attribution of NII by nature of activity. In addition, lending and transactional NII has been restated due to the reallocation of revolving facilities from retail other to personal loans. The total NII has remain unchanged.*

** *Includes NII related to credit cards, overdrafts and transactional deposit products, and deposit endowment.*

\# *Other includes negative endowment, e.g. fixed assets.*

Lending NII increased 6%, on the back of continued advances growth, although at lower margins. UK operations' NII grew 16% in pound terms as margins widened.

The endowment benefit can be seen in the growth in capital endowment (up 11%) and transactional NII. Total transactional NII increased 20%, driven by volume growth in transactional credit products, increased retail and commercial customer deposits, and deposit endowment.

FirstRand's approach to managing the endowment profile (the asset-liability management (ALM) strategy) has resulted in positive outcomes for shareholders since implementation in 2017, through the pandemic and to date. The approach is explained in more detail in the *CEO's report* which is available at https://www.firstrand.co.za/investors/integrated-reporting-hub/directors-reports/.

FirstRand's focus on growing liability-related NII played out strongly across all deposit franchises and remains a key underpin to its superior return profile.

FNB broader Africa NII growth reflects advances growth and endowment.

Origination approach played out in lower net interest margin on assets, with positive offset from deposit franchise

Group net interest margin (NIM) improved seven basis points to 4.47% (2022: 4.40%). Lending margins continue to come under pressure from the competitive environment, origination strategies and mix change (higher proportion of residential mortgages and corporate and investment banking (CIB) advances). This was, however, mitigated by the performance of the deposit franchise (and the net endowment benefit) from the domestic and broader Africa franchise given current rate cycles.

Credit performance as expected given origination approach

The group's credit performance was in line with expectations, with the credit loss ratio below the TTC range of 80 – 110 bps despite the prevailing macroeconomic environment. The overall credit loss ratio increased to 78 bps (2022: 56 bps), driven largely by SA retail and the UK operations.

This underlying performance reflects the group's origination strategies, particularly post the pandemic, and was achieved despite the current pressures from high inflation and interest rates. However, given these pressures, balance sheet provision levels remained conservative against the in-force book as new origination adapts to macros dynamically. Overall performing coverage on core lending advances decreased slightly to 1.72% (2022: 1.78%), reflecting book growth, mix change and the removal of the additional stress scenario provisions raised in the prior year in anticipation of the current year macro impacts.

The weaker-than-anticipated macroeconomic environment drove a build-up in arrears (stage 2 balances). Stage 2 advances (excluding the temporary stress scenario) increased 4% or R4.8 billion to R114.7 billion. Operational arrears, which represent a third of these balances, increased 30%, which was expected given the origination strain from advances growth over the last 18 months as well as the deteriorating environment. Notwithstanding this increase, paying customers represent approximately two-thirds of total stage 2 balances.

Non-performing loans (NPLs) increased to R57.4 billion (2022: R50.9 billion), but declined to 3.80% as a percentage of core lending advances (2022: 3.88%), due to book growth.

CHANGE IN NPLs

	30 June 2023 vs 30 June 2022		
	R million	**% change**	**Percentage point contribution to overall NPL increase**
Operational NPLs*	**3 064**	**9**	**6**
Other paying NPLs**	**1 268**	**14**	**3**
NPLs (excluding UK operations)	**4 332**	**10**	**9**
UK operations	**2 214**	**28**	**4**
Change in total group NPLs	**6 546**	**13**	**13**

* *Include debt-review and other core lending advances ≥90 days in arrears.*

** *Include debt-review and other core lending advances <90 days in arrears and still subject to curing criteria.*

Group NPL balances increased in the second half of the financial year, resulting in year-on-year growth of 13% following multiple periods of declining NPL balances. This was in line with expectations.

SA retail NPLs increased 10% to R32.8 billion (2022: R29.9 billion) or 7.08% of core lending advances (2022: 6.97%). The overall increase was driven by residential mortgage NPLs (+R2.3 billion).

SA commercial (including FNB commercial and WesBank corporate) NPLs increased 6% to R5.8 billion (2022: R5.5 billion) or 3.42% of advances (2022: 3.62%). This decrease in the NPL ratio was as a result of the 12% growth in advances.

NPLs in the SA CIB portfolio increased 23% year-on-year, primarily reflecting the migration of certain high-value, highly secured cross-border exposures. The broader Africa NPL ratio decreased to 4.62% (2022: 4.93%) as a result of lower NPLs in Botswana and Zambia following proactive write-offs, a slowdown in new inflows and ongoing good recoveries.

In the UK operations, NPLs increased to 2.72% of advances (2022: 2.61%). This was mainly due to growth in advances across all products. MotoNovo NPLs continued to be affected by slower repossessions in the UK, and the impact on collections due to the previously reported notice of sums in arrears (NOSIA) operational event.

NPL coverage decreased to 45.3% (2022: 49.8%), reflecting the change in mix. Whilst operational NPLs, which attract higher coverage, contributed a greater proportion than paying NPLs, this was offset by the lower coverage in corporate and commercial and the better-quality inflows into residential mortgages. These portfolios are highly secured and experiencing improved recovery rates. Corporate NPL coverage declined significantly to 37.4% (2022: 60.2%) due to the migration of the highly secured cross-border exposures. Residential mortgage NPL coverage marginally decreased to 20.2% (2022: 21.5%).

The overall impairment charge increased 55% to R10 949 million (2022: R7 080 million), driven by the:

- increase in overall stage 1 provisions, which was expected given current levels of advances growth and a marginal reduction in the coverage ratio since June 2022 across most of the portfolio;
- increase in stage 2 provisions reflecting book growth and expected origination strain. Coverage ratios have largely been maintained, increasing in the UK operations given the currency impact;
- 13% reduction in gross write-offs and an 11% reduction in post write-off recoveries;
- c. R1 billion year-on-year swing in RMB's impairment charge (given prior year releases); and
- 57% increase in impairments in the UK operations.

ANALYSIS OF IMPAIRMENT CHARGE

	Six months ended				June 2023 vs December 2022	December 2022 vs June 2022	June 2022 vs December 2021
	30 June	31 December	30 June	31 December			
R million	**2023**	2022	2022	2021	% change	% change	% change
Movement in balance sheet provisions							
Performing book provisions	**1 658**	964	(1 357)	627	72	(>100)	(>100)
NPL provision	**1 198**	(482)	(1 112)	(1 042)	(>100)	(57)	7
– Provision movements	**1 198**	339	(1 112)	(1 042)	>100	(>100)	7
– NPL release due to debt-to-equity restructure*	**–**	(821)	–	–	(100)	–	–
Credit provision increase/(decrease)	**2 856**	482	(2 469)	(415)	>100	(>100)	>100
Gross write-off and other	**5 344**	6 904	7 999	7 035	(23)	(14)	14
– Bad debts written off**	**6 778**	6 382	7 373	7 796	6	(13)	(5)
– Debt-to-equity restructure*	**–**	716	–	–	(100)	–	–
– Exchange rate and other	**(1 434)**	(194)	626	(761)	>100	(>100)	(>100)
Amounts recognised directly in income statement							
Modification loss	**317**	353	267	412	(10)	32	(35)
Interest suspended on stage 3 advances	**(1 251)**	(1 599)	(1 363)	(1 630)	(22)	17	(16)
Post write-off recoveries	**(1 325)**	(1 132)	(1 381)	(1 375)	17	(18)	–
Total impairment charge	**5 941**	5 008	3 053	4 027	19	64	(24)
Credit loss ratio (%) – core lending advances	**0.81**	0.74	0.47	0.65			
Credit loss ratio excluding UK operations (%) – core lending advances	**0.91**	0.75	0.45	0.79			

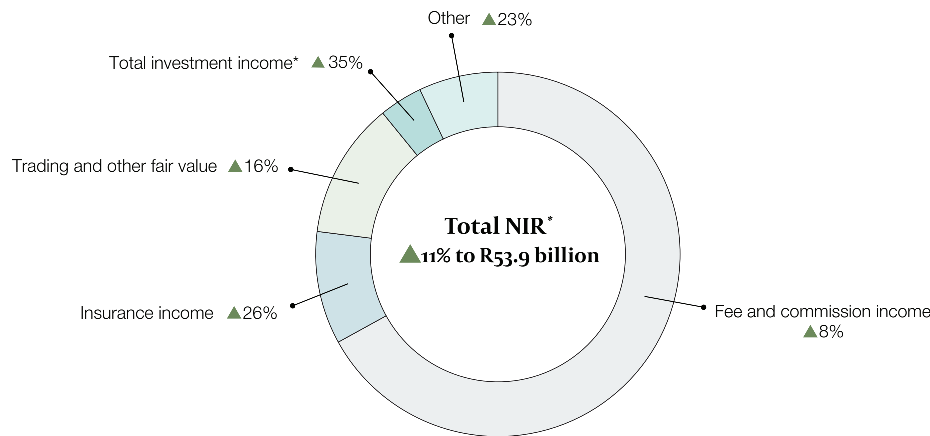
* *Refer to page 79 of the Analysis of financial results for the year ended 30 June 2023 (available on the group's website at https://www.firstrand.co.za/investors/integrated-reporting-hub/financial-reporting) for more information on the debt-to-equity restructure.*

** *Write-off of gross balances, excluding prior year provisions held, which have been recognised in the income statement over various reporting periods.*

This table shows changes in impairments on a rolling six-month view, based on movements in the balance sheet. The R1 658 million performing provision increase since December 2022 resulted from book growth. The overall impairment charge increase of R3 869 million year-on-year is explained largely by the change in performing provisions (including the exchange rate impact), given the release in the prior year of the last of the Covid-19 provisions and, to a lesser extent, the stage 3 release. The current year reflects origination strain and the weakening macro environment. With reference to coverage, performing coverage decreased on the back of advances growth. The benefit of the origination tilt explained earlier is still reflected in coverage, however, this has been offset by an increase in forward-looking information (FLI) provisions given the deteriorating macro assumptions.

Resilient non-interest revenue reflects customer and transaction volume growth, strong insurance income and private equity realisation

The following chart shows the diversity of the group's sources of non-interest revenue (NIR). Total group NIR increased 11%, supported by 8% growth in fee and commission income, 16% growth in trading and other fair value income, and a 26% increase in insurance income. The significant growth in investment income was partially offset by a R498 million impairment provision relating to the Ghana sovereign debt restructure.



* *Includes share of profit from associates and joint ventures after tax. Excluding the impact of the Ghana impairment, total NIR increased 12%. Total investment income was up 4%, including the impact of the Ghana impairment and debt-to-equity restructure.*

FNB delivered NIR growth of 11%, driven by customer acquisition, and growth in underlying customer activity and transactional volumes across the domestic and broader Africa franchises. Good insurance premium growth and a more normalised claims experience contributed further. FNB Life's new business annual premium equivalent (APE) increased 18%, with premiums up 17%.

RMB's NIR increased 11%. Knowledge-based fee income grew strongly on the back of origination activities and advisory mandates. The private equity business also delivered resilient annuity income and a material realisation, slightly offset by impairments taken in the portfolio. Despite a strong performance from the broader Africa portfolio, domestic trading income was lower compared to the previous year. The softer performances from equities and commodities in the first half continued in the second half, and extended to fixed income, reflecting lower client volumes and spread compression.

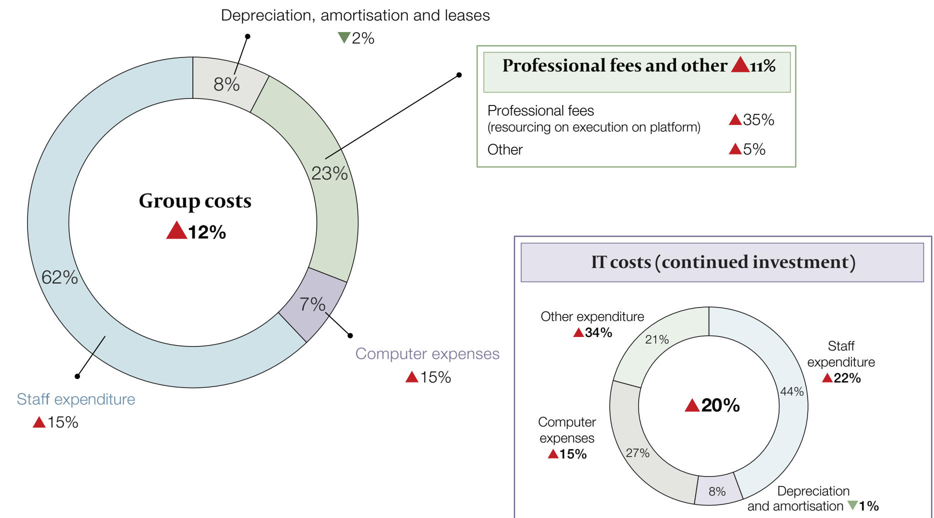
Above-inflation cost growth driven by continued investment spend and staff costs

Total operating expenses were 12% higher, including a 14% increase in direct staff costs, driven by targeted and general salary increases and a 5% increase in headcount. Other cost drivers include:

- the short-term insurance growth strategy;
- the build-out of the domestic enterprise platform;
- scaling the group's footprint and platform in broader Africa; and
- people, process and system investments in the UK business.

The cost-to-income ratio decreased to 51.8% (2022: 52.5%).

The following chart provides a breakdown of operating expenses.



Overall cost growth was also impacted by continued investment in growth initiatives and the significant currency devaluation. The investment in platform and processes continues and includes professional fees, which increased 35%, and computer costs. Travel costs have also structurally increased post the pandemic combined with the normalisation of travel.

Staff expenditure accounts for 62% of the group's total cost base. Direct staff costs increased 14% driven by headcount growth (related to growth strategies), salary inflation and a repricing of technical skills in the year under review. This, combined with a normalisation in remuneration costs (with variable remuneration increasing 11% and 46% growth in share price-linked awards), resulted in total staff costs increasing 15%.

Aldermore experienced higher inflationary pressures on its cost base, which was partly offset by some staff rationalisation at the end of the previous financial year.

The group continues to invest in technology and platform, and the majority is expensed. Total IT costs grew 20%, including a 22% increase in staff expenditure and 15% growth in computer expenses.

Balance sheet strength maintained

The objective of the group's FRM framework is to protect and enhance FirstRand's financial performance through the holistic management of the balance sheet and income streams within the context of the macro environment. This includes the strategic positioning of the balance sheet relative to long-term trends, and tactical tilts associated with the current point in the cycle.

The structure of the balance sheet reflects the group's long-term strategy to increase resilience, diversify credit exposures across sectors and segments, increase asset marketability and optimise the use of institutional funding.

FirstRand continues to enhance its risk-adjusted funding profile through further growth of its deposit franchise, which enables optimised use of institutional funding where required. The weighted average remaining term of domestic institutional funding reduced to 29 months at June 2023 (2022: 39 months). The reduction reflects an increase in money market issuances relative to longer-dated senior debt, Tier 2 and Additional Tier 1 issuance.

The group remained strongly capitalised with a CET1 ratio of 13.2%, a Tier 1 ratio of 13.8% and a total capital adequacy ratio of 15.6%. Gearing increased to 12.4 times (2022: 12.2 times), driven by 9% growth in average total equity and 11% growth in average total assets for the year.

Conclusion

FirstRand's dividend strategy is to provide its shareholders with an appropriate, sustainable payout over the long term. Given FirstRand's high-return profile and ongoing capital generation, the board was comfortable to pay a dividend at 1.7 times cover representing a payout ratio of 58.8%.

Looking at the year ahead, growth in earnings is expected to land within the group's long-term target band of real GDP plus CPI plus >0% to 3%. FirstRand also expects its ROE to remain at the upper end of its stated range of 18% to 22%.

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