Risk Report

Introduction

Managing risk in financial services is essential to ensuring profitability, growth and long-term sustainability, thereby protecting the interests of shareholders, depositors, investors, policyholders and other stakeholders.

The following driving forces reinforce the role played by risk management in corporate governance.

- Section 27 of the Banking Institutions Act, Act No.2 of 1998, states that a bank or its holding company shall at all times conduct its business in a prudent manner and consistent with the best standards and practices of corporate governance and sound financial management.
- The King Report on Corporate Governance 2002 has a dedicated risk management section detailing the board's responsibility for designing, implementing and monitoring the process of risk management and setting risk appetite limits.
- Implementation of Basel 2 will enforce a significant increase in risk management sophistication and reporting.

While the Group embraces these risk management principles, it also realises that risk management goes beyond regulatory requirements. A successful business has to manage all business risks effectively to achieve its objectives, avoid adverse outcomes and prevent reputational damage. It has to get many things right, knowing that a single factor could cause suboptimal performance or even failure.

The board acknowledges its responsibility for the entire process of risk management, as well as for forming an opinion on the effectiveness of this process. Management is accountable to the board for designing, implementing and monitoring the process of risk management, as well as integrating it with the day-to-day activities of the Group. The board is ultimately responsible for any financial loss or reduction in shareholder value suffered by the Group. It is therefore responsible for ensuring that proper risk management and monitoring systems are in place.

The Group has adopted 'The Business Success and Risk Management Framework' in the past year. The framework formalises periodic assessment of risks in business units. These assessments provide a holistic, yet focussed, view of all business areas of the Group, drawing attention to issues requiring attention and formulating action plans to address them.

Risk management principles

Risk management in the Group is guided by several principles, the most important of which are:

- assignment of responsibility and accountability for all risks;
- adoption of a framework for integrated risk management;
- protection of our reputation; and
- risk governance.

Responsibility and accountability

Responsibility for risk management resides with management at all levels, from members of the board to individuals.

Overall risk management policies, risk appetite and tolerances are established by senior management, reviewed and where appropriate, approved by the board. These policies are clearly communicated throughout the Group and apply to all businesses.

Integrated Risk Management Framework

The 'Business Success and Risk Management Framework' is effective, comprehensive and consistent for the purpose for which it has been developed.

Under this framework, responsibility for risk management remains with line-management. Management allocates resources to support the framework. Risks are identified, evaluated and managed continuously, taking into account interrelationships between risks.

Structured risk assessments take place on a recurring basis and assess both the likelihood of an event occurring and the impact should it occur.

Protection of our reputation

A strong corporate reputation is a valuable asset to a financial institution.

By managing and controlling risks incurred in the course of conducting business, the Group protects its reputation. This means avoiding large concentrations of exposures of all kinds, as well as transactions that are sensitive in respect of tax, legal, regulatory, social, environmental or accounting reasons. A cautious approach is adopted for risks that cannot be sensibly evaluated.

Risk governance

Risk governance is an approach that balances demands for entrepreneurship, control and transparency, while supporting the Group's objectives with an efficient decision-making process.

Management of risk is guided and monitored by a number of committees. (Details are contained in the Corporate Governance section of this annual report.)

Risk, policies and procedures

In the ordinary course of business, the Group is exposed to various risks. Below is an overview:

Credit Risk

Credit risk represents the potential loss to the Group as a result of a counterparty being unable or unwilling to meet its obligations. Credit risk arises from two types of transactions:

- Lending transactions, giving rise to counterparty risk (the risk that a counterparty to a transaction will be unable or unwilling to repay capital and interest on advances and loans granted to it); and
- Trading transactions, giving rise to issuer and settlement risk. Issuer risk is the risk that payments due from the issuer of a financial instrument will not be received. Settlement risk is the risk that settlement of a transaction does not take place as expected, with one party effecting settlement as they fall due but not receiving settlements to which they are entitled.

Management and measurement of credit risk

The Senior Credit Risk Committee is responsible for managing credit risk. This committee operates under the Bank board's approved discretionary limits, policies and procedures.

A centralised decision making structure with decentralised limits is the basis on which applications for credit are entertained. Decentralised limits tend to be relatively low to ensure a high degree of centralised involvement in all areas where credit risk is incurred.

The Group applies the following fundamental principles to manage credit risk:

- A clear definition of target market;
- A quantitative and qualitative assessment of the creditworthiness of counterparties;
- Appropriate credit-granting criteria;
- Analysis of all related risks, including concentration risks (e.g. asset class, industry and counterparty concentration);
- Prudential limits;
- Regular monitoring of existing and potential exposures once facilities have been approved; and
- A high level of executive involvement in, and non-executive awareness of, decision-making and review.

Credit risk classification and provisioning policy

It is policy to make provision for specific impairments and to ensure that calculations for portfolio provisions are promptly made on a consistent basis. The external auditors review these provisions during the annual audit.

Two types of provisions are in place: specific and portfolio.

Specific provisions

The specific provision represents the quantification of actual and inherent losses from individually identified exposures.

Specific provisions are evaluated on a case-by-case basis for all non-performing exposures. In determining specific impairments, the following factors are considered:

- Exposure to the customer;
- Client capability to generate sufficient cashflow to service debt obligations;
- Viability of the client's business;
- Amount and timing of expected cashflows;
- Realisable value of security held; and
- Deduction of any recovery related costs.

Portfolio provisions

The portfolio provision supplements the specific provision as outlined above and provides cover for anticipated future impairments which are supported by current market conditions and default statistics.

Balance sheet risk management

This includes financial risks relating to asset and liability portfolios, comprising liquidity, funding concentration and interest rate risks on the balance sheet.

Treasury division manages the liquidity mismatch and interest rate risk arising from the Group's asset and liability portfolios. It is required to exercise tight control on funding, liquidity, concentration and interest rate risk within defined parameters.

The Asset and Liability Management Committee ('ALCO') manages balance sheet risks on a consistent basis with pre-approved principles and policies. The balance sheet position is regularly reported to the executive committee and the Board of Directors.

Risk Report

Interest rate risk

Interest rate risk arises from the impact on net interest earnings of increases or decreases in the absolute levels of interest rates.

It is managed by ongoing measurement of the interest rate mismatch and basis risk, translated into sensitivity of interest income and economic value across varying interest rate scenarios.

The Group base its interest rate risk management processes on the following fundamental steps:

- Measurement and assessment of interest rate mismatch gaps, detailing the sources of interest rate exposure at a given time, which forms the basis for:
  - Translations into interest income sensitivity analysis; and
  - Daily management of interest rate risk by Treasury subject to independent ALCO review.

Liquidity risk

Liquidity risk is the risk that Group does not have sufficient cash to meet its financial obligations at acceptable costs, especially in the short term.

Sources of liquidity risk include unforeseen withdrawals of demand deposits, restricted access to new funding with appropriate maturity and interest rate characteristics, inability to liquidate a marketable asset timeously with minimal risk of capital loss, unpredicted customer non-payment of a loan obligation and a sudden increased demand for loans.

Liquidity management is vital to preserving market confidence, safeguarding the Group's reputation and ensuring sustainable growth.

Operational risk

Operational risk is inherent in the Group's operation. The goal is to manage this risk to acceptable levels and to minimise unexpected events. Senior management is responsible for identifying and mitigating operational risks.

Operational risk includes amongst others the management of business continuity risk, information security risk, information risk management as well as the response to financial crime.

Business continuity risk

A comprehensive programme exists to assess and enhance our capability to support the availability of systems, restore technology platforms, resume operations and deliver core business processes in the event of problems.

Information risk management

Changes to IT systems can introduce risk if not properly planned and implemented. Information security continues to receive attention so that the Group can respond proactively to threats to data, systems and information. Changes to line and business continuity environments are monitored to minimise disruptions.

Financial crime

The Group has zero tolerance for financial crime, internal or external. All incidents are fully investigated to understand source and cause, achieve recovery, initiate legal action, and implement mitigating action.

Reputational risk

Reputational risk is caused by damage to an organisation's reputation, name or brand. It implies a breakdown of trust, confidence or business relationships, and can arise if other risks emerge and are not dealt with.

The Group enforces policies and practices to manage reputational risk. Its strong values statement is regularly and proactively reinforced, as is its commitment to sound corporate governance practices. All activities, processes and decisions are bound by carefully considered principles.

It fosters an acute awareness at all levels of the impact of practices that may result in a breakdown of trust and confidence in the organisation. Policies and practices are regularly enforced through transparent communication, accurate reporting, internal audit, regulatory compliance review and risk management practices.

Solvency risk

Insolvency is the chronic condition of being unable to pay one's debts in full. An insolvent company cannot discharge its debts. It must either be liquidated or rescued. A group's solvency may be threatened if other risks have been mismanaged. Capital adequacy is an exclusive concept which bankers, insurance companies, analysts and regulators attempt to measure in various ways. For further reference to capital adequacy, refer to the Chief Financial Officer's report.

Market risk

Market risk arises when volatile exchange or interest rates have a negative impact on current and future earnings potential. The Bank operates within the Market

Risk Report

Risk Management Framework of the FirstRand Banking Group, where principles of managing risks associated with trading positions are set.

Trading limits are approved by the board, with the day-to-day operations and utilisation thereof resting with the Group Treasurer. Accordingly, the risk of adverse movements arising from fluctuating currency exchange rates and interest rates is managed in the dealing room within treasury, where operations take place within limits assigned to each dealer, based on his/her knowledge, expertise and experience. The Group Treasurer and independent risk manager monitor the trading portfolio daily and report weekly to relevant risk monitoring structures in the Group and to the Chief Executive Officer.

Market risk related operational risk

All activities are authorised and conducted using operational systems that are adequate for the recording, valuation and settlement of all transactions. Security measures are in place to prevent access of unauthorised persons. In line with generally accepted good risk management practices, the Group has an adequate segregation of duties in respect of dealing, confirmation, settlement and risk exposure measurement.

Counterparty limits

This risk arises from a counter party to a transaction failing to meet punctually a financial commitment. The risk is managed in the dealing room, by allotting counter party trading limits on foreign exchange, capital market, and the money market transactions. The risk manager monitors these limits daily and reports deviations to relevant executive management.

Underwriting risk

Underwriting risk is the risk that the actual exposure to mortality and morbidity risks will exceed the best-estimate of the statutory valuator. The statutory valuator performs regular investigations into actual mortality and morbidity experience, with the best estimate assumptions being adjusted accordingly. All mortality and morbidity risks above a set retention limit are reinsured. All applications for mortality and morbidity cover are evaluated against strict underwriting criteria and are accompanied by compulsory HIV testing, in the case of cover above set limits.

The diversification of products, risk covered and geographical location of policyholders ensures that the concentration of underwriting risk is alleviated.

Internal audit

The Group's internal audit function performs an independent appraisal activity with the full cooperation of the board and management. Its objective is to assist executive management with the effective discharge of their responsibilities by examining and evaluation of the Group's activities, resultant business risks and systems of internal control. Its mandate requires it to bring any significant control weakness to the attention of management and the audit committee for remedial action. Based on the recommendations of executive management and review of the Group Audit committee, the board relies on the adoption of appropriate risk management, compliance and internal control to ensure a sound system of risk management and internal control. Internal Audit reports functionally to the Group Audit committee and administratively to the CEO of the Group.

Nothing has come to the attention of the directors or the external or internal auditors to indicate that any material breakdown in the functioning of internal controls and systems has occurred at a Group level during the year under review.

Internal control

Internal control comprises methods and procedures implemented by management to safeguard assets, prevent and detect error and fraud, and ensure the accuracy and completeness of accounting records and the timely preparation of reliable financial information.

The directors are responsible for maintaining an adequate system of internal control. Such a system reduces, but cannot eliminate, the possibility of fraud and error. Shareholders, depositors, policyholders and regulatory authorities have a vested interest in the accuracy and integrity of the financial statements and in knowing that accountability of assets is adequately safeguarded, verified and maintained. These controls are based on established written polices and procedures and are implemented by skilled personnel with an appropriate segregation of duties.

To ensure that the Group's business practices are beyond reproach, all employees are required to maintain the highest ethical standards. Nothing has come to the attention of the directors to indicate that any material breakdown in controls, procedures and systems has occurred during the year under review.