Chairman's statement

BANKS MUST BUILD CONSTRUCTIVE RELATIONSHIPS

When I begin the process of writing my Chairman's statement, I sometimes browse for a quotation relevant to my topic, by someone with more wisdom than myself. This year, for the first time, I googled quotations on banking and it came as somewhat of a surprise to discover that out of the first 150 quotations I found, 99.9% were highly damning of both the principles and institutions of banking.

IN ADDITION, and in some ways even more interesting, almost every US President, from Thomas Jefferson to John F Kennedy, argued rigorously against the power and influence of the banking system. For example Jefferson said; " If the American people ever allow private banks to control the issue of their money, first by inflation and then by deflation, the banks and corporations that will grow up around them, will deprive the people of their property until their children will wake up homeless on the continent their fathers conquered."

It is not so much the fact that many wise people believe that banks are fundamentally "bad" for society that resonates with me, it is more that the relationship between governments and banks is one fraught with conflict but at the same time totally symbiotic, and this has been the case since the days of Aristotle (who also, for the record, held the practice of usury in complete contempt).

One of the most significant results of the financial crisis was that, to quote the Centre for the Study of Financial Innovation ("CSFI"), "the dash by governments to rescue their banks may have staved off a collapse of the system but it has left the banking industry deeply politicised". In the CSFI's highly regarded "Banking Banana Skins 2010", aptly titled "After the Quake", the 400 regulators, bankers and observers of the banking sector who contributed to the survey cited "political interference" as the most significant risk facing banks. According to the survey, political risk has many negative connotations; it can distort commercial judgement by "politicising" lending thus increasing the credit risk profile and it can create moral hazard through a perception that banks are too big to fail and will always be bailed out whatever decisions they take to get to that point.

My own view is that banks hold a very significant place within the economy and, whether we like it or not, governments and their designated regulators will always look to establish the levels of control and influence they believe to be appropriate. This is not necessarily a bad thing, as long as that influence seeks to protect the economy, depositors and shareholders rather than further populist political agendas. Banks globally must make peace with the fact that they face a deep public anger that will take a very long time to dissipate and governments and regulators will use this time to make some far reaching changes to the industry. The ways that some of these changes are implemented may be, by their nature, flawed. Banks will argue against them as they see their wings are increasingly clipped and the cost of increased regulation becomes more onerous. However, many banks brought this upon themselves, by pursuing strategies of excessive leverage and poor credit extension, and they must now face the consequences.

Although the South African banks weathered the storm and emerged in pretty good shape, we do anticipate that some of these changes are likely to materialise locally, particularly given our G20 membership. As an example, the South African Reserve Bank is expected to implement the Basel Committee on Banking Supervision's proposals on capital and liquidity, (the so-called Basel III proposals).

from the desk of...

LAURIE DIPPENAAR [CHAIRMAN]

What has been extremely reassuring is that our government and banks agreed to work together to investigate the impact of these proposals in the local context, particularly given the structural funding issues in the South African banking system. A joint task team was set up to consider issues relating to the lack of retail savings, the disintermediation of banks which resulted from the growth in money market funds and the different regulatory treatment of banks and money market funds.

FirstRand participated in the quantitative impact study that the Basel Committee conducted and preliminary calculations carried out as part of this exercise show that if the current proposals are implemented there would be a reduction in both Tier 1 and total capital adequacy ratios. I am pleased to report however that whilst the new regulatory minimum has not yet been finalised, FirstRand believes it will be adequately capitalised to meet the new requirements.

FirstRand's operating environment – it's still challenging out there for everyone

The macroeconomic environment is another issue that weighs on the minds of bankers, particularly as our earnings are significantly geared to GDP growth. The global economy did stage a recovery during the year under review, driven by the respective radical fiscal and monetary policy responses in many developed economies. However, the positive sentiment associated with the recovery was tempered towards the latter part of the financial year, as it became increasingly evident that global activity will experience severe "growth headwinds" over the next few years.

While emerging markets were not isolated from these events, balance sheets in these economies are generally healthier and in a better position to sustain growth at or above long term growth trends. South Africa lagged the global recovery somewhat, emerging from recession during the third quarter of 2009 with growth supported by significant monetary and fiscal policy stimulus and external trade.

FirstRand's diverse portfolio of banking and insurance businesses produced a strong performance.

The combination of interest rate cuts, the modest recovery inhouse prices (mainly during the latter half of the financial year) and higher equity prices did ease the pressure on consumers. This had a positive impact on retail bad debts, but credit growth remained extremely subdued. Whilst South African corporates have been extremely resilient, investment activity in most sectors is limited.

Group performance – all of our banking franchises did well

Against this difficult, albeit improving, macroeconomic background FirstRand's diverse portfolio of banking and insurance businesses produced a strong performance. Normalised earnings improved 39% to R9.96 billion with a normalised return on equity ("ROE") of 18%.

In trying to unpack this performance, although we did experience some modest topline growth, most of this years' earnings recovery was driven by the reversal of the two most significant negative issues from the previous comparative period. One of these, namely the "unwind" of the bad debts emanating from the large retail lending books, is mainly due to the changing environment. The other, reducing losses from certain offshore trading portfolios within our investment bank relates to the "own goals" I discussed in last year's statement and I would like to spend some time on this issue.

FRANCHISE VALUE

There are many strategies within the Group which are designed to grow revenues in an environment that is expected to be challenging for the topline.

Whilst I do not want to dwell for too long on the past, it does have some relevance to our current strategy. May I remind you of what I said last year; "Going forward there will be an increased focus on client driven activities and a healthier balance between these activities and proprietary trading or investment activities. In addition, secondary market activities will link to client activities or leverage the existing primary market position. Whilst it is likely that this shift may result in lower ROE's, it will improve quality of earnings and reduce volatility and still produce acceptable returns to shareholders".

This shift in focus is particularly relevant to our investment bank's business and you will see in the operational review of RMB on page 43 that they have rigorously followed through on this approach. As part of its strategy to rebalance its business and improve the quality of its earnings, RMB has significantly strengthened its domestic client driven activities and scaled its trading activities in line with its risk appetite framework. This has allowed RMB to proactively manage the trade-offs between earnings, volatility, profitability and growth and I believe this approach will generate the appropriate returns for shareholders and ensure that the "bull market" strategies of the past will not be repeated.

There are many strategies within the Group which are designed to grow revenues in an environment that is expected to be challenging for the topline. The earnings of FNB, our commercial and retail bank, are currently benefiting from the massive reduction in bad debts. However, FNB recognises that once that unwind begins to lose momentum, meaningful and innovative responses will be required. As a result, FNB is aggressively growing its franchise in certain segments of the South African market and expanding its footprint in high growth African markets.

FNB also continues to benefit from a strong focus on efficiencies and sustainable containment of cost growth. This should be of particular interest to those market watchers that believe that the effective management of costs is not in the DNA of FirstRand. Whilst I acknowledge that as an entrepreneurial culture we do get excited about growing the topline, it is important to appreciate the significant progress FNB has made in maintaining cost growth to well below inflation for two years running, with the absolute increase in costs in the year under review the lowest in recent history.

So our banking businesses are in good shape and are taking all the necessary actions to deliver sustainable returns to shareholders. I would now like to turn to our insurance subsidiary, Momentum.

Merging Momentum with Metropolitan – unlocking shareholder value

The earnings of our insurance subsidiary Momentum were helped by a recovery in equity markets, particularly in the first half of the year, combined with a continued strong operational performance. This translated into overall normalised earnings increasing 10% to R1.81 billion with the ROE remaining ahead of Momentum's target at 22%.

During the year under review we announced our intention to merge Momentum with Metropolitan and unbundle the merged entity from FirstRand. Contrary to the endless speculation by press and analysts that FirstRand motivated to unbundle Momentum because we want to clean up our structure and give up on our bancassurance strategy, the merger was actually motivated to FirstRand by Momentum's management and Board. The company needs to pursue new growth initiatives, particularly in the lower income markets, and this is where Metropolitan has built a strong franchise. Much has been said and written on the benefits of the merger, which I do not intend to repeat here. Suffice to say that we consider the creation of a new player in the market to be very exciting from a growth perspective and I reiterate that FirstRand remains fully committed to growing our successful bancassurance business between Momentum and FNB, on a preferred relationship basis.

I recently looked at some data that showed the level of growth Momentum achieved from 1992 – when it merged with RMB, to date. Earnings in 1992 were R21 million compared to this year's number of R1.8 billion representing a compound growth rate of 28%. What this shows is that Momentum has produced excellent returns for FirstRand shareholders over the years, and we have been very fortunate to have an insurance subsidiary of such quality, with an excellent and longstanding management team, in our "stable" for so long.

Bankers' pay – finding the proper alignment of interests

I now want to return briefly to a topic that I discussed in some detail in last year's report – that of remuneration. I am sure if I googled this topic I would find hundreds of blogs dedicated to the vilification of bankers, their hubris and their greed. As a banker myself, it is tough to be self righteous in the face of such strong public anger and the only thing I can say in FirstRand's defence is that as a Group founded and managed for over 20 years by owner-managers with a significant personal stake in the

business, we have always tried to align employee reward with shareholder returns.

In the Report of the Remuneration Committee ("Remco") on page 79 the committee's Chairman, Pat Goss states; "The Group believes that the "deferral" of certain components of performance payments will ensure senior and executive management focus on creating medium to long term value for stakeholders. Therefore during the year under review, for the first time, FirstRand increased the deferral period of a component of variable pay to a period longer than 12 months. Remco is of the view that the balance between short term incentives and equity based long term deferred incentives represents a healthy mix which will encourage focus on sustainability of profits and performance."

In line with this statement, between 20% and 40% of all performance payments above R1.5 million was deferred in FirstRand shares for two years. In addition 40% of performance payments above R1.5 million made to the FirstRand Executive committee was deferred in FirstRand shares for two years, with more than 40% of performance payments made to the CEO and COO being deferred for two years. I believe that this structure should provide shareholders with comfort that the executive management of this Group are appropriately motivated to grow long term value.

This is further underlined by the proposed purchase by FirstRand senior management of ordinary shares currently owned by the Group's founders, namely myself, GT Ferreira and Paul Harris, at a total value of R398.4 million.

OWNER-MANAGER CULTURE

Much of FirstRand's success since inception can be attributed to the "owner-manager" culture that has been embedded in the Group over many years. This culture has been critical to the spirit of innovation and entrepreneurship that has differentiated the Group from its peers. The transference of ownership of these shares to FirstRand senior management goes some way towards creating the next generation of "owner-managers" to take the businesses forward, and in addition, as senior management's own capital is now at stake, the interests of executives and shareholders continue to be closely aligned.

Looking back briefly before looking forward

Before I conclude my report with a comment on the Group's prospects I would just like to briefly discuss the World Cup. This event proved to be everything we hoped it would be; a positive window on our country in the eyes of the world; a flexion point of immense pride for every South African and, despite the hopes of many a naysayer around the world, an incredibly efficient and well run tournament. Much of the credit for this must rest with FIFA as they provide an extremely tight framework for the host country, characterised by ruthless oversight, non negotiable deadlines and clear accountability. With unwavering political will and strong leadership by Danny Jordaan and his team, South Africa really did rise to the occasion, and hopefully this has finally put to bed the perception that Africa is low tech, undisciplined and corrupt. The stadiums were all finished in time and were world class, matches started on time, supporters weren't mugged every time they visited Soweto, the transport system worked, the TV networks didn't fall down – so many examples of this country's "big match temperament".

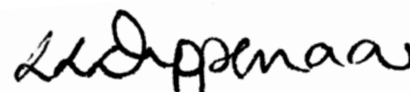
I am not the first person to ask why we cannot keep this "delivery" mindset for executing on our other infrastructure plans in the areas of service delivery, electricity and water, which are critical to the long term prosperity of the country. Can we learn and improve on what FIFA gave us? I hope we can, as South Africa is competing with a number of high growth emerging markets for investment flows, and we need to invest in our own capacity to deliver growth in the longer term.

Looking forward, the South African external economic environment seems to have stabilised, but topline growth in the medium term will remain challenging. The unwind of bad debts in the retail franchises will continue to provide support to the Group's current earnings recovery, however growth in advances will remain low as levels of consumer indebtedness are still at historic highs and corporates remain cautious.

Despite these "headwinds", and in line with our strategy, we continue to invest in our infrastructure in South Africa, particularly where significant growth opportunities have been identified and we continue to grow our footprint and client franchise in other selected African markets. In his CEO's report on page 10, Sizwe Nxasana provides more detail on the current execution of this strategy.

In closing...

I would like to thank the FirstRand executive management team and the many people we employ throughout the Group for producing this strong performance in what were challenging conditions. My last words remain for Van Zyl Slabbert, who passed away this year after serving for eight years on our Board. On hearing of his death, someone remarked to me that it felt as though a Prime Minister had died, such was the stature of the man. In the years that he served on the FirstRand Board he made an irreplaceable contribution to our debates, particularly the potential impact of social and political changes on our business. His was a formidable intellect, and both FirstRand and South Africa will miss that wisdom in the years to come.



Laurie Dippenaar
Chairman