owner-manager culture

The Group's owner-manager culture is embedded throughout the business and is key to our relentless focus on long-term value creation. This is further reflected in the alignment between management reward and shareholder returns.

– LAURIE DIPPENAAR

Chairman's statement

Laurie Dippenaar

Chairman

Big picture issues that occupy my mind.

One of the objectives I set myself when I write my statement every year is to reflect my personal perspective on the world we operate within and contemplate some of the "big picture" issues I believe to be relevant to our business and its capacity to deliver appropriate returns to shareholders.

Almost always, these issues are macroeconomic in nature, in other words they are outside of management's control but the business needs to be managed within the context they create.

Last year I talked about how banks need to develop constructive dialogues with government and regulators and that this was something the banks had brought upon themselves through the excesses of 2002 to 2008, as risk, leverage and greed pushed banks, then entire countries, then the world into an unprecedented crisis.

During those "heady" times, banks did not prove that they could be relied on to "self regulate" and therefore the current wave of regulations is likely to continue for some time, particularly given the very low level of trust that exists between the parties. Whilst I do believe that banks have become far more rigorous in the application of risk frameworks, they now need to earn that trust back.

Transparency builds trust

One issue that could hinder the process of banks earning that trust back is the very sensitive topic of bankers' remuneration. Now I did cover this issue briefly last year, and whilst again acknowledging that it is difficult to be self righteous on the topic I do fundamentally believe 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. This continues to be the case, which is why , as outlined last year, we were one of the first SA banks to introduce a large "deferred" component of management remuneration, directly linked to performance. In addition the founders sold a significant block of equity to senior management, and this will certainly focus leadership's minds on shareholder returns.

For the first time this year, as a result of changes to the Companies Act, we have been required to disclose a deeper picture of management remuneration levels than previously. The four year history of guaranteed and performance packages of the franchise CEO's can also now be viewed in the Remuneration committee report on page 83.

Personally I am comfortable with the additional transparency. The absolute levels of our CEO and CFO's packages have been in the public domain for some time and although it has generated some commentary in the press, overall this has been fair and balanced. I think this is partly because FirstRand's remuneration on "a relative" basis to our peers is not out of line, particularly given the superior returns the Group has consistently delivered. Generally our shareholders have supported our performance management practices, and in the Remuneration report itself there are a few key statistics that show that the growth in senior management's remuneration was definitely not out of line with growth in shareholder value.

However, there is no doubt that outside the "relativity" argument, the issue of whether bankers are just paid "too much" remains a hotly debated (and highly emotive) topic. I recently read a series of very interesting articles in the Financial Times that tried to understand the structural issues driving salaries across the world. One of the compelling theories they raised was that the remuneration practices of the banks over the past decade had attracted a disproportionate level of skills to the sector. This probably meant that unfortunately a much smaller number of clever graduates went into engineering or pharmaceutical companies and therefore instead of inventing new life saving drugs or innovations to hold buildings up during earthquakes, those brains ended up inventing the highly sophisticated financial

instruments that ultimately created the credit crisis. Intuitively this makes some sense to me, however, I do not believe that such a structural distortion unwinds that rapidly – if at all. Despite all their problems, banks remain gigantic contributors to world economies and therefore they will continue to need skills. It is what those skills focus on creating going forward that is the point and obviously remuneration practices are key to getting this right. Perhaps when we look back ten years out we will see that one key positive of the credit crisis is that it caused a reversal of this structural dislocation, and the world's brain trust shifted back to those other critical industries. We may suddenly see a plethora of innovations in medicine, climate control, engineering and manufacturing coming through. I hope so – a cure for malaria, HIV/AIDS or cancer or a tsunami-proof house would be truly marvellous developments.

The operating environment – some very challenging realities we are responding to

Before I turn to some commentary on the overall performance of the Group I would like to cover how I currently see the macro environment. Banks' earnings are inextricably linked to the health of the economy and currently we are facing some very difficult conditions.

The period before the global financial crisis was characterised by strong economic growth and low macroeconomic volatility (the "great moderation"). It lured all economic players (households, banks, governments) into taking on more risk and greater leverage (more debt). As the world gets rid of the excesses that built up during the great moderation, global growth is expected to remain muted and volatility is expected to remain high.

As I write (it is now the end of September 2011) developed markets have reached stall speed and fears of a global recession have surfaced. There are constant references and reminders in the press of the catastrophic consequences that a systemic event, like a major sovereign default, will have on the global economy. This is all part of the new environment we find ourselves operating in.

Whilst in South Africa, our excesses are being unwound gradually with the economy growing below potential, credit growth lagging economic activity and house prices remaining flat. These issues present huge impediments to earnings growth.

We have been adjusting our business to these realities for some time now and we constantly review our risk appetite to ensure that it is in line with the operating environment. Greater detail on these actions can be found in the rest of the annual integrated report, particularly in the CFO's report on page 16 and the franchise operating reviews pages 30 to 46.

Simplistically put in the following table – on the left read "before the great moderation" on the right read "right now".

Before		After
Aggressive risk appetite	vs	slightly conservative or neutral.
Opened taps to mortgage lending	vs	tightened taps on mortgages.
Under-priced credit for market share	vs	pricing appropriately for credit and happy to lose market share and protect ROE.
Greater reliance on wholesale funding	vs	greater focus on retail deposits.
Started to originate and distribute	vs	origination all on balance sheet.
Acquisitions in international markets	vs	growth outside SA mainly in Africa and Africa/Asian corridors.
More proprietary trading than client revenues	vs	major shift to client revenues.

This is by no means an exhaustive list but they are some very significant actions that management took. They are also critical to us delivering on our strategic intent to create long-term franchise value and deliver superior and sustainable economic returns to shareholders within acceptable levels of volatility. I think it's fair to say that the results of some these actions are already beginning to show up in the performance.

Our performance was a credit to the team

So turning to a brief high level overview of the Group's results for the year, given the trading environment I think these results are extremely impressive. Although the decrease in retail bad debts did contribute significantly to the performance, all three operating franchises, FNB, RMB and WesBank also showed very strong operational performances. This manifested itself in growth in customers and transactional volumes at FNB, strong fee and commission growth at WesBank and RMB benefitted from good deal flow throughout the year.

Our asset margins benefitted from new business re-pricing across the large lending books, although given the significant size of the in-force advances (particularly in residential mortgages) compared to current levels of new business, the benefits will take time to materialise. However, I refer you to my list above – proper pricing for credit clearly underpins improved returns.

The Group's balance sheet showed reasonable overall growth in advances which reflects very strong new business volumes in a number of the lending books. There appears to be a perception, in the media and amongst politicians, that the banks are unwilling to lend, I think some of our new business numbers defy that perception. WesBank alone advanced R57 billion of new loans this year, and even with our more conservative stance on mortgages

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we advanced R21 billion of new loans. I think this proves that we are also "open for business".

The other key metric worth focusing on for a moment is the Group's cost-to-income ratio, which increased marginally and which really reflects the pressure on the topline, particularly as core costs only increased 8%, some of which can be directly attributed to volume growth.

However the key issue is that Group has decided to bring the calculation of its cost-to-income ratio in line with industry practice. Certain fee and commission income expenses which are directly attributable to the generation of this income are now set off against that income, instead of being included in operating expenses and the effect of this change in methodology is a meaningful reduction in the cost-to-income ratio, which also results in FirstRand now being the most efficient bank relative to the other big four banks, on a truly comparable basis. This is particularly interesting for me because for as long as I can remember, market commentators have opined that the Group's "federal" model makes it vulnerable to duplication and potentially more inefficient than its peers. These commentators also believed that the Group's entrepreneurial culture was not conducive to taking cost management seriously and that topline growth was the only thing that got us excited. Well, as an early architect of the federal model and the culture I feel somewhat vindicated as this change in methodology clearly shows that FirstRand's management team can grow revenues and manage costs as well as its competition.

In summary, on every metric I believe the Group's leadership and every member of their teams should be very proud of these results.

Some growth issues

Looking forward is not a very comfortable pastime currently. It is extremely easy to be deeply pessimistic about the future. There are so many potential fault lines lurking in the world. Although some of these issues do not have a direct impact on our business, South Africa's place in the world means that our destiny remains inextricably linked to the fortunes of Europe, America and Asia.

The important thing is to continue managing the business on the scenarios we see playing out. Whatever happens globally, our own domestic structural issues will result in a period of low GDP growth, high unemployment and increasing inflation. It is most likely that interest rates will not be increased as the fiscal response needs to pull any growth lever it can and this will help ease consumers through what is turning out to be a prolonged de-leveraging process.

Given the growth headwinds we are experiencing in our home market, it makes a great deal of sense to be looking on the broader African continent for pockets of growth. Whilst we need to be realistic about the impact our current African expansion strategy may have on our earnings profile in the short term, there is no doubt that real growth opportunities exist.

Growing "quality" earnings requires patience

In his CEO's report, Sizwe Nxasana provides some additional insight as to how we view growth in Africa. Certainly we are all in agreement that the continent is experiencing a real and sustainable renaissance driven by the hunger for natural resources in China and India and the meaningful progress many African countries have made in terms of political and economic reforms.

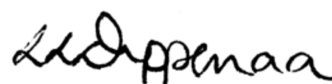
I believe that FirstRand has a very compelling strategy to grow its franchises on the African continent, matched with a highly disciplined approach to protecting shareholder returns. As I have commented many times in past reports, FirstRand believes return on equity ("ROE") is the most important measurement of profitable growth for shareholders, and in fact this belief borders on obsession.

What really matters for us is that as we grow in Africa, we create long-term value and returns for our shareholders. We are therefore committed to a highly-disciplined approach, which I believe we demonstrated when we did not proceed with the Sterling Bank transaction in Nigeria. We have a very clear framework where we balance the critical "play-off" between capital deployment, acceptable ROE "drag" and growth. This approach is likely to manifest as an incremental growth strategy in the main, a mixture of greenfields, bolt-on acquisitions and larger acquisitions only within a very strict risk framework.

The Group is very comfortable with this approach and combined with its entrepreneurial culture has developed a strong track record of creating shareholder value through establishing and growing businesses from scratch.

In closing...

I would like to sign off this year with a vote of thanks to Paul Nkuna who retires as the Mineworkers Investment Company representative on the FirstRand Limited Board. Paul has been an incredibly valuable member of the Board since we concluded the Group's BEE Transaction and I wish him good fortune in his retirement. We welcome as his replacement Mary Bomela. All that is left is to say is a heartfelt thank you to the leadership team and every staff member of this Group for a truly exceptional year.



Laurie Dippenaar
Chairman