CHAIRMAN'S STATEMENT

Laurie Dippenaar

Increasing regulation continues to cast an ominous shadow over the banking industry worldwide. I spent quite a lot of time on the topic in my report last year and my argument was that banks, in the main, have brought the burden of new regulation on themselves. I expressed disappointment that it had re-emerged as the key concern for senior executives in various surveys last year and the concern appears even more elevated this year.

Recently the tax and management consultancy PwC, surveyed 175 banking and capital markets chief executives in 54 countries. Over-regulation was a concern for 89% of them, up from 80% previously, while a massive 87% of chief executives thought that regulation would continue to have a disruptive effect in the next five years. Five years! That will take us to 2020, 12 years on from the global financial crisis. It makes you wonder what the real agenda is.

There is a very strong view that banks are useful political "footballs" as they are enormous institutions, systemically important, are still to this day uncovering illegal practices and can appear unfeeling and sinister to their customers. So they remain easy targets, particularly for the populist politician. In certain cases I am beginning to think that regulators have lost sight of their mandates, and that some proposed changes, whilst superficially ticking "protect the customer" boxes, have serious potential for systemic risk in the long run.

It is important that regulators steer clear of trying to please their political masters. Using regulation to win the hearts and minds of voters is one thing but damaging the economy is quite another. Politicians love to use the phrase "ensuring a safer system" but when does that tip over into "ineffective and unprofitable banks and disenfranchised customers"? The natural constraints and incentives of the free market system also play an important role. Banks obviously won't be successful if they don't treat customers fairly and if they aren't careful and wise in loan and investment policies and decisions.

What makes this subject so interesting is the ongoing wave of regulation in the USA, which many commentators believe places burdens on financial institutions that not only impact the world and national markets, but also individual citizens, through consumer regulations so strict that the cost to implement will eventually price the consumer out of most financial institutions. Additionally, regulatory reporting and compliance provisions are costly. In an article for the Wall street Journal, Frank Keating tries to distill this cost into a useful comparative.

"Consider a conversation I had recently with a banker in Nebraska. For the first time, he said, his bank now devotes more work hours to compliance than to lending. Specifically, he has 1.2 employees on compliance for every one employee focused on lending and bringing in business.

Imagine a manufacturing company that deployed more than half of its work force as Occupational Health and Safety Administration compliance officers. Such a company would be unable to grow, let alone contribute to broader economic growth."

This analogy resonates with me. Yes, regulation to stop excessive risk taking, mitigating abuse or price fixing and ensuring that depositors money is not frittered away on investment banking deals all make headlines and keep politicians looking honest and regulators looking prudent and proactive. However, the kind of regulation the banker in Nebraska is talking about is extremely worrying as it makes organisations that need to become more efficient (so that they can pass on cost benefits of technology and innovation to customers) become more inefficient. Another quote from the Wall Street Journal:

"In the three decades before the Dodd-Frank bank regulation law passed in 2010, an average of more than 100 new banks opened each year. In the five years since 2010, exactly one new bank has opened — a small bank in Bird-in-Hand, Pennsylvania, serving the Amish community.

Going from more than 100 new banks each year to only one new bank in five years is an amazing decline. Bankers say the drought is a sign of new regulatory requirements in the wake of the financial crisis, which are boosting expenses and discouraging potential startups from even trying."

Of course this is the USA and a large developed market, probably the most regulated market in the world, but still 100 to 1 in five years is pretty depressing. Also, it's important to note that most emerging markets are following global regulators, so even if you run a bank, or you want to start a bank in a growing economy you will still eventually feel the pressures and many of these pressures will end up being bad for customers.

It's an interesting topic in the South African context too, as the banks here face up to a world of ever increasing regulation. Some of it we welcome as it seeks to create level playing fields, eradicate systemic abuse (the use of garnishee orders comes to mind) and enforce caps on credit life where some lenders were making ridiculous profits at customers' expense. However, the sense of some regulations is less clear, such as the recent dti proposals to significantly reduce caps on unsecured lending. Whilst on the surface this proposal aims to reduce the risk of unsustainable (and in some cases unpayable) interest rates, the balance must be struck with regards availability of credit, appropriately risk adjusted. This is very important in a country where millions of people need to borrow to live and build their future NAV. It also has very negative connotations for the resurrection of the ABIL good bank which we believe has a real role to play in economic activity going forward.

What is clear is that increasing regulation is here to stay, but what we need to guard against is over-regulation which can reduce bank flexibility to meet the unique needs of customers, particularly where common sense is replaced by complex rules. Fear of violating regulations and potential lawsuits leads to fewer loans, ultimately hurting customers and their communities

HEADWINDS COMING FROM EVERY DIRECTION BUT GROUP DELIVERED RESILIENT PERFORMANCE

Moving on from regulatory headwinds, there are other emerging pressures that are equally worrisome for our business. The economy that we are currently operating in is not showing the level of activity required to change some of the structural issues we face as a country, particularly the double deficit, power shortages, rising unemployment and high levels of leverage in the consumer segment.

Despite the deteriorating economic backdrop, I am pleased to report that FirstRand continued to grow earnings and produce excellent returns for shareholders in the year to 30 June 2015. Normalised earnings increased 14% to R21.3 billion, and normalised ROE increased slightly to 24.7%.

The group's operating franchises performed well, again demonstrating their leading market positions. FNB produced ongoing topline growth and profitability on the back of sustained momentum in non-interest revenue and net interest income with good growth generated from both advances and deposits.

> We are extremely proud to have generated R23 billion of value with our BEE deal

WesBank's domestic franchise produced a particularly resilient performance despite the subdued local new car market and the MotoNovo business in the UK again showed excellent profitability in both rand and GBP terms.

RMB's investment banking and corporate banking franchises underpinned a solid performance in a year of subdued corporate activity and liquidity pressures.

The group has exercised further prudence on the back of deteriorating macroeconomic indicators and continued to strengthen its balance sheet and remains conservative in its credit provisioning.

OUR BEE TRANSACTION HAS VESTED; CREATING R23 BILLION OF BROAD-BASED VALUE

The redistribution of wealth in the broader South African society remains a key focus for the government and the private sector continues to play a major role in this process through procurement strategies, corporate social investment, enterprise development, employment equity programmes and BEE transactions.

In his book, *Capital in the Twenty-first Century*, the French economist, Thomas Piketty, produced unparalleled research on the causes and impacts of economic inequality and as he points out, in sub-Saharan Africa, where economic development still remains relatively nascent, the issue of the widening gap between the "haves and the have nots" is becoming an unintended consequence of an otherwise positive trend of economic growth.

Growth in sub-Saharan Africa has been rapid and sustained, underpinning a narrative of "It's Africa's time". This suggests that the economic and political turmoil that characterises many African countries is coming to an end, replaced with rapid urbanisation, a thriving middle class and massive investment in infrastructure development and industrialisation. According to the International Monetary Fund, in the last 20 years sub-Saharan Africa's economies have, almost without exception, expanded.

However, Francisco Ferreira, the World Bank's chief economist for the Africa region was recently quoted as saying that the World Bank has a hypothesis that the structure of growth in Africa has actually reinforced existing inequality between regions and between urban and rural populations.

"There are exceptions but in a large number of African countries the growth has been driven by the natural resource sector, oil and mining, and those are sectors that don't employ that many people; they have linkages to the rest of the economy that are more tenuous than services or agriculture or manufacturing, you have a lot of growth, you have a lot of wealth being produced, you have a lot of GDP, but that doesn't percolate as far down into the population one might hope."

Another number that often gets quoted in the inequality debate in South Africa is our income Gini coefficient ratio of 0.65 – currently one of the highest in the world. As part of an ongoing process to understand pay inequality, the FirstRand remuneration committee commissioned an interesting piece of research from PwC which analysed the Gini coefficient of a number of large companies on the JSE, including FirstRand.

The results are extremely interesting as intuitively one would think FirstRand's ratio would be higher than South Africa given some of the high salaries paid to senior executives, however, in fact FirstRand's Gini coefficient is 0.42 which is on a par with the USA (0.41). The Gini coefficient of one of the platinum mining company's analysed was calculated even lower at 0.34 (on the same level as New Zealand), again surprising if one considers the industry's pay structures.

The simple answer is that the difference between any of these companies and South Africa is that everyone in a company has a job, whereas South Africa has millions of people without jobs. Clearly the single biggest driver of our poor Gini coefficient is an unemployment rate of 25%, therefore to fix income inequality we need to create jobs.

The currently increasing rather than reducing inequality is a fundamental area of concern globally that needs to be urgently addressed, as I strongly believe that the wider the inequality gap gets the higher the risk of social unrest, something that rapidly derails economic development. It is that belief which underpinned FirstRand's commitment to a broad-based black economic empowerment transaction, to spread wealth and ownership as widely and as deeply as possible, rather than make a few well-placed individuals even richer.

We are extremely proud to have generated significant value for the participants in the scheme, which overall represents a total of R23 billion extra value created over ten years. We are particularly pleased that so many of our employees have benefited from the group's success over the past ten years with a total of R6 billion of value created for almost 13 000 people through the staff schemes.

Also, whilst our BEE partners, Women's Development Bank Trust and Investment Holdings, Mineworkers Investment Trust and Management Services and the Kagiso Charitable Trust have agreed to retain their shares until 2018, during 2015 significant value from the scheme began to cascade down to a very broad group of beneficiaries in the underlying trusts through dividends.

It worries me that certain government departments are now saying that the first wave of BEE transactions didn't work and are now pushing for a second wave of transactions designed to create narrower pockets of influence through the creation of black industrialists. How can government argue that the schemes haven't worked? Just look at the data released by Intellidex in their recent study of value created for beneficiaries through BEE deals conducted by the 100 largest companies on the JSE.

"The average value created was R2.3 billion per deal. The headline value creation figure of R317 billion was generated from 136 deals conducted by the 100 companies studied"

"We are struck by the general conclusion that BEE deals have generated a significant amount of value that will have contributed to the overall ambition of black economic empowerment. Deals have played an important role in normalising the economy, even though so much more remains to be done"

These numbers are quite staggering and the research also clearly indicates that there is even more value to flow, as more and more deals mature and vest. I want to provide some added context to that R317 billion number on the basis of a report recently published by the Department of Agriculture. According to the report the estimated value of South Africa's agricultural land, machinery, buildings and livestock is R285 billion, so if all of the beneficiaries of BEE deals that have vested so far, acted as a collective, they could buy that stock outright and still have change for working capital!

Of particular interest to me is that the financial services sector delivered the second largest chunk of value after mining. Also companies associated with this group in one way or another alone have made, or are yet to make a significant contribution.

FirstRand	concluded BEE deal	R23.3 billion
RMBH (shareholder)	strategic partnership with Royal Bafokeng	R7.1 billion
RMI	strategic partnership with Royal Bafokeng	R9.9 billion
Discovery	unbundled from FirstRand in 2007	R2.4 billion
MMI	unbundled from FirstRand in 2010	R3.0 billion

The fiscal balances of the country also benefited from these transactions; FirstRand's deal alone generated R1.9 billion of tax payments to SARS.

To conclude on this topic and at the same time try and answer those voices in government that question the value of these deals, I would like to quote the Intellidex research again as it is a rational voice and its conclusions are based on empirical evidence.

"BEE deals generate capital in the hands of beneficiaries that can be used in many ways, ranging from consumption to funding new business start-ups. Deals ensure improved balance sheets of black beneficiaries, creating equity value, but those balance sheets can be deployed in multiple ways as soon as deals mature. This is a desirable outcome – it would be counterproductive to lock beneficiaries into illiquid equity exposures merely to achieve black ownership, but that are otherwise economically irrational. The objective should be to generate assets that can serve an economic purpose. That is achieved by ensuring black beneficiaries are able to use those assets to pursue rational economic objectives including diversifying asset exposures and optimising life cycle consumption and investing patterns."

EVEN TOUGHER OPERATING ENVIRONMENT EMERGING

We have been predicting a tougher operating environment for some time, and many people, including myself, have been surprised at how long it has taken for the negative cycle to emerge properly. The group's results are remarkably resilient given how difficult it has been this year and we are confident that FirstRand has the necessary strategies and operating platforms to continue to generate growth and earnings above our hurdle rates. It must be said, however, that the level of outperformance that can be achieved becomes more difficult given the high earnings base created in the past.

Looking forward, there are significant headwinds building and we all need to work extra hard to continue to deliver the superior growth and return targets we set ourselves.

MANAGEMENT CHANGES AND SUCCESSION PLANNING

It is widely recognised that FirstRand has demonstrated a good track record in succession management. I believe it is partly our owner-manager culture that allows home-grown talent to rise to the top on merit, combined with our business model where business unit CEOs are highly empowered to drive strategy and operations albeit within broad strategic frameworks set at the centre.

A clear sign of good succession planning is a strong internal pipeline. According to recent research from PwC in high performing companies one insider CEO follows a previous insider 82 % of the time, nearly 10% higher than low performing companies. In fact, companies already considered low performers are mostly the ones forced to hire fixers from the outside.

The management changes that have occurred over the past 12 months at FirstRand have, in my view, been managed well. FirstRand's philosophy regarding management succession is that when one person moves on and another takes over, it is not the end of one race and the start of another. It is rather like a relay race where the baton is passed from the incumbent to the successor. Sizwe Nxasana has passed the baton to Johan Burger, who has a deep understanding of the group and a fine strategic mind. As a team, together with their strategic executive committee, they guided the group through a period of significant value creation for shareholders. During this time, FirstRand delivered a compound annual growth rate in normalised earnings of 21%.

Although an incredibly humble individual, Sizwe has been an inspirational leader and a role model for every single employee of the group. He will be sorely missed by all of us but we hope to welcome him back at some point in the future. We also know that the projects he will be pursuing over the next few years will add enormous value to the country as a whole. We wish him luck.

Laurie Dippenaar
Chairman